

Chapter 1. AN OVERVIEW OF PUBLIC EXPENDITURE MANAGEMENT

This chapter has two objectives. First, it places public expenditure management (PEM) in the broader context of the role of the state, good governance, macroeconomic policy, and the changing environment (especially in information and communication technology). To view PEM only through a technical prism would fundamentally distort the picture. Second, the chapter provides a quick run-through of the entire expenditure management cycle. This chapter can therefore serve as a map of the book for the thorough reader, as well as a stand-alone sketch of the key issues for the busy public official (who should also read the last section of the concluding chapter 17). For both types of readers, we hope this brief overview will at least bring home the point that the management of public expenditure is neither a purely technocratic issue nor suitable for simple quick fixes, on the one hand, yet is always amenable to some practical improvement, on the other.

A. THE OBJECTIVES AND CONTEXT OF PUBLIC EXPENDITURE MANAGEMENT

1. The meaning and role of public expenditure management

The budget should be a financial mirror of society's economic and social choices. In order to perform the roles assigned to it by its people, the state needs, among other things, to: (i) collect resources from the economy, in sufficient and appropriate manner; and (ii) allocate and use those resources responsively, efficiently and effectively.¹ Public expenditure management pertains only to (ii), and is thus only one instrument, albeit a key instrument, of government policy. Hence, although this book focuses on PEM, readers are advised to always keep in mind the integral relationship between revenue and expenditure—i.e. between the money collected directly or indirectly from the people (and, in most developing countries, from aid donors), and the use of that money in a manner that reflects most closely the people's preferences.² Also, close cooperation between tax and budget officials is a must for many areas, e.g., budget forecasting, macroeconomic framework formulation, trade-offs between outright expenditures and tax concessions.

The question of the mechanisms by which the people's preferences are ascertained, political accountability is obtained, and government action is monitored, is central to politics and very important, but outside the scope of this analysis (as well as beyond the mandate of international development institutions).³ Nevertheless, the analysis and discussion throughout this volume is largely predicated on the existence of *some* government legitimacy, *some* measure of legal and political accountability, and *some* separation of powers among the executive, legislative, and judicial branches of government. As a logical extreme, it would in theory be conceivable to "improve" PEM in a kleptocracy designed exclusively for the benefit of the power elite (as for example in Mobutu's Zaire), but it would certainly not assist the country's economic development. (The elements of good governance are summarized in the next section.)

That said, *public expenditure management is instrumental in nature*. There is a necessary distinction between the expenditure *policy* question of "what" is to be done, and the expenditure *management* question of "how" it is to be done. It is true that attempts to set hard boundaries between policy and implementation eventually lead to unrealistic policies, ad hoc implementation and, over time, both bad policy and bad implementation. However, the distinction between the soundness of PEM procedures and processes and the goals that they are meant to achieve remains very important. Among other things, the mechanisms, techniques, skills, and data required for good PEM are different from those needed to formulate good policy.⁴ Accordingly, the analysis and discussion herein is generally applicable regardless of the economic orientation, strategic priorities, or policy choices of the government in question.

At the same time, however, it is fundamental to realize that *public expenditure management is country-specific*. PEM approaches and recommendations must be solidly grounded on the economic, social, administrative, and implementation capacity realities of the specific country. Like any other technology—from water pumps to agricultural fertilizers to construction—public expenditure "technology" must be appropriate technology, in terms of (i) local factor endowments, (ii) local institutions, and (iii) real local needs. Hence, *any* PEM innovation generated abroad must be carefully analyzed in the light of the local context and rejected, adopted, or adapted as needed. Particularly important for the analysis of applicability is an evaluation of the country's institutional framework and the availability of relevant and reliable data and sufficient skills. As an analogy, the scarcity of licensed builders, heavy

construction equipment, and firm soil in a particular location doesn't necessarily mean that houses shouldn't be built there, but certainly counsels against the building of skyscrapers—particularly when they may not be wanted in the first place. At the very minimum, external and national change agents must be mindful of the Hippocratic injunction “First, do no harm” (as well as today's colloquialism “If it ain't broke, don't fix it”).

2. The policy context and the objectives of PEM

a. *The policy context*

The key goals of overall economic policy are conventionally defined as growth, equity, and stability.⁵ It has long been understood that these three goals are complementary over the long-term. Economic growth provides the resources needed for poverty reduction, but cannot be sustainable if it is not accompanied by sufficient stability and equitable policies. Unstable economic and financial circumstances are inimical to growth, and typically hurt the poor most. But stability in a context of persistent economic stagnation and poverty is hardly a desirable outcome. In the short-term, however, these goals may be mutually conflicting, and a sound resolution is required (and hence a robust institutional mechanism) that takes all three into consideration in a coherent policy package.

b. *The three key objectives of PEM*⁶

As noted, public expenditure management is instrumental in nature. As a central instrument of policy, it must pursue all three overall economic policy goals. Financial stability calls, among other things, for fiscal discipline; economic growth and equity are pursued partly through allocation of public money to the various sectors; and, most obviously, all three goals require efficient and effective use of resources in practice. Hence, the three goals of overall policy translate into three key objectives of good public expenditure management: *fiscal discipline (expenditure control)*; *allocation of resources consistent with policy priorities (“strategic” allocation)*; and *good operational management*.⁷ In turn, good operational management calls for both efficiency (minimizing cost per unit of output) and effectiveness (achieving the outcome for which the output is intended).⁸ But in addition, as stressed earlier, attention to proper norms and due process is essential as well. This book shall return again and again to these three key objectives, but a few general considerations are advanced below.

There are linkages between the three key objectives of PEM, their corresponding major function, and the government level at which they are mostly operative. Fiscal discipline requires control at the aggregate level; strategic resource allocation requires good programming, which entails appropriate cabinet-level and interministerial arrangements; and operational management is largely an intraministerial affair. It should be stressed, however, that fiscal discipline and operational management are amenable to “technical” improvement than is the strategic allocation of resources. As Petrei, 1998 puts it:

“Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population’s preference. The allocation of funds results from a series of forces that converge at different points of the decision-making process, with an arbitrator who ruled according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want. In any event, the effort made at this stage of the budget process to collect and analyze information is less than at any other stage.”

Our focus on public expenditure management should not lead us to forget the essential link between revenue and expenditure. The triad of PEM objectives can easily be expanded into a triad of *fiscal* objectives. Fiscal discipline results from good forecasts of revenue as well as expenditure; strategic allocation has a counterpart in the tax incidence across different sectors; and tax administration, of course, is the revenue aspect of good operational management of expenditure.

The scheme below summarizes these relationships.

<u>Objective</u>	<u>Revenue Function</u>	<u>Expenditure Function</u>	<u>Organizational Level</u>
1. Fiscal discipline	<i>Reliable forecasts</i>	<i>Expenditure control</i>	<i>Aggregate</i>
2. Resource allocation and mobilization	<i>Tax equity and incidence</i>	<i>Expenditure programming</i>	<i>Interministerial</i>
3. Operational efficiency	<i>Tax administration</i>	<i>Expenditure management</i>	<i>Intraministerial</i>
<ul style="list-style-type: none"> a. <i>Economy</i> b. <i>Efficiency</i> c. <i>Effectiveness</i> d. <i>Due process</i> 			

This scheme is a simplification, intended to help fix the key concepts in one's mind. Reality is more complex. First, as noted, the three objectives may be mutually conflicting in the short run (and trade-offs and reconciliations must be made) but are clearly complementary in the long run. For example, mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Second, good aggregate budgetary outcomes must emerge from good outcomes at each level of government. For example, while fiscal discipline must ultimately be manifested at the aggregate level, it should emerge as the sum total of good expenditure control (and reliable revenue forecasts) in each ministry and agency of government, rather than being imposed top-down.

Therefore, an overall expenditure constraint is necessary but not sufficient for good PEM; on the contrary, imposing the constraint *only* from the top may result in misallocation of resources and inefficient operations. Typically, such top-down aggregate limits are intended to root out waste, fraud, and corruption. But waste, fraud, and corruption are hardy weeds. If the top-down limit is imposed *in isolation* and without any attention to the internal workings of the public expenditure system, the outcome may well be to underfund the more efficient and worthwhile activities, precisely because they do not carry benefits for the individual

bureaucrats and their private “partners”⁹. (Conversely, improving the internal systems without a hard constraint is not credible.) Similarly, the best mechanisms for inter-ministerial coordination are worth little if the sectoral expenditure programs are inappropriate or inconsistent with overall policy. Finally, management and operational efficiency cannot normally be improved except in an overall context of fiscal discipline and sound allocation of resources—to which good management itself makes a key contribution.

c. Complicating the issue

Reality is more complex in other ways as well. Although fiscal discipline, strategic resource allocation, and operational efficiency are in general the three key objectives of PEM, in most countries the budgeting system is expected to achieve a variety of aims. A. Premchand lists eleven dimensions of public expenditure management (Table 1).¹⁰ Most of these dimensions can be readily reconciled within the triad of PEM objectives, and some are in effect different formulations of the same objective. However, the reality is that all these dimensions—duplicative or not—have come to be associated with public budgeting at various times. Because it is manifestly impossible for any budget system to conform to all these dimensions at the same time, a strategic decision is needed regarding which one or two or three of these dimensions to focus at a given time in the specific country concerned. Thus, although we will continue to refer throughout this book to the triad of PEM objectives, the inevitable simplification should be kept in mind.

{Insert Table 1}

d. A word about sequencing

If you can't count the money, you can't allocate it, and if you can't allocate it you can't manage it. Fiscal discipline, in many ways, comes first; resource allocation and operational efficiency come next. This is literally true in those few developing countries that have extremely weak revenue forecasts and cash management systems. In those countries, improving expenditure control is first and foremost, and any effort at addressing the other two objectives of PEM would be futile and possibly counterproductive. However, it is essential to: (i) design and implement improvements in expenditure control in ways that do not jeopardize the improvements in sectoral allocation and resource management which must eventually follow; and (ii) have a clear ex-ante sense of how far to push improvements in expenditure and cash

control before it becomes timely and necessary to address strategic allocation and management issues.

In countries where expenditure control and cash management are already minimally acceptable, none of the three PEM objectives of expenditure control, resource allocation, and good operational management should be pursued in isolation from the others (just as the overall policy goals of growth, stability, and equity are interrelated). Improvements in one or another area can and should go forward as and when circumstances permit (see the “tortoise-hare” approach to reform outlined in chapter 17). But a coherent vision of the entire reform process is needed to prevent “progress” in any one objective from getting so far out of line as to compromise progress in the other two, and thus the public expenditure management reform process in its entirety. Hence, a multiyear perspective is essential for good PEM. Specific reform priorities and sequencing considerations for each of the major components of PEM are suggested in the last section of chapter 17.

3. The institutional context

Several developing countries have accepted technical advice for decades and introduced innovations in their budgeting systems, to the point where the formal PEM system appears robust and coherent in every respect. Yet, efficiency of public expenditure remains poor, corruption is endemic, and public services are of worse quality and even less accessible than they were at the start of the “reforms”. Why? One explanation is found in the institutional dimension of the budget process.¹¹

Colloquially, the term “institution” is used as a synonym for “organization”. However, institutions are best understood as *rules*, and are thus distinct from the organizations that function under them.¹² To use a sports analogy, the game of football (soccer) is played better or worse depending on the players, but all players must adapt to the same rules; the “institution” of football does not change unless the basic rules are changed (e.g., by allowing the use of hands). Budgetary outcomes are profoundly influenced by institutions. Because institutions comprise both formal and informal rules, many technical “improvements” have failed because they were in conflict with the less visible informal rules and incentives. (This is especially true in very small countries and in multi-ethnic societies.)

Thus, for example, the tendency to overestimate revenues may stem from concrete incentives to do so rather than from technical weaknesses. (Two “stages” are normally involved here: first, the forecasts are deliberately manipulated to ensure the continued functioning of the patronage system; second, when expenditures must be cut owing to “unexpectedly” low revenues, cash rationing is used as a way to favor client and kinship groups.) Or, in a multi-ethnic country, a performance bonus scheme for budget officials may be perfectly designed on the surface but fail to produce improvements if it is inconsistent with the informal rule that demands that managers use their power to help members of their own ethnic group. Indeed, under these circumstances, the “innovation” may lead managers to manipulate expenditure forecasts and outturns in the interest of “their” people, and thus to a less efficient system.

The total stock of institutions is always larger than is visible on the formal surface, especially in developing countries. This leads to four basic points, among others:

- A design failure to take into account key informal rules is likely to lead to a failure of the budgeting reform itself. (As repeated elsewhere in this book, it was the unexposed part of the iceberg that sank the *Titanic*);
- *Durable* institutional change, in general, and public budgeting, in particular, take a long time to be implemented successfully (a result of what Douglass North called “path dependence” [North, 1991]);
- One way to improve the *overall* institutional framework is to make the informal rules more visible;¹³
- Budget organizations and new units can be merged, restructured, recombined and created, but no change in behavior (and hence in budgetary outcomes) will result unless the basic rules, procedures, and incentives change as well. For example, simply merging a Ministry of Finance and a Ministry of Planning will not do much by itself to improve coordination of current and investment budgets.

4. The governance context

a. The link between governance and development

The risk of relativism inherent in the earlier statement that PEM “technology” is country-specific is obviated by the universal relevance of certain fundamentals of governance. The link between good governance and economic development has long been understood by many scholars, development practitioners, and, above all, the average man and woman in the developing countries themselves. However, a variety of considerations (primarily, the Cold War) kept governance away from the official concern of development institutions, and hence outside the technical advice and financial support for PEM improvements. Since the end of the 1980s, however, perceptions and policies have changed dramatically.¹⁴ Even the remaining alleged exception to the link between governance and development (the East Asian “miracle”) collapsed under the weight of the financial crisis that began in Thailand in July 1997 and quickly spread to Indonesia, Korea, and to a lesser extent to other Asian countries. It is now clear that fundamental public and corporate governance weaknesses were among the structural causes of the crisis. Since then, references to “Asian values” to justify practices inimical to good governance have been conspicuous for their absence.

b. The components of good governance

There is a general consensus that good governance rests on “four pillars”: accountability, transparency, predictability, and participation. Accountability means the capacity to call public officials to task for their actions; transparency entails the low-cost access to relevant information; predictability results primarily from law and regulations that are clear, known in advance, and uniformly and effectively enforced; and participation is needed to supply reliable information and to provide a reality check for government action.

It is clear that none of these four components can stand by itself; each is instrumental in achieving the other three; and all four together are instrumental in achieving sound development management. For example, accountability mechanisms in the budget process are hollow if there is no reliable financial information, and meaningless without predictable consequences. Furthermore, all governance concepts are universal in application but relative in nature. Accountability is a must everywhere, but does not become operational until one

defines accountability “of whom”, “for what”, and “to whom”. Transparency can be problematic when it infringes on necessary confidentiality or privacy. Full predictability of inefficiency or corruption is not a great advantage. And it is evidently impossible to provide for participation by everybody in everything, and unwise to use participation as an excuse to avoid taking tough but necessary decisions.

c. Governance and public expenditure management

The relevance of these concepts to the various aspects of public expenditure management will be brought out throughout this volume. A few generally applicable considerations are provided below.

Lack of *predictability* of financial resources undermines of strategic prioritization and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for nonperformance to boot). Predictability of government expenditure in the aggregate and in the various sectors, is also needed as a signpost to guide the private sector in making its own production, marketing, and investment decisions.

Transparency of fiscal and financial information is a must for an informed executive, legislature, and the public at large (normally through the filter of competent legislative staff and capable and independent public media). It is essential not only that information be provided, but that it be *relevant* and in understandable form. Dumping on the public immense amounts of raw budgetary material does nothing to improve fiscal transparency. The IMF assembled in 1998 a Code of Good Practices on Fiscal Transparency (see Box 1 and Annex I), which underlines the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. While not all the specifics of the Code necessarily apply to all countries, its principles are generally applicable to developing and transition economies as well as developed countries.

Box 1
Selected Requirements for Fiscal Transparency

Clarity of Roles and Responsibilities

- A budget law or administrative framework, covering budgetary as well as extrabudgetary activities and specifying fiscal management responsibilities should be in place.
- Taxation should be under the authority of law and the administrative application of tax laws should be subject to procedural safeguards.

Public Availability of Information

- Extrabudgetary activities should be covered in budget documents and accounting reports.
- Original and revised budget estimates for the two years preceding the budget should be included in budget documents.
- The level and composition of central government debt should be reported annually with a lag of no more than six months.

Open Budget Preparation, Execution, and Reporting

- A fiscal and economic outlook paper should be presented with the budget, including among other things, a statement of fiscal policy objectives and priorities, and the macroeconomic forecasts on which the budget is based.
- A statement of "fiscal risks" should be presented with the budget documents.
- All general government activities should be covered by the budget and accounts classification.
- The overall balance should be reported in budget documents, with an analytical table showing its derivation from budget estimates.
- A statement of accounting standards should be presented with the budget.
- Final central government accounts should reflect high standards, and should be audited by an independent external auditor.

Independent Assurances of Integrity

- Mechanisms should be in place to ensure that external audit findings are reported to the legislature and that remedial action is taken.
- Standards of external audit practice should be consistent with international standards.
- Working methods and assumptions used in producing macroeconomic forecasts should be made publicly available.

Source: International Monetary Fund (only a few requirements are shown here: see Annex 1 for more details).

Appropriate *participation* by concerned public officials and employees and by other stakeholders is required for the sound formulation of expenditure programs; participation by external entities, for the monitoring of operational efficiency; and feedback by users of public services, for the monitoring of access to and quality of the services.

Accountability is needed both for the use of public money and for the results of spending it. Because, through overuse, the term "accountability" has acquired mantra-like qualities (and has no exact translation in many languages), it is helpful to unbundle it at the outset. Effective accountability has two components: (i) answerability and (ii) consequences. First, answerability (the original meaning of the word "responsibility") is the requirement for central budget officials and sector ministry personnel to respond periodically to questions concerning where the money went and what was achieved with it. The dialogue itself matters, much more than any bean counting or mechanistic recitation of outputs. Second, there is a need for predictable and meaningful consequences (not necessarily punitive; not necessarily

monetary; not necessarily individual). This should be self-evident. However, the need for consequences of some sort is so often disregarded in practice that one must make the elementary point that without consequences, “accountability” is only an empty and time-consuming formality.

Largely because the PEM system, must be accountable both for the use of the public money and for the results of spending it, accountability in public expenditure management has two dimensions. Stronger *internal accountability* of budget system personnel to their superiors may be necessary, but is more applicable to “overhead” PEM activities (e.g., policy advice, macroeconomic forecasting, etc) than to sector ministries responsible for services to the public. For the latter, *external accountability* is needed as well. Particularly with the dramatic improvements in information and communication technology (see below), feedback from service users and the citizenry can now be obtained at low cost and for a greater variety of activities, and is an essential adjunct to improving efficiency and effectiveness of service delivery. Strengthening external accountability is especially necessary in the context of initiatives for greater decentralization or managerial autonomy, when new checks and balances are required to assure that access to and quality of public services is not compromised as a result.

There is also an inevitable “accountability trade-off” between clarity and relevance. Accountability can be clear and direct for narrowly-defined tasks, but is necessarily vague for broad and hence more relevant outcomes flexibility. Care must be taken not to dump responsibility for government malfunctioning solely on the public managers. Without predictability and clear lines of responsibility, the “new accountability” reduces to simple scapegoating of civil servants for the failures of their political masters.

d. *A word about “performance”*

All accountability must be for performance. Of course. But “*performance*”, too, is a *relative and culture-specific concept*. Government employees could be considered “well-performing” if they always stick to the letter of the rules, in a system where rule compliance is the dominant goal; if they account precisely for every cent of public money, in a system where protection of resources is the dominant goal; if they obey without question a superior’s instructions, in a strictly hierarchical system; if they compete vigorously for individual influence and resources, in a system where such competition is viewed positively; if they cooperate

harmoniously for group influence, in a system where conflict is discouraged; and so on. Whenever the word “performance” is heard, the immediate question should be: “In terms of what?” It is essential to understand that administrative cultures are not inherently superior or inferior (so long as they abide by the governance fundamentals discussed earlier), and that they evolve in response to concrete problems and incentive structures. Even when an administrative culture has become badly dysfunctional, it is still necessary to understand its roots if one wishes to improve it in a durable way.

This book’s general definition of performance is *the achievement of agreed results within the funding provided, without diluting their quality and respecting the prevailing norms of due process*. (With respect to public expenditure management, of course, performance should be assessed by reference to the three objectives of expenditure control, strategic allocation and good operational management). This definition attempts to bridge the gap between the traditional paradigm of public administration as “probity and propriety” and the “New Public Management” paradigm of “policy and performance”.¹⁵ (Annex V summarizes the debate on the NPM.)¹⁶ Our view is that “policy and performance” are indeed the appropriate model, but must be accompanied by respect for due process in order to be *sustainable*. In sum: (i) results orientation is necessary in PEM, *but* (ii) results must be properly defined, *and* (iii) an exclusive focus on results without consideration of process will not only destroy the process but eventually produce bad results as well.¹⁷

5. Corruption and public expenditure management

Although corruption in government is often identified with large procurements and major public works projects,¹⁸ public expenditure is hardly the only source of potential corruption. Tax administration, debt management, customs, ill-designed privatization, the banking system, etc., can be equally troublesome in that respect. But certainly, one major route to improving PEM (and, of course, improving the quality of governance as well) is to reduce the opportunities for corruption in the process and punish corruption when it occurs. The reverse is also true: a major way of reducing corruption is to strengthen PEM. Quite aside from any moral or legal consideration, corruption weakens fiscal discipline; distorts the allocation of resources; harms operational efficiency and effectiveness; and, obviously, is antithetical to due process.

Definitions of corruption can be extremely complex. The simplest definition is as powerful as it is short: *corruption is the misuse of public or private office for personal gain.* “Misuse” (unlike abuse”) covers both “sins of commission” (i.e., giving illegal favors), and “sins of omission” (i.e., deliberately turning the other way). And the inclusion of the term “private” in the definition of corruption underlines the fact that there cannot be a bribe received without a bribe given. In the context of developing countries, this points out that much corruption is externally generated. Clearly, attention needs to be paid to the “imported corruption” as well as to the homegrown variety.

A remarkable, indeed historic, convergence of actions and policies has occurred in this area in just two years, 1997 and 1998, as a natural outgrowth of the earlier recognition of the governance-development nexus. The World Bank enacted an official policy against corruption in September 1997. Other multilateral development banks (MDBs) followed suit rapidly. The anticorruption policy of the Asian Development Bank was approved in July 1998 (see Annex IV for a summary), and anti-corruption cooperation among the MDBs has been strengthening since then¹⁹. At the same time, as noted earlier, the IMF promulgated the Code for Fiscal Transparency. Finally, the Organization for Economic Cooperation and Development (OECD—the “developed countries’ club”) succeeded in negotiating in December 1997 a landmark convention against bribe-giving, which entered into force at the end of 1998 (Annex ____). For the first time in history, the convention makes the bribing of foreign officials a crime at par with national laws concerning bribery of national officials—in all member countries of the OECD.²⁰ (In parallel, the OECD also adopted a set of principles for ethics in the public service—see annex II.)

Box 2
The Semantics of Corruption

The definition of corruption is clear, but one must beware of assuming that the same term reflects the same reality in different developing countries. While in some countries the word "corruption" may be reserved only for million-dollar bribes, inch-deep highway surfaces, and nonexistent schools, in other countries the word is used to include minor irregularities or minuscule conflicts of interest. In one South Asian country, for example, a major newspaper reported in a front-page article of September 1998 that:

The Government is to work out a modality next week to take action against Parliamentarians who are engaged in business activities with state or public institutions, the Minister announced. He cited the Supreme Court judgement on the case. The court decided that one parliamentarian was not suited since he was managing a petrol shed. "We know about several others who have fixed the official telephone to their business places in a way that Parliament has to pay for their telephone charges (equivalent to tens of dollars). We cannot allow this situation to continue anymore", the Minister said.

Clearly, these practices are inappropriate and do not fit into the strict definition of corruption. There is also a "slippery-slope" argument that zero tolerance is required if corruption is not to eventually become a large problem. But, in comparison with the level of corruption in other countries, such practices as quoted above are trivial. The terms used, however, are often identical. Therefore, a finding that corruption is widespread must be interpreted carefully in the light of just what is meant by corruption in the specific country's context.

Thus, although many economists, country officials, and development professionals had always been aware of the inefficiencies and inequities of corruption, it is only recently that the taboo on even mentioning the "C word" has been removed and a clear consensus has emerged: in the long run, corruption (i) is bad for economic efficiency and growth; and (ii) hurts the poor most. Corruption is increasingly being seen as neither beneficial ("grease for the machine"), nor inevitable ("the way the system works"), nor respectable ("everybody does it"). This new consensus has been translated into actual policies of international organizations and governments around the world. Although the process is only beginning, and most of the implementation lies ahead (and corruption will of course never entirely disappear), for the first time in contemporary history there is a concrete opportunity to reduce substantially "the cancer of corruption".²¹

6. The macroeconomic programming context

Macroeconomic and financial programming has been dominated for well over a generation by the simple but powerful model developed by Jacques Polak (Annex III) and used in virtually all stabilization programs supported by the IMF.²² Adjustment in government revenues and expenditures has always been important in that model, partly through its (monetary) impact on domestic credit and money creation, and partly through its (Keynesian) influence on national income and the demand for imports. Furthermore, since the early 1990s,

the rediscovery of the economic costs of excessive fluctuations in exchange rates has reduced the emphasis on currency devaluation as an instrument of economic and financial adjustment. As under the Bretton Woods system operating in the postwar period until 1973, the IMF has come back again to regard the exchange rate as a nominal “anchor”, and the burden of adjustment has correspondingly shifted to the fiscal side.²³

The degree of fiscal adjustment is normally measured by the reduction in the overall government deficit. The fiscal deficit, obviously, is determined by both revenue and expenditure. Hence, by definition, a fiscal policy focused entirely on public expenditure adjustment would be incomplete. But in practice, the change in macroeconomic programming emphasis toward fiscal adjustment has coincided with a major rethinking of the role of the state—toward downsizing and the shedding of many earlier functions.²⁴ Measures on the revenue side do remain important in most developing countries—but away from short-term tax increases and toward actions that broaden the tax base and raise the elasticity of the tax system with a view to long-term revenue expansion. However, the downsizing of the role of the state has naturally led to greater reliance on public expenditure reductions as an instrument of fiscal adjustment.²⁵ In turn, sustainable expenditure reduction is a chimera unless the expenditure *management* system is in reasonable good shape. Hence, the current emphasis on public expenditure management and its key role in macroeconomic programming.

7. The genie outside the bottle: information and communication technology (ICT)

It is impossible to provide a good overview of the context of PEM without some reference to the informatics revolution. The monumental change wrought in every field by the new information and communication technology is still only in its initial phase. The subject of ICT is too vast to be adequately discussed in this volume. Nevertheless, Chapter 14 provides a brief summary of opportunities, issues, and concerns raised by ICT developments for the public sector in general and PEM in particular. And annex X presents a full description of an ICT-intensive integrated financial management information system, as an illustration of what may be possible, and as an eventual objective to aim for when and where country needs and capabilities permit. But a few general considerations should be raised here.

First, *ICT is a tool*, immensely powerful yet essentially no different from a photocopier or a car, in the sense that user needs and requirements must come first and dictate whether and how the ICT tool should be used. For certain functions, pencil and paper, or a telephone, or a face-to-face meeting, or a visit to the library, are far more effective than computers or the Internet. This obvious point must be stressed because there are frequent instances when governments, consultants, or donor agencies encourage computerizing anything in sight. Indeed, many would argue that IT innovation is now largely supply- and marketing-driven rather than dictated by the needs and requirements of the users. It is essential to assess realistically and compare the costs of a given ITC change with the actual benefits expected from it.

Second, *neither the ICT “techie” nor the “public manager” should work in isolation from each other*. As noted, improvements in effectiveness stem largely from better rules and procedures in the sector concerned. To apply advanced ICT to obsolete or inefficient rules and processes means in effect to computerize inefficiency. Doing the wrong thing faster is not progress. On the other hand, the absence of relevant ITC knowledge risks either costly mistakes or missed opportunities for dramatic service improvements.

Third, *ICT cannot substitute for good management and internal controls*. Indeed, the introduction of computers can give a false illusion of tighter expenditure control, in cases where a large part of the expenditure cycle occurs in parallel outside the computerized system.

Fourth, faster and integrated public financial management information systems carry correspondingly *greater potential risks* for the integrity of the data, and can even jeopardize the financial management system in its entirety if developed carelessly and without sufficient checks, controls, security and virus protection²⁶. Also, it is often argued that ICT reduces the corruption. In fact, computer technology eliminates almost all opportunities for corruption for those who do not understand fully the new technology, but opens up new corruption vistas for those who understand the new systems well enough to manipulate them.

To sum up, the adoption of more advanced ICT should meet the following criteria: (i) Always fit the user requirements and the real objectives of the activity; (ii) assure that the more advanced ICT goes hand in hand with improved rules and processes; (iii) protect data and systems integrity; and (iv) aim at an integrated strategy and avoid a piecemeal approach (which can fit specific needs but adds up to a ramshackle and even dangerous system). Note,

however, that an integrated approach requires compatibility and coordination, but not necessarily a single system.

That being said, ICT offers a wonderful potential for increasing government accountability, transparency, and participation; improving the efficiency and effectiveness of public sector operations; widening access to public services; and disseminating information to the public and getting feedback from relevant stakeholders and service users. With specific reference to PEM, among other things, information and communications technology can help solve the centralization/decentralization dilemma, by making relevant data easily available at all government levels; vastly facilitates budget analysis and programming; and improves the timeliness of budget information.

B. THE BUDGET CYCLE: A BIRD'S-EYE VIEW

This section assembles the concluding “key points” segments of the various chapter of the book and in effect summarizes the entire public expenditure management cycle, for the convenience of the busy policymaker or the reader interested only in a brief overview. Readers interested in the detailed analysis and discussion of each topic, instead, would be well advised to skip this section entirely, go directly to chapter 2 and following chapters, and use this section later only as a memory aid. (Recommendations on directions for reform and appropriate sequencing are assembled in the last section of Chapter 17.) Throughout the book we shall use the term “Ministry of Finance” to indicate the central government entity in charge of public expenditure.

1. The budget and its preparation

a. Budget coverage

The “general government” consists of the central government and subnational levels of government. The public sector includes the general government and all entities that it controls (e.g., state-owned enterprises). Each level of government and public sector entity should have its own budget. For accountability and financial control, reports should consolidate the financial operations of the general government and (to the extent it is possible) the financial activities of all entities controlled by the government.

The coverage of the budget should be comprehensive. The budget should include all revenues and all expenditures of the government whatever the arrangements for managing separately some particular programs, the legal provisions for authorizing expenditures, and the financing source.

Operational efficiency requires taking into account the specific characteristics of different expenditure programs when designing budget management rules, e.g. concerning transfers of resources for one budget item to another. When there is a strong link between revenue and benefit, earmarking arrangements may be considered to improve performance in public services delivery; they should otherwise be avoided.

Special management arrangements should not be allowed to hamper expenditure control and efficiency in resources allocation. Hence, extrabudgetary funds, special accounts, expenditures financed by external sources, etc., should be submitted to the same scrutiny as other expenditures. For this, they should follow the same expenditure classification system as other programs. Also, their related transactions should be recorded in gross terms, without “netting out” receipts and expenditures.

In addition to direct spending, all policy commitments and decisions that have an immediate or future fiscal impact, or generate fiscal risks, should be disclosed and scrutinized together with direct spending (tax expenditures, contingent liabilities, loans, and quasi-fiscal expenditures).

b. Budget preparation

In keeping with the three key objectives or PEM, the budget preparation process should aim at: (i) ensuring that the budget fits macroeconomic policies and resource constraints; (ii) allocating resources in conformity with government policies; and (iii) providing conditions for good operational management. Hard choices and trade-offs must be made explicitly when formulating the budget. Postponing such decisions until budget execution prevents a smooth implementation of priority programs, and disrupts program management.

The budget is the financial mirror of government policies. Therefore, mechanisms for formulating sound policies and ensuring the policy-budget link are essential. They include:

- Coordination mechanisms for policy formulation within the government;
- Consultations with the civil society;
- Adequate means for legislative review of policies and the budget;
- Regulations to reinforce the budget-policy link, notably (i) systematic review of the resource implications of a policy proposal; (ii) supremacy of the budget over other regulations on fiscal issues; and (iii) specific powers of the legislature in budgetary matters.

The preparation of a macroeconomic framework should be the starting point of budget preparation. The degree of sophistication of macroeconomic projections depends on technical capacities within the country, but every country should frame budget preparation within a macroeconomic framework, based on realistic assumptions, without overestimating revenues or underestimating compulsory expenditures. To commit the government explicitly and to ensure public accountability, the fiscal targets and macroeconomic projections should be published, in a “userfriendly” format.

Financial constraints must be built into the expenditure programming process, to avoid the problems arising from “open-ended” approaches, i.e. excessive bargaining, and avoidance of necessary choices. Annual budget preparation (as well as any expenditure program) should be organized as follows:

- A *top-down approach* which consists of: (i) defining aggregate resources available for public spending over the planned period (derived from a sound macroeconomic framework); (ii) establishing sectoral spending limits that fit government priorities; and (iii) notifying line ministries of these spending limits, early in the budget process;
- A *bottom-up approach* which consists of formulating and costing sectoral spending programs for the planned period within the given sectoral spending limits; and
- *Iteration* and reconciliation mechanisms for eventual overall consistency between aims and availability.

Budget preparation includes specifically the following activities: (i) preparation of the macroeconomic framework; (ii) preparation of a budget circular, which gives guidelines for the preparation of sector budgets and expenditure ceilings by sector; (iii) preparation of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the Ministry of Finance; (v) finalization of the draft budget; and (vi) submission to the legislature. All countries should adopt some appropriate medium-term perspective on budgeting, and countries where conditions are conducive should consider implementing a formal multi-year expenditure programming approach.

To choose among programs and to prepare their implementation plan, spending agencies need to know the amount of resources allocated to their sector. Within those limits, since they are accountable for sectoral policy and performance, line ministries should be responsible for the preparation of their sector budgets.

Weaknesses in budgeting depend in large part on political factors and on the organization of the government, e.g. lack of coordination within the Cabinet, unclear lines of accountability and overlaps in the distribution of responsibility. Mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- Decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions related to tax expenditures, lending, and guarantees and other contingent liabilities);
- Financial constraints must be built into the start of the budget formulation process, consistent with policy priorities and resource availability. Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget preparation process;
- Policy coordination mechanisms that fit the country context are needed, with particular attention to the budget-policy link. The medium-term fiscal impact of policy decisions must be systematically assessed;

- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have participated in designing the programs and have authority for managing them. This requires, in a number of countries, review and revision of the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed by external aid and should scrutinize their budget as a whole, regardless of the source of financing and despite the fact that the project approach adopted by donors may favor fragmentation in budgeting.

Implementing new policies and making shifts in the composition of expenditure takes time. In the short term, most expenditures are fixed. Thus, assessments of forward costs, including the recurrent costs of investment projects, are required when preparing the budget, and the total costs of investment projects of a significant size (and their implementation schedule) should be reviewed when preparing the budget and shown in the budget documents or in annexes to the budget.

The preparation of rolling multi-year expenditure programs contributes to improving budget preparation, mainly by facilitating the preparation of the ceilings that should frame the preparation of the annual budget, and by increasing predictability in sector management and efficiency in public spending. A formal and detailed program covering all sectors has recently become known as a Medium-Term Expenditure Framework (MTEF), but less demanding approaches to a multi-year perspective can be adopted.

To avoid undesirable outcomes and perverse effects, the following principles should be adopted in multi-year expenditure programming:

- multi-year estimates can be indicative for the outyears but must be fully consistent with the budget in their first program year;
- whatever their coverage, multi-year programs must be framed by a multi-year macroeconomic framework, including estimates of aggregate expenditures by function and by broad economic categories (wages, other goods and services,

transfers, interests, investment). This requirement applies not only to comprehensive MTEFs, but also to multi-year approaches with a partial coverage (public investment programs, sector expenditure programs);

- multi-year programs should not be allowed to be used as an excuse for increased claims from spending agencies. They should focus on the forward impact of policy decisions to be made in the annual budget under preparation, and exclude new programs that are not funded with certainty. Therefore, the total costs identified in the multi-year programs should be less than the projected revenues from all sources.
- the process of preparation of multi-year programs should be analogous to the budget preparation process. In particular, it should be framed by annual expenditure ceilings.
- depending largely on the country's administrative capacity, multi-year expenditure programs may have different status (internal management document, published and official document, etc.); different coverage (some sectors or programs only, or PIP only, or MTEF with aggregate or detailed coverage); different degree of detail (as detailed as the budget or in a more aggregate presentation).

c. Organizational issues

The responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined and delimited:

- The center of the government (Prime Minister, President office, etc.) coordinates policy formulation and arbitrates any conflict that may appear in budget preparation.
- The Ministry of Finance sets the guidelines for budget preparation, scrutinizes budget requests and ensures the coordination of the budget preparation process, as well as budget the overall consistency of budget with policy and macroeconomic objectives.
- Line ministries and agencies are responsible for preparing their sector programs and budget, within the policy directions and financial envelopes decided by the government.

Assignment of expenditures to subnational government should be established on a clear basis, and arrangements for revenue assignment should follow expenditure assignment. The central government should avoid downloading its fiscal problems on to subnational governments. Accordingly, increased expenditure assignments must be balanced by compensatory measures on the revenue side. Certain mandates of overriding national significance may not specifically carry additional resources, but should be the exception to the rule.

In order to ensure both efficiency and fiscal discipline, incentives and sanctions are needed. Subnational governments should benefit from savings they made, but protective measures are required in case of mismanagement or budget overruns.

The legislature has a key role in reviewing and approving the budget. For this, adequate capacity and resources are needed. However, to achieve the three objectives of fiscal discipline, resource allocation and good operational management, certain limits on the amendment power of the legislature are normally set.

2. Budget execution

It is possible to execute badly a well-prepared budget; it is not possible to execute well a badly prepared budget. However, budget execution requires more than simply assuring compliance with the initial budget. It must also adapt to intervening changes, and enable operational efficiency. Procedures for controls are needed, but should not hamper efficiency nor lead to altering the internal composition of the budget, and must focus on the essential while giving spending agencies flexibility to implement their programs.

a. Assuring compliance: Expenditure control

The budget system should assure effective expenditure control. In addition to a realistic budget to begin with, a good budget execution system should have the following:

- complete budgetary/appropriation accounting system. It is necessary to track transactions at each stage of the expenditure cycle (commitment, verification, payment) and movements between appropriations or budget items (apportionment, virements, supplementary estimates);
- effective controls at each stage of the expenditure cycle, whatever their form and organization;
- A system for managing multi-year contracts and forward commitments;
- A personnel management system, which should include staff ceilings in countries undertaking a civil service reform.
- Adequate and transparent procedures for competitive procurement and systems for managing procurement and contracting out.

b. Budget implementation

When a well-prepared budget is being implemented, allocative and operational efficiency call for the following principles:

- Budget funds should be released in a timely manner.
- Cash rationing should be avoided (except in emergency). A budget implementation and a cash plan must be prepared, but should be based on budget estimates and take into account existing commitments.
- Supplementary estimates must be strictly regulated and their number limited.
- Virements (transfers between items) are justified, but should not lead to altering the priorities established in the budget. Rules for virement should be set up to allow for both management flexibility and control of the major items.

- Internal controls (within line ministries) are generally preferable to ex ante controls performed by central agencies, but to do so a strong monitoring and auditing system is mandatory. Commitments and verification controls should be internal, in order to avoid excessive interference of central agencies in budget management.
- When payment processing and accounting controls are decentralized, a central control on cash is required. When payment processing and accounting controls are centralized, a system is needed to assure that payments are made in a timely manner and according to the budget and the cash plan, without superimposed prioritization by the central agencies. Advances in information technology should permit to reconcile the need to decentralize controls for efficiency reasons and the need to assure central control of expenditure.
- Some carry-over of appropriations should be authorized, at least for capital expenditures, but needs to be regulated.

c. Cash management and the Treasury function

Cash management has the following purposes: aggregate control of spending, efficient implementation of the budget, minimization of the cost of government borrowing and maximization of return on government deposits and financial investments. The key principles are:

- Centralization of cash balances. This centralization (not to be confused with centralization of payments), should be made through a "Treasury Single Account". A Treasury Single Account is an account or a set of linked accounts through which all government payment transactions are made. It should have at least the following features: (i) daily centralization of the cash balance (when it is possible); (ii) accounts open under the responsibility of the Treasury; and (iii) transactions recorded into these accounts along the same set of classification. This model could fit both centralized and decentralized arrangements in public expenditure management, provided that modern information technology is available.

- Cash planning is essential. It includes: (i) the preparation of an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, the preparation of monthly cash and borrowing plans; (iii) weekly review of the implementation of the monthly cash plan. In turn, in order to prepare monthly cash plans, it is necessary to monitor commitments in order to avoid arrears generation or delays in payment.
- Borrowing policy needs to be set in advance, and the borrowing plan must be made public. Borrowing by subnational governments must be regulated, and should be consistent with overall fiscal targets.
- External debt should be contracted in accordance with the budget or a multi-year expenditure program, and monitored closely.

3. The technical infrastructure

a. Accounting

Good accounting and reporting systems are crucial for public expenditure management, accountability, and policy making. Accounting systems are classified along the following categories:

- *cash accounting*, which focuses on cash flows and cash balances. Cash accounting fits the need for expenditure control, provided that it is complemented by an adequate system for registering commitments and reporting on arrears.
- *modified cash accounting*, which adds to cash accounting a complementary period for recognizing end-of-year payments. (This system normally adds trouble and risk, and is generally to be avoided.)
- *modified accrual accounting*, which covers in addition liabilities to cash and *financial* assets. Modified accrual accounting gives a complete framework for registering liabilities and expenditures;

- *full accrual accounting*, which is similar to the accounting systems of commercial enterprises and covers *all* liabilities and assets. Accrual accounting gives an appropriate framework for assessing full costs and performance. However, it has heavy data, technical, and administrative implementation requirements which make it unsuitable for many countries and will affect the reliability of the system if inappropriately or prematurely introduced.

Whatever the basis of accounting, the accounting system should have the following features :

- Adequate procedures for bookkeeping, transactions registered systematically, adequate security system, systematic comparison with banking statements.
- All expenditure and revenue transactions should be registered into the accounts according to the same methodology (including expenditures from funds and autonomous agencies, and aid-financed expenditures).
- Common classification of expenditure along functional and economic categories.
- Clear accounting and well-documented procedures.
- Statements regularly produced (see reporting below).
- Systems for tracking the uses of appropriations (“budgetary accounting”) at each stage of the expenditure cycle (commitment, verification, and payment).
- Clear procedures and full disclosure of budget financing operations (“below the line”) and liabilities.
- Clear arrangements for the retention, access and security of supporting documentation including computerized records.

b. Reporting

The reporting system must be designed to fit the needs of the different users (the legislature, the public, budget managers, policy decision-makers, etc.). Minimum reporting requirements include:

- Reports on the management of the budget showing all movements on appropriations and line items (allotments, supplementary estimates, virements, etc.).
- Reports for accountability to the legislature.
- Financial reports: consolidated accounts of the general government, statement on arrears, report on debt and contingent liabilities, and report on lending.
- Reports to assess budget policy, and line-agencies' reports.

c. Management control, audit and evaluation

Management controls, (also called “internal controls”) are the policies and procedures put in place by the managers of an entity to ensure the proper and effective operation of the entity. There are many kinds of management controls. Developing an effective system of controls requires, first, a careful assessment of the risks facing the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable costs.

Management controls are a basic responsibility of any manager. To be effective, the management control system must have the strong support of the entity's leadership. Policies and procedures must be observed consistently throughout the organization. Irregularities revealed by the control system must bring prompt and effective corrective action. To assure continued effectiveness, both the risks facing the organization and the control system, itself, must be reassessed frequently.

No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities will be detected. At the same time, even well-designed controls can be defeated by collusion, especially if that collusion involves senior executives who have the power to disarm or bypass the control system. As stressed

earlier, effective accountability requires appropriate external feedback and “voice”.

Internal audit is part of an organization’s management control structure. It performs audits of lower level units on behalf of the top management of the entity. Some of its most important functions are to test the management controls themselves and to assist management in assessing risks and in developing more cost-effective controls.

External audit of the government is typically performed by a separate organization, the SAI, which usually reports its findings to the legislature and/or the public, as well as to the audited entity itself. SAIs may perform several types of audits, including ex ante audits, compliance/regularity audits, financial (assurance) audits and value-for-money (efficiency) audits. The appropriate audit emphasis depends on the particular circumstances of each country. Weak or non-existent management controls in government organizations may require the SAI to conduct extensive auditing of individual transactions in an ex ante or compliance/regularity mode. However, this is an inefficient use of audit resources. An SAI in these circumstance should work with the legislature and the Ministry of Finance to implement a coherent strategy for building effective systems of management control.

The credibility of external audit requires that the SAI and its staff be independent of the governmental units being audited and have unrestricted access to required information. This independence is typically set forth in the legal provisions establishing the SAI. The SAI must guard this independence zealously but, at the same time, its effectiveness depends on maintaining a professional, cooperative relationship with the legislature, the government and the entities being audited.

There are several organizational models of SAI designed to reinforce independence while also providing effective management of the SAI as an organization. Most are variations of the “office” model, headed by an Auditor General reporting to the legislature (typical of Commonwealth countries) or of the “court” model, in which the auditors have the status of law court judges (as for example in France and Italy). Combinations of these two basic models are also seen in some countries.

To be effective, the SAI’s audit staff must possess the professional skills required by the audits being performed. For an SAI to move from ex ante and regularity audits to financial assurance and value-for-money audits will require extensive training or the hiring of new

professional cadres to perform these more complex audits.

The SAI, especially one pursuing strategic objectives such as improved management controls or undertaking more advanced types of audits, needs an effective means of communicating audit results and a sound approach for encouraging appropriate corrective action.

No audit, however thorough, can provide absolute assurance of detecting every irregularity or error. An audit can give only reasonable assurance that any material errors will be found and reported. Even this level of assurance that any material errors will be found and reported. Even this level of assurance can be given only if the auditors have access to all needed records and the audit was performed in accordance with generally accepted auditing standards.

Program evaluation is a systematic effort to identify and measure the effects of government policies and programs. The more sophisticated forms of evaluation, experimental design and time series analysis, involve the collection and statistical analysis of large volumes of data to isolate reliably the effects of the program from other factors that might have caused these effects (“impact evaluations”). Case studies provide less reliable information about causation but have proven useful in identifying ways of improving efficiency.

For an evaluation to succeed, there must be clear agreement on the question being examined and the data required to provide a reliable answer. Those performing the evaluation must have the professional skills and resources needed to collect and analyze the data. The evaluator often must depend heavily on the cooperation of operating units to gain needed access and to collect needed data. Program evaluation itself, like value-for-money audit, must show that it is cost-effective relative to the improvements to be identified or the progress expected.

d. Implementing a multi-year perspective

As emphasized earlier, a multi-year perspective is important for good budgeting. There are a variety of approaches for introducing such a multi-year perspective. The most comprehensive and detailed approach is frequently referred-to as a Medium-Term Expenditure

Framework (MTEF), which is a whole-of-government framework including all government expenditure, at an appropriate level of disaggregation. Such a full-fledged framework has heavy data and implementation requirements, and in many developing countries can be wasteful or even counterproductive if introduced prematurely or implemented badly. Fortunately, partial approaches to the necessary multi-year perspective exist and can be considered—especially in developing countries. However, in addition to improving the budget process in the short term, such partial approaches must be designed to help build the local capacity needed for an eventual introduction of more comprehensive multi-year expenditure programming.

The main points relevant to a comprehensive multi-year perspective in budgeting were made earlier under the discussion of budget preparation. The main points relevant to the partial approaches are summarized here. The two main partial approaches to medium-term programming are one that incorporates all government expenditure in a particular sector, and one that incorporates all expenditure in a major expenditure category.

The former approach is comparatively recent, and has become known as a Sector Expenditure Program (SEP). Basically, the key points applicable to multi-year programming are also relevant to SEPs. Because it covers only one sector, however, it is even more important that an SEP be prepared under a stringent financial constraint flowing from the macroeconomic framework. Otherwise, this partial route to a multi-year perspective is likely to introduce a “needs” mentality—with all the problems such an mentality causes for public expenditure management—or merely provide a “pet sector” for aid donors, with the ensuing distortions in strategic resource allocation.

The latter approach is normally applied to “investment”, and has been common in aid-dependent developing countries under the name of Public Investment Program (PIP). PIPs emerged in the early 1980s as a reaction to the rigidities of the “development planning” of the 1970s, and as a means to improve the programming of external aid—most of which is for investment purposes. PIPs are on a “rolling” basis and cover a 3-4 year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor moneys, and can harm the expenditure management process. However, like a good SEP, a well-prepared PIP can improve the process as well as strengthen the recipient country’s control over aid. Ideally, a strong PIP should:

- include only economically sound investment projects that are clearly related to government policy. (For the out-years, the evaluation of projects may be indicative, but projects must always meet the “double sense” criterion of “development sense” and “common sense” before they are included in any form for any year). Procedures to prevent the birth of “white elephant” projects are especially important.
- cover all central government investment and investments by other public entities which are financed by the central government;
- be strictly framed by the ceilings derived from the macroeconomic framework (but recall the iterative nature of macroeconomic programming--public investment should never be defined as a mere residual derived from the other fiscal and macroeconomic targets);
- include in the first year only projects for which financing is *certain*;
- assure that adequate complementary local funding is included in the annual budget. “Counterpart funding” problems are likely in any event, but are a certainty if the aggregate budgetary provision for investment is insufficient;
- include in the outyears only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only “on-going policies”, as recommended for multi-year programming in general);
- prevent over-reliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important requirement. External expertise is needed. However, if the PIP process becomes inadvertently a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process, nor contribute to local capacity, nor, of course, lead toward a more comprehensive approach to multi-year expenditure programming. This risk, of course, exists in aid-dependent countries whether or not they have a public investment programming process.

e. *Aid management*

In aid-dependent developing countries, all three objectives of PEM require that the recipient government and not the donors should “drive” the allocation and utilization of aid funds—while respecting, of course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are ten major requirements for robust aid management. Among these, the following are essential:

- external resources must be integrated with overall resource utilization, and thus included in the budget;
- there should be one, and only one, aid management entity (preferably in the Ministry of Finance) covering all external aid, including technical assistance;
- aid management should be structured along donor lines (e.g., an ADB “desk”, a World Bank “desk” etc.) rather than sectoral lines (e.g., a “health assistance” desk);
- the aid management entity should function to facilitate, not obstruct, and avoid interfering in ministries’ budget proposals or project selection.

f. Information and communication technology (ICT)

The key messages in this area were summarized earlier in this chapter. We only underline here the fundamental point that, like all technology, **ICT is a tool**. It can be used appropriately or inappropriately, for good or for bad purposes, and its potential and risks must be *understood* and appropriately taken into consideration. In particular, it is sometimes thought that advanced ICT closes the door to corruption. However, while it eliminates corruption opportunities for some, it opens up new ones for others who are better able to understand and manipulate the technology.

4. Strengthening public expenditure management

a. The role of performance indicators

Greater performance orientation in public expenditure management is a goal, and must not be confused with any specific means of encouraging it. In particular, better performance in budgeting should never be confused with “performance budgeting”, which may lead to better or (more often) worse performance depending on circumstances. Performance is a relative concept, which can be defined in terms of effort or in terms of results. The subjective dimension of performance should never be neglected, and genuine effort should be recognized, or it will no longer be exerted. However, it is advisable in most cases to define performance in terms of objective measures.

Objective indicators of performance can relate to:

- input—the resources used to produce a service (e.g., doctors). The corresponding criterion is “economy”.
- output—the service itself (e.g., number of vaccinations). The corresponding criterion is “efficiency”.
- outcome—the purpose achieved by producing the service (e.g., lower morbidity). The corresponding criterion is “effectiveness”.
- process—the manner in which inputs are procured, outputs produced, or outcomes achieved (e.g., good “bedside manners”).

The output of one stage is an outcome of the previous stage and an input into the next. Thus, in activities close to the ultimate user, the output-outcome link is direct and outputs are a good way of contracting with service providers. In upstream activities instead (e.g., medical research) the measurement of performance is much more ambiguous. We stressed earlier in this chapter the “accountability tradeoff”, by which accountability can be strong or broad but not both. In any case, the *quality* of the service requires explicit monitoring, or quantitative performance indicators will inadvertently lead to lower quality. The selection of appropriate performance indicators, therefore, depends on the nature of the service as well as the circumstances of the country in question. The only general rule is that — in those cases when performance measurement is demonstrated to be appropriate and cost-effective— performance should be assessed according to that *combination* of input, output, outcome and process indicators which is realistic, cost-effective, and suitable for the specific activity, sector, and country.

Among the several caveats the risk of counterproductive behavior ranks high. It is essential to think carefully about the impact on actual behavior of using any specific indicator of “performance”. For example, when an aboriginal tribe in Australia was told that its subsidies would depend on keeping sanitary facilities clean, they did so most effectively by cleaning the toilets thoroughly and then closing them to the public. With these caveats, good performance indicators can be extremely helpful in fostering greater economy, efficiency, and effectiveness, if they meet the “CREAM” criterion: they should be Clear, Relevant, Economic, Adequate, and Monitorable. If any one of these requirements is not met, the indicator should not be used. When indicators are used, the next question is setting the appropriate target: the general rule is that a target should be challenging but achievable.

Contracting out—the transfer to the private sector of the implementation of activities previously performed by government is in a sense a logical extension of performance orientation (and belongs, as well, in the realm of the third PEM objective of good operational management). Contracting out is the transfer to the private sector of the delivery (not the financing) of government services. It offers the potential for efficiency increases both in the delivery of the service contracted out and, through the “market-testing” effect, in the government delivery of other services. However, contracting out also calls for great caution, and requires, among other things:

- a competitive environment;
- definition of the business need and of the activity to be contracted out;
- coordination with other related governmental activities;
- careful consideration of the quality of private management;
- protection of transparency and of service quality;
- specification of performance standards (which meet the CREAM criterion) and of consequences for non-performance;
- experienced contracting staff or advisors; and
- very close monitoring of contractor’s performance.

The risks associated with contracting out are particularly great in the case of Build-Operate-Transfer (BOT) arrangements, whereby a private entity finances and builds the facilities, then recoups its investment through an exclusive concession to operate them, and finally transfers them back to the government. This does not mean that BOT arrangements

should be avoided, but that governments must be mindful that the complexity of such arrangements provides greater opportunities for corruption. Also, risk assessment is essential, for the government may well be obliged to foot the bill if the private contractor bankrupts or defaults.

b. A strategy for reform

It would be a gross oversimplification to attempt to summarize further the summaries of general reform recommendations shown in Chapter 17, to which the reader is referred. The general prescriptions for a successful reform strategy are, in fact, the same as the broad themes of this book: (i) never transpose into a different social and economic context reforms introduced elsewhere, without a realistic assessment of their impact and requirements and appropriate adaptation if necessary; (ii) never move beyond the basics until certain that the basics have been set right; (iii) never hope for a quick-and-easy technical solution to complex and long-standing budget process problems; and above all (iv) keep the local authorities firmly in charge of the reform process, and never assume that the “experts” are invariably right. Competition and contestability can be as effective in screening out bad ideas as they are in screening out bad products. Therefore: (i) question; (ii) question; and (iii) question some more. If the advice is good and the experts are right, they will be able to answer to everyone’s satisfaction. More importantly, local officials can then implement the reforms themselves, with external advice, certainly, but in a supporting rather than a controlling role.

¹ As Chapter 15 explains in detail, efficiency relates to the concrete results of government activity, effectiveness relates to the achievement of the purposes for which those activities are intended.

² In this book, we do not address the complex question of how population preference can be ascertained. We do underline that the process of allocating public moneys to various users and beneficiaries is not only bureaucratic but inherently political as well. Indeed, Kenneth Arrow proved mathematically almost 40 years as the “impossibility” of aggregating individual preferences into a single social preference function that is stable, consistent with economic efficiency and not dependent and not dependent on coercion. (See Arrow and Scitovsky, 1969.). Other contributions, known collectively as “public choice theory” look at the budget as being determined by a market-type medium- whereby “rational individuals converge or an effort to maximize their own satisfaction” (Petrei, 1998).

³ By contrast, the question of whether it is the aid donors’ or the host government is preferences that determine the pattern of public spending is a central issue for PEM in developing countries and is considered at length in chapters 4 and 16, and elsewhere in the book.

⁴ On the revenue side, there is a similar distinction between tax policy and tax administration although, again, the two are clearly interrelated.

⁵ Summarized in the ADB mission statement as: socially and environmentally sustainable economic growth that reduces poverty (see ADB, 1999).

⁶ These are often called levels (e.g., by Campos and Pradhan, 1995). However, the term can easily be misinterpreted as implying a logical sequence or a hierarchy among the three.

⁷ The latter two objectives of strategic resource allocation and good operational management are easily recognizable in the distinction traditionally made in economics between allocative efficiency and use efficiency.

⁸ Management consultants and organizational theorists have popularized the “Three Es” of Economy, Efficiency, and Effectiveness, where economy is defined as minimizing input cost. Economy has administrative utility because it is linked largely to the procurement function and hence to a major potential source of waste and corruption. However, it is not independently useful for economics or policy making, as it is subsumed into efficiency, which entails minimum cost *per unit of output*.

⁹ Petrei (1998, p. 338) concludes that in Latin America “pressure to spend less has led to better spending in many cases, but in many others it has led to the opposite result.”

¹⁰ Among other publications, in his presentation on public expenditure management at the Asian Development Bank in Manila on November 18, 1998.

¹¹ Among others, see Schiavo-Campo, 1994; and Campos and Pradhan, 1995.

¹² See, among others, North, 1991 and Williamson.

¹³ This point is different from the codification of custom, which is sometimes wrongly advocated as a way of giving greater weight to informal rules. Contrary to stereotype, customary rules do adapt to changes in circumstances. But, when codified into formal law, custom loses its natural adaptability and becomes a straightjacket on change. (See Hughes, 1997.)

¹⁴ References to World Bank Governance and Development 1992; ADB, 1995; ADB, 1998.

¹⁵ Stewart and Ransom, 1988.

¹⁶ The pragmatic approach of this book eschews ideological positions or advocacy of particular models (or, for that matter, opposition to particular models). However, because the “New Public Management” has entered the international lexicon, and has alternatively been sanctified or demonized, we thought it useful for the reader to have available the summary of issues presented in Annex II.

¹⁷ Chapter 15 discusses in some detail performance measurement and its applications to the budget process.

¹⁸ See Tanzi, 1998.

¹⁹ A Working Group of the multilateral development banks has been formed and meets periodically to exchange information on progress of activities and to coordinate efforts.

²⁰ Until then, the United States had been the only country to penalize US companies that bribed foreign officials, through the 1979 Foreign Corrupt Practices Act.

²¹ In the words of World Bank President James Wolfensohn in his speech at the 1996 Annual Meetings of the World Bank and IMF, which in many ways set in motion the official chain of events.

²² See his “The IMF Monetary Model at Forty”, IMF Working Paper No.97/49, April 1997. The model is naturally more applicable to complex economies in relatively stable circumstances (for which the basic relationships among monetary, fiscal and real sector aggregates can be presumed to remain approximately constant), than to developing countries in turbulent environments. In all cases, however, it is at least a useful starting point. A readable and short summary is presented in Polak’s “The IMF Monetary Model: A Hardy Perennial”, *Finance and Development*, December 1997. Because of the utility of this brief article, it is reproduced as Annex VI, by permission.

²³ These revisions in approaches are (loosely) related to two important principles of international economics. First, there is the “two-out-of-three” rule enunciated by Charles Kindleberger (Kindleberger, 1958). Of the three objectives of balance of payments equilibrium, economic policy autonomy, and fixed exchange rates—a government can have only two. Autonomy and fixed rates will eventually produce external imbalances; autonomy and external equilibrium will require exchange rate adjustments; and fixed rates and external equilibrium demand some sacrifice in economic

policy autonomy. (This principle is at the root of the Maastricht convergence criteria for European monetary union.) The changing approaches to the international system also reflect the more recent scheme, which posits a three-way trade-off among the capacity to stabilize the economy and fight recessions; the external openness that permits international capital flows; and stability in external trade and exchange rates. As Paul Krugman views the dilemma, the international system can meet two of these objectives, but not all three at the same time – and changes in international circumstances will produce a different choice among the three objectives. Accordingly, the policy issue revolves around the least costly alternative from abandoning one of the three (Krugman, 1998, <http://www.mit.edu/~krugman/triangle.html>).

²⁴ See World Bank, 1997.

²⁵ The extent of the downsizing can be seen, among other things, by the sharp reduction in government employment worldwide from the early 1980s to the early 1990s. (See Schiavo-Campo, 1998.) In transition economies of the former USSR, instead, the key issue is the collapse of government revenue. In these countries, public expenditure has already contracted far beyond any desirable point; arrears have been accumulating; and better public expenditure management is wholly secondary to the imperative of strengthening tax administration and collection.

²⁶ Indeed, the first advice to a government moving from a manual public accounting and recording system to a computerized one should be to keep the manual ledgers going alongside the new system until the new system is working well, and is secure and free of risk.

Chapter 2. THE BUDGET AND ITS COVERAGE

Government policy objectives include quantitative aims, such as raising the literacy rate by a specified amount, or qualitative goals, such as improving market competitiveness (see chapter 15 for a discussion of performance monitoring and budget efficiency indicators). They can be achieved through a variety of instruments: direct government spending, indirect spending (tax expenditures, contingent liabilities, loans, etc.), tax policy, regulations, and direct commands. Government policy goals can also be achieved through financial transactions undertaken by the Central Bank or the state-owned banking sector (“quasi-fiscal expenditures”) or through state guarantees and insurance. However, direct government spending is the most important instrument, and the government budget is the financial mirror of most government policies.

A. BASIC DEFINITIONS

1. What is the “budget”?

The word “budget” comes from *budget*, a Middle English word for the king's bag containing the money necessary for public expenditure.¹ Budgets evolved in two directions. At first, Parliaments fought to take control of the budget and make governments accountable for the use of resources. In democratic societies, for instance, approval of the budget (the “power of the purse”) is the main form of parliamentary control of the executive. The budget authorizes to the executive to spend and collect revenues. In later years, the scope of government activities expanded considerably, and the role of the government budget became more complex. Today, government expenditure is aimed at a variety of objectives, including economic development, and social goals, or redistribution objectives. Hence, governments need sound fiscal policies, i.e., policies concerning government revenues, expenditures, and borrowing to achieve macroeconomic stability and other government objectives. The budget is the most potent instrument of the government in carrying out its policies. In countries with representative governance systems, the budget is the financial mirror of society's choices. Public money should be spent only under the law.

The scope of the budget depends on the field of activities of the government, but must also be in a form to allow government policies to be appropriately scrutinized by the legislature and the public. As noted, *this book does not cover the revenue side*. However, it is important to note that, from the macroeconomic point of view, it is crucial to review revenues and expenditures together. In a number of countries, bills on the budget and revenues are presented to Parliament and scrutinized separately (e.g., Nepal). This presents inconveniences with respect to scrutiny. Assessing the soundness and the realism of tax forecasts should be the preliminary step in analyzing a budget. Since fiscal stabilization, distribution, or allocational objectives can be achieved either through tax policy or through public expenditure policy, common issues need to be reviewed together, especially those concerning policy goals that can be achieved either through direct spending or through tax expenditures, or both. Accordingly, it is necessary during the budget formulation process to coordinate the preparation of the expenditure and revenue portions of the budget and consolidate them into a single document at the time of presentation to Parliament. In this volume, we focus on the expenditure side.

The budget period is in almost all countries twelve months (“the fiscal year”). In most countries, the fiscal year coincides with the calendar year. In several others, it starts on July 1, and in a few cases, it covers a different period (e.g., October 1-September 30 in the U.S.). Because many other relevant statistics (e.g. international trade) are reformed and published on a calendar year basis, a January 1-December 31 fiscal year is more convenient for analytical and reporting purposes.

2. What is the “government”?

The government consists of public authorities and their instrumentalities. The combination of all government units is the *general government*, which consists of the following entities. ²

- *Central government*. The central government includes all governmental departments offices, establishments, and other bodies that are agencies or

instruments of the central authority of a country, departmental enterprises attached thereto, relevant nonprofit institutions, and the geographical extensions of central government authority that operate at the regional or local level without the attributes necessary for existence as separate government units. Departmental enterprises are industrial or commercial units that are noncorporate, closely integrated with the rest of a government department or agency, and likely to hold small working balances (for example, the office responsible for printing and selling the official gazette).

- *Local government.* Local government consists of governmental units exercising independent competence in the various urban and/or rural jurisdictions of a country's territory. Local government units may include counties, cities, towns, townships, school districts, water or sanitation districts, combinations of contiguous local government organized for various purpose, etc. In some countries, the boundaries between the local governments and central government are not clearly defined. For example, when a province is under military control, the level of government is not distinct from the central government. By definition, an entity is treated as local government only if it is entitled to own assets, and raise funds, has some discretion in its spending, and is able to appoint its own officers, independently of external administration.³ This is the key difference between decentralization, which includes *devolution* of policy authority, and *deconcentration*, by which the authority of the center is exercised more effectively through local entities acting as agents of the central government.
- *State governments* are an intermediate subnational entity in federal countries (e.g., India, Australia). State government has substantial authority of its own, including budgetary. In some countries, e.g., Canada, state governments are named provincial governments. In other countries, e.g., Sri Lanka, provincial governments have less extensive powers than state governments do in federalist countries.
- *Social security and social assistance funds.* Depending on their size and on

the way they are managed, social security funds are either classified as a separate subsector of the general government or included into the level of government at which they are operating.

Concerning decentralized or autonomous agencies, the nature of their function and the source of their authority constitute the proper criteria for assessing the level of government at which they should be incorporated (e.g., a hospital managed by the Ministry of Health, wherever it is located, is part of the central government).

Each level of the government should have its own budget to cover its own sphere of activity and responsibility. Most countries generally share such arrangements in place. However, in some transition economies, the organization of the budget system and the mode of negotiation of tax-sharing arrangements, based on political bargaining, do not ensure a clear assignment of responsibilities in budgeting. In these cases, one of the first steps in public expenditure reform should be to clarify the distribution of responsibilities among the different levels of the government, and to put in place stable and transparent arrangements for organizing the relationships among these levels.

3. What is the “public sector”?

In addition to the government itself, the public sector includes entities owned or controlled by the government, such as state-owned enterprises or financial institutions. In market economies, public enterprises should be commercially oriented and aim at profitability. For this purpose, they must have autonomy in management and be corporatized. Thus, their expenditures and revenues cannot be submitted to the same scrutiny and approval mechanisms as the government budget and the government budget, which should cover only their financial transactions with the government and not their transactions with the rest of the economy.⁴

However, a financial approach must also be developed for the public sector as a whole. Thus, the budget can show in an analytical table, presented for information only, the consolidated account of the public sector (sometimes called “consolidated budget,”

although it does not have the legal status of the government budget).

For accountability and transparency, the government should report on the performance and the financial situation of entities that it controls. Chapter 11 defines a government reporting entity which should consist of all entities controlled by the government. In practice, the definition of the government reporting entity varies from one jurisdiction to another.

B. GENERAL PRINCIPLES

In general, as noted, the budget is the financial mirror of government policy. Thus, to be an effective instrument, the budget should be as comprehensive as possible. Two major issues are involved here: First, if the budget excludes major expenditures, there can be no assurance that scarce resources are allocated to priority programs and that legal control and public accountability are properly enforced. Second, the amount of expenditures not included in the budget is itself often uncertain and opaque. In turn, this makes macroeconomic programming more difficult and increases the risk of corruption and waste. Budget comprehensiveness does not mean that all expenditures should be managed according to the same set of procedures. For efficiency, specific arrangements for administer some programs may be established, provided that they do not lead to a fragmented approach to budgeting and expenditure policy formulation.

In many countries a significant share of government expenditures is managed through special procedures. These special arrangements include: revolving funds to provide more flexibility in government spending, notably to overcome the annual rule; trading funds for departmental enterprises and other commercial services rendered by the government; emergency funds; special funds for specific expenditure purposes (such as road funds, health funds) managed at the sector level; expenditures financed by external loans; counterpart funds; budgets of autonomous/decentralized agencies, notably in the higher-education and health sectors; and special accounts managed by the Ministry of Finance or its Treasury Department. In a number of countries, expenditures managed through such arrangements are not shown in the budget and

managed through “extrabudgetary funds.”

Box 3 Extrabudgetary Funds in Thailand

In Thailand, a serious cause for concern is the tendency to have a large segment of public expenditure outside the discipline of the budget and the jurisdiction of the legislature. The executive exercises control over the three types of nonbudgetary funds: extrabudgetary funds, revolving funds, and special funds. A high proportion of government expenditure remains outside Parliament, giving powers to the executive and within it to the Ministry of Finance which controls these funds.

Extrabudgetary funds include the following:

- Reserve fund for emergency spending;
- Advance spending by the government authorized by law;
- Treasury reserves for special purposes;
- Temporary deposits of government agencies at the Ministry of Finance;
- Donations to government agencies;
- Foreign grants and loans;
- Receipts of public-service institutions such as hospitals, schools, and other welfare institutions;
- Compensation for loss or damage to government properties.

Revolving funds are set aside from the regular budget and operated by the agencies that initiated them. The purpose is to provide flexibility in the use of funds by the executive which is missing or restricted within the normal budgetary management system. There is no specified time frame within which the funds must be spent. At present, there are more than 80 revolving funds in active circulation, amounting to more than 3 billion baht at the end of 1987.

Special funds are the Oil Fund to regulate the retail price of oil products in the market, the Farmers' Aid Fund, the Rural Development Fund, the Land Reform Fund, and the Rubber Farming Assistance Fund.

Source: "The control and management of government expenditure: issues and experience in Asian countries, ESCAP-UNDP Development Paper No. 13, 1993.

Box 4
The Growth of Extrabudgetary Funds in the People's Republic of China

The narrowing of the scale of central government activities has brought about a decline in budgetary expenditures from 31 percent of GNP in 1978 to 20 percent in 1991. The deepest cuts have been in capital expenditures, from 12.6 percent of GNP in 1978 to 3.9 percent in 1991, as reforms transferred the bulk of investment responsibilities to state-owned enterprises. Further sharp cuts took place over those same years in budgetary defense spending, from 4.7 percent of GNP to 1.8 percent. Against the general trend, non-defense current expenditures rose slightly, from 13.7 percent of GNP to 14.7 percent; social expenditures, administration, and price subsidies all grew moderately in terms of GNP, while debt service grew very rapidly, albeit from an extremely small base. Decentralization of government functions enlarged the budgetary presence of local government, and the devolution of decision power increased the importance of local government in the budgetary process. The central government's share of budgetary expenditure is now below 40 percent, down from a peak of 54 percent in 1981.

Some of the most rapidly rising expenditure categories have increasingly fallen on local authorities, which in turn have developed extrabudgetary sources of income to finance their current and capital expenditures. The decline of the public sector's economic functions is reflected in the reduced share of investments (capital construction and technological transformation). This has been particularly sharp at the local government level: in 1978, the central-to-local split was about 56:44; in 1991, it was 74:26. Culture, education, science, and health enlarged their share of the budget, and price subsidies increased from nil to 10 percent of the budget. Budgetary revenues have declined in parallel largely because of price and enterprise reforms. By 1991, the ratio of revenues to GNP was little more than half the level in 1978.

A prominent feature of the fiscal landscape in China during 1978-1994 was the growth of extrabudgetary funds. These were funds outside the scope of the formal budget (including in terms of monitoring and approval) but subject to control by different levels of government. Most extrabudgetary funds were controlled by local governments. Revenues for these funds initially included the retained earnings of local state-owned enterprises (SOEs), public utilities surcharges, transportation fees, rental income on public housing, and various social funds, as well as ad hoc fees and charges. Extrabudgetary expenditures were mainly directed toward priority capital projects of local governments. The balance of extrabudgetary revenue and expenditure remained in surplus. The size of extrabudgetary funds rose steadily in relation to budgetary funds, to nearly 100 percent (for revenues) and 80 percent (for expenditures) in 1992.

Local governments in principle were not allowed to borrow, but the guideline was often not followed. In practice, local budget deficits were often financed through extrabudgetary funds, grants from the central government, and arrears as well as through various financial instruments.

Sources: Intergovernmental Fiscal Relations: The Chinese System in Perspective, IMF Working Paper 97/129, October 1997; and Budgetary Policy and Intergovernmental Relations, World Bank, Report No. 11094-CHA, 1993.

These and other issues concerning the comprehensiveness of the budget are discussed below. While going through the discussion, the reader is advised to keep in mind the three key objectives of public expenditure management: expenditure control, strategic allocation, and operational efficiency. Certain general considerations and minimum rules, however, need to be stated at the outset, regardless of the reasons for placing an activity or expenditure outside the budget.

In general, when existing budgetary procedures are inadequate to manage certain activities, or do not allow spending agencies to use revenues from cost recovery, the optimal choice is either to improve the budgetary procedures and/or to set up specific procedures for those particular activities, but not to place the activities themselves outside the budget. In special cases, as we shall discuss, earmarking arrangements, separate funds, or autonomous management may be desirable for improving efficiency in public spending. However, autonomy in management must not be allowed to lead to loss of expenditure control and less efficient allocation of resources. The standards of scrutiny and accountability for expenditures financed from funds, autonomous agencies, or special accounts should not be lower than those applied to other expenditures.

Therefore, the following *minimum rules* should be applied to every program, whatever its mode of management:

- Estimates of revenue and expenditures should be consolidated into the budget in gross terms, whatever the form of legislative authorization for these expenditures, and not netted out;
- Expenditures and revenues should be classified on the basis of the same classification system as the overall budget;
- Accounts of autonomous funds and special accounts must be audited externally and regularly;

- Financial reports of government activities should consolidate the operations of autonomous funds/agencies with other operations.

1. **Need for a Comprehensive Budget**

a. *Extrabudgetary funds (EBFs)*

The reasons for creating EBFs depend on the country and cover various objectives such as protecting priority expenditures from budget cuts; avoiding implementation problems in budget execution; sidestepping the inapplicability of some appropriation management rules to certain types of expenditures according to requests from some powerful political barons or lobbies; resolving difficulties in the proper allocation of expenditures due to excessive bargaining during the budget preparation process; or insulating donors' projects and programs in priority sectors at their request. In a few cases, the clear motive for establishing an extrabudgetary fund is the desire to hide transactions from public or legislative scrutiny. In such cases, the implicit motive could be to permit theft and corruption.

Whatever the motive, EBFs pose problems for the allocation of resources. Transactions outside the budget are not subject to the same kind of fiscal discipline as are budget operations, partly because they "carry their own money" and partly because they are not explicitly compared with other expenditures. Consequently, activities that would not normally survive the scrutiny of a regular budget process often continue, from their own inertia or from vested interests. Often, transactions made from these funds are not classified according to the same criteria as budgetary expenditures, hampering a sound analysis of the government expenditure program. This classification aspect can be easily improved, provided that there is willingness for transparency.

Nevertheless, EBFs are a common feature of budgetary systems in most countries. In developed countries, non-budgetary function averages about one-third of total government expenditures (mostly from social securities which accounts for about 90 percent of non-budgetary expenditure). In developing countries, the weight of social security is lower, but other non-budgetary expenditure relatively higher---for about the

same overall percentages as in developed countries (although the variability is much greater).

Extrabudgetary funds are often financed from earmarked revenues (e.g., road funds, regional funds, energy funds). Some economists argue⁵ that total spending and its composition should be determined simultaneously. Earmarking would be a way of revealing taxpayers' willingness to pay for a desired service, and to make a trade-off between decreased taxes and the increased delivery of public goods. Both the level of public-service output and taxes would be determined through earmarking mechanisms. According to the public-choice school, this could lead to an optimal allocation of resources and a balanced budget, but only under restrictive assumptions that are generally not met for public goods (e.g., constant returns to scale and no externality). Actually, fiscal discipline cannot be enforced through a process where the budget will be derived from particular interests.

Moreover, the institutional negative aspects mentioned above cannot be ignored.⁶ Generally earmarking revenues, even when the funds are consolidated into the budget decreases flexibility in resource allocation and hampers adequate program prioritization. It makes programs dependent on specific revenues and can lead to a misallocation of resources with excessive spending, simply because the funds are available, or shortages because the activities in question do not benefit from general tax revenues. Earmarking does not allow the government expenditure program to be scrutinized as a whole and thus prevents making the necessary trade-off between different expenditures. Most troublesome is that earmarking subjects expenditure decisions not to efficient criteria but to the ability of politicians and lobbies to secure protection for their favored programs. Finally, extrabudgetary funds tend to proliferate over time: the existence of an extrabudgetary fund in one ministry is often used by other ministries to "justify" their right to earmark revenues and setup their own special funds. In some countries, this can reach the point where a minister's status and self-respect depends on his having an EBF of his own. Eventually, the budgeting system becomes totally fragmented and the government loses this essential instrument of economic policy. However, as discussed below, earmarking can be desirable in specific cases and under some precise conditions.

Box 5
Pork in the Philippines

The 1999 budget contains measures intended to end the use of “pork-barrel” funds, which members of Congress have hitherto drawn on to finance economic and social projects at their discretion in their home districts. The measures target the problems of wastage, program prioritization, inefficient fiscal management, and the lack of transparency associated with the allocation of these discretionary funds. These funds include mainly the congressmen’s Countrywide Development Fund (CDF) and the senators’ Congressional Initiative Allocations (CIAs).

The CDF started as three funds in 1989: the Visayas Development Fund, the Mindanao Development Fund and the Inter-regional Development Fund. It is intended to fund development projects in the depressed areas of Luzon, Visayas, and Mindanao. The Congress called it the CDF in 1990. The CDF should be utilized only for infrastructure projects, livelihood programs, health and social services, calamity assistance, and purchase of equipment. (For instance it cannot be used to fund salaries, new positions, and other personnel benefits). Also, the CDF can be used only for projects with a fixed project life. The CDF is one of the special purpose funds indicated in the General Appropriations Act (the legislation that authorizes the annual spending program of the government). While the legislators identify the projects to be funded, the money is released and the funding is implemented by a government agency or instrumentality.

The CIAs refer to congressional changes/modifications in the general appropriations proposal submitted by the President. Their amount is not fixed nor centralized under one appropriations item. Unlike the CDF, this account is spread across agencies and the allocation per legislator depends on his allocation in the budget of a particular agency. To the extent that the Appropriations and Finance Committees are able to reduce certain budgetary items, these reductions are realigned to the legislators’ respective pet programs or projects. The CIAs are more open to misuse and about ten times bigger than the CDF. Representatives impute their budgetary insertions and “pork barrel” funds to the inability of line departments and agencies to meet local needs. They argue that their “pork barrels” only correct the “error” in the national agencies’ budgets which do not consider the needs of their particular constituencies.

The Commission on Audit in its 1996 financial report found cases of one or all of the following illegal acts: making cash advances or claiming checks, signing disbursement vouchers and purchase orders, granting contracts to favored firms, allowing the overpricing of goods, and diverting the funds to purposes other than the approved ones.

A proposal for a legislative-executive Budget Accord has been included in the 1999 budget. The accord should end the use of pork-barrel funds and promote greater participation and transparency in budgeting.

Sources: Department of Budget and Management; Philippine newspapers, various issues.

b. *Funds managed by the Ministry of Finance*

Many Treasury Departments hold “special accounts” (for example, in Japan, Korea, Indonesia, and India). Some of these accounts are used to manage EBFs placed under the authority of the Ministry of Finance or line ministries, and therefore pose the same problems as other EBFs, as regards allocation of resources. In some cases, transactions made through these special accounts concern internal financial transfers within the government rather than true expenditures. To some extent, these are comparable to a common Treasury account where internal transactions are accounted for separately. However, such arrangements are complicated and time-consuming. Moreover, in reality, nontransparent and “true” expenditures are often made through these funds.⁷ “Reserve funds,” counterpart fund accounts for foreign grants or loans, etc., are often not transparent.

c. *“Black boxes” and parallel budgets*

In some countries, revenue from natural resources is often treated more as a contribution to the purse of the President or to a political slush fund “black box”, than as a contribution to the government budget. Secrecy of revenues from oil resources and of their uses is still common. In some developing countries, revenues from commodity boards were used in the 1970s to set up a parallel budget,⁸ which was not submitted to any scrutiny. Including these revenues and expenditures in the budget is a prerequisite to improving transparency and governance. Although there could be few exceptions (for example, for security reasons), *there is never a good reason for secrecy concerning revenues and rarely a good reason for secrecy concerning expenditures.* Thus, while exceptions are possible, the existence of “black boxes” or secrecy about revenues should be interpreted as prima facie evidence of weaknesses in governance or outright corruption.

There is also a general tendency to allocate windfall revenues and some nontax revenues to particular programs. This hampers adequate prioritization among expenditure programs. From a fiscal sustainability viewpoint, the optimal (and “safest”) use of windfall revenues is to pay off the more expensive types of debt in the

government's portfolio. Under unusual circumstances, and for specified and basic human needs (e.g., drought relief, crash vaccination programs), it may be appropriate to assign windfall revenues to those needs. Before the actual expenditures are made, however, sound and well-designed administrative arrangements must be in place.

d. Expenditures financed by external sources

In the 1970s and 1980s, expenditures financed with tied external loans or grants were often omitted in the budgets of aid-dependent countries. This was sometimes explained by the difficulties of monitoring these expenditures or by the fact that budgetary procedures were not adapted to project management. To a certain extent, the reasoning was similar to that used to justify extrabudgetary funds. Progress has been made toward better coverage of externally financed expenditures in the budget, although the coverage of grants, technical assistance, and expenditures financed by external loans often remains incomplete. Donors have a key responsibility to help and facilitate the incorporation of these expenditures into the budgets of recipient countries.

3. Special Arrangements

a. Special management procedures

Funds are often created to bypass budgetary procedures. This may be due to lack of fiscal discipline, but may also be explained by the fact that the budgetary procedures are not adapted to the management of a certain category of expenditures. As discussed in chapter 5, in many countries, traditional appropriation management rules, such as rules for transfers between line items ("virements") or the cancellation of appropriations at the end of the fiscal year, are too rigid. Improvements in these rules should be considered and would limit the need to set up special arrangements.

Thus, expenditures financed from counterpart funds generated by sales of commodity aid need to be managed under specific procedures, taking into account the requirements of the donors. That such tying of counterpart funds is generally inefficient does not relieve the country of the burden of satisfying donor requirements.

Expenditures financed from counterpart funds must be included in the budget, but specific rules are needed to manage them (for example, exemption from the annual rule, and a flexible spending limit linked to the amount of revenues collected from the sales of commodities).

Revolving funds may also be needed to purchase goods that will not be delivered immediately and the payment for which would otherwise be jeopardized by the budget annual rule. Departmental enterprises need such mechanisms to carry out their trading activities.

Both for flexibility in management and institutional reasons, such as the special status of certain professions or activities, a number of “autonomous agencies” have been established in many countries, notably in the higher-education sector. These agencies are mainly financed with transfers from the budget of the central government, but have their own budget (called annexed budget in some countries).

Certain countries are increasing the number of their autonomous agencies. The aim is to separate (“decouple”) the delivery of services or administrative tasks from policy formulation and to establish contractual relationships between agencies and line ministries. This approach does not fit necessarily the administrative capacity and culture of every country. However, it could improve operational efficiency in public expenditure management, provided that it is implemented cautiously, in the sectors where it makes sense to separate the policy formulation function from the more operational functions, and provided further that contractual relationships are established in transparent manner.

However, establishing revolving funds or autonomous agencies for operational efficiency should not be an excuse to exclude programs and policies from legislative scrutiny or to renew them indefinitely. It should not lead to loss of expenditure control.

b. Road Funds

The fact that road users are identifiable and that they bear some taxes (such as

gasoline taxes) is used to justify earmarking arrangements for road maintenance or construction. Road funds have been set up in many developing countries: some are simple accounting arrangements, while others finance the provision of services. In general, experience with road funds has been disappointing and has led to the conclusion that, with some qualifications, earmarking ought to be avoided.⁹ Furthermore, when money was tight, earmarked funds were often frozen or diverted to other uses. Thus, the existence of road funds did not even guarantee an appropriate mix of maintenance, rehabilitation, and new investment in roads.

Taking this experience into account, the concept of second-generation road funds is being developed,¹⁰ inspired by the agency model developed in some OECD countries. The main features of this new approach are: involving road users in the management of roads; ensuring that all parties know their responsibilities; establishing clear accountability rules; and defining charging instruments related to road uses that are easy to separate from other taxes and charges and simple to administer. The simulation of market discipline could improve the management and the efficiency of “second-generation” road funds.

Box 6
Road Maintenance Initiative (RMI) of Africa

Why not bring roads into the marketplace, put them on a fee-for-service basis, and manage them like a business? This was the key concept of RMI launched by the United Nations Economic Commission for Africa (UNECA) and the World Bank in 1988, in an effort to identify the causes of poor road maintenance policies and develop an agenda for reforming them. However, since most of the roads will remain in government hands, commercialization requires changes in four important areas:

- Involving road users in the management of the roads;
- Securing enough money for road maintenance, year after year;
- Ensuring that all parties know what they are responsible for; and
- Establishing a system for managing road programs, with clear accountability.

These four areas are interconnected. The financing problem cannot be solved without the strong support of road users. But this support cannot be won without steps to ensure that resources are used efficiently, and for this, ways must be found to control monopoly power and constrain road spending to what is affordable, and managerial accountability must be increased. Furthermore, managers cannot be held accountable unless they have clearly defined responsibilities. These building blocks have far-reaching implications and could be applied to other sectors in Africa.

With road transport as the dominant form of transport in sub-Saharan Africa accounting for 80-90 percent of the region's passenger and freight movements, and providing the only access to most rural communities, the RMI has taken a fundamental long-term approach to reform: procedures cannot be changed until attitudes have changed. The task of changing attitudes begins with two steps: first, the costs of inadequate maintenance must be established; second, the group with the power to decide how much should be spent on roads needs to be enlarged to include the people who actually use the roads.

Source: *Finance and Development*, December 1995.

Only experience will tell. Some questions have already been raised.¹¹ Does the road fund meet good governance and anticorruption requirements? Can a board of directors genuinely represent consumer interests and not be subservient to contractors and producer interests? Is the road fund wholly devoted to roads or is merely a convenient “parking place” for money that ministers plan to divert elsewhere? Can the more demanding financial management requirements be competently handled in developing countries? Is the road fund independently audited? Despite these and other pertinent questions, the new concept is promising and merits cautious but positive support.

Box 7

Road Funds: Some Lessons From a Developing Country

Several developing countries, including Ghana, have road funds. Although Ghana's road fund has been in place for more than ten years, it has not been able to create the basis for sustainable road maintenance financing. Levels of financing have been unstable, fluctuating from year to year. To arrest this trend, the government has agreed to increase the fuel levy significantly to a level sufficient to maintain the entire road network. Getting the Treasury to agree to this graduated path to sustainable financing was a significant accomplishment, and required considerable political skill and goodwill within the Ghanaian government. For example, to avoid passing all of the proposed increases directly and immediately on to the consumer, Ghana's Treasury agreed to cede some of its other excise revenues to the road fund, so that overall fuel taxes would remain at basically the same level, even as the proportion earmarked for the road fund rises.

A key lesson from the Ghanaian experience is that having a fund is not sufficient in itself to ensure road maintenance. The creation of a board to oversee the fund, with sufficient authority and autonomy, is essential to reduce the possibility of raids on the fund by other government offices. Significant portions of Ghana's road network are still in poor condition. The fact that their road fund can only partly fund the required maintenance is typical of most road funds. The gap is normally financed with budgetary allocations and donor financing. In contrast, other developing countries (e.g. Burkina Faso) are able to finance virtually all their road maintenance requirements without a dedicated road fund.

Source: World Bank Internet page, adapted from Sam M. Mwale, Policy Research Group, Nairobi, Africa Transport Technical Note No. 8, May 1997.

c. Tax earmarking

Different tax earmarking arrangements may be found.¹²

- A specific tax or fee for a specific end-use, e.g., social security taxes, gasoline taxes for highway investments;
- specific tax or fee for a broad end-use, e.g., lottery proceeds that finance investments;
- general tax earmarked for a specific end-use, e.g., a fixed-percentage revenue devoted to specific programs.

In most cases, arrangements that earmark a share of total revenues from general taxes are questionable (issues of social security are reviewed below). Concerning other specific taxes and fees, a distinction is generally made between: (i) strong earmarking, where there is a close link between the payment of a user charge and the associated expenditure (e.g., fees for attending courses of a university); and (ii) weak earmarking where the link between the benefit and the fees or the taxes is less clear (e.g., the use of lottery proceeds for investments).¹³

As previewed in the earlier discussion on road funds, when there is a strong benefit-revenue link and the service is provided to well-identified users, earmarking may be desirable to induce agencies to improve performance and facilitate cost recovery. The use of earmarked taxes could increase taxpayers' knowledge of how the taxes they pay are used, making it more likely that they will exercise vigilance over the efficiency of the services.¹⁴

d. User charges

The issue of user charges is complex. Among other things, the benefits need to be weighed against the additional "transaction costs" of defining and collecting the

charges. In general, however, for both revenue and technical efficiency reasons, it is necessary for the government to require user charges when providing quasi-private goods, provided that the spending agencies that collect revenues are free to retain at least a significant portion of the revenue. (A hospital or a university would have no incentive to improve its efficiency if it could not use freely some of the revenue from selling its services.) Even when earmarking is desirable, however, an estimate of the revenue and the corresponding expenditures must be provided in the budget.

Box 8

User Charges: Electricity Provision to Outer Islands in Tuvalu

The Tuvalu Solar Electric Cooperative Society (TSECS), formed in 1984, is a commercial enterprise with a charter to promote solar photo voltaic (PV)-derived electricity for household lighting on the outer islands. After several years of trial and error, TSECS is now able to provide reliable PV-based electricity for lighting needs on a fee-for-service basis to about 400 households on the outer islands. The utility maintained by a well-trained technical staff with local and visiting technicians. It benefits from fee collection through an outside agency preventing diversion of funds to other projects, local user committees mediating between users and the utility, and an exclusive focus on PV systems.

Tuvalu's experience indicates that solar PV systems can be used successfully in remote areas for rural electrification at costs lower than those of commonly used diesel systems.

- Good rate of fee collection by an impartial organization based outside the community and use of the fees exclusively for the project;
- Local user committees, which can arbitrate disputes between the users and technicians about fee collections, disconnections and poorly functioning systems and keep the users informed about the functioning of the enterprise;
- Good maintenance, provided by local technicians and visiting senior technicians;
- TSEC's exclusive focus on PV systems;
- Availability of systems of different sizes to meet the varying technical needs and financial resources of the users;
- Continuing and competent internal and external training; and
- Readily available external technical support to assist with system design and training development.

The Tuvalu case indicates that the success of its solar PV system depends not only on the technology itself but on personnel training, good fee collection systems, and careful financial management.

Source: Andres Liebenenthal, Subodh Mathur, and Herbert Wade, "Solar energy: Lessons from the Pacific Island experience," World Bank Technical Paper 244, May 1994.

Systems for user charges must be transparent and efficient. The following principles should be adopted when setting up user charges.¹⁵

- *Clear legal authority.* The legal authority for an organization to charge the services should be clearly defined. This authority should be a general framework and should not set the precise amount of the charge to be applied, to allow the charges to be adjusted without further legislative authority;
- *Consultation with users.* Consultations serve to avoid misunderstandings and are useful in designing and implementing the charging system;
- *Full costing.* The full cost of each service should be determined, regardless of whether the intention is to recover costs fully or only partly. In the latter case, this information will make transparent the subsidy granted for the service (cost measurement is reviewed in chapter 10);
- *Appropriate pricing strategy.* Wherever relevant, pricing should be based on competitive market prices or on full cost recovery, or should take into account studies on variations in demand to limit congestion.
- *Equity considerations.* For equity considerations, reduced charges can be applied to lower-income individuals, users located in remote areas, etc. The criteria for applying reduced charges must be transparent. Different ways of meeting these equity objectives should be reviewed, since providing benefits directly is generally more transparent and efficient than providing them through reductions in user charges;
- *Competitive neutrality.* When pricing services, the costing should be accurate and should incorporate all items of cost faced by private-sector entities operating in the same sector;

- *Effective collection system.* The system for collecting user charges must be efficient. Nonpayment of user charges should be followed up immediately;
- *Audit.* Regular audits of the organization levying and collecting the charge are required;
- *Performance.* The performance of organizations should be monitored regularly to ensure appropriate levels of efficiency and service quality (see chapter 15 for a detailed discussion of this issue).

Several countries include in the budget only net expenditures of agencies that exercise commercial activities or recovery costs, and the budget appropriation corresponds to the difference between planned expenditures and expected revenues. If the gross amounts are large, netting out could impede a sound analysis of the government activities and an accurate estimate of economic costs. “A move to net budgeting will reduce the *measured* size of government, and lead to a reduced comparability of expenditure data relating to general government.”¹⁶ Efficiency requirements cannot supersede the need of Parliament and the public to know what the government agencies are doing. In some countries that net out appropriations, books are kept internally by the agencies on an accrual basis,¹⁷ and gross expenditures and revenues are recorded, but this is insufficient to satisfy the needs for Parliamentary scrutiny and public information.

e. *Social security*

Social security covers a variety of services classified into three broad categories:¹⁸ (i) social insurance, which is generally financed with contributions from employers and employees, and yields benefits linked to the contributions; (ii) the direct provision of a service or cash payment to a defined group of beneficiaries (e.g., family allowances, pensions, maternity grants); and (iii) social assistance, i.e., payments or services contingent on the investigation of the needs and financial status of the beneficiary (assistance to the elderly, handicapped, jobless, etc.).

The compulsory nature of social insurance and its far-reaching social, economic, and financial implications call for the inclusion of social security funds in the budget. A possible exception exists for countries where management of these funds also involves employers and employee unions.¹⁹ It could be difficult to integrate into the budget social security funds that are not directly managed by government entities. Nevertheless, taking into account the fact that they may cover a significant share of government expenditures, social security funds should at least be consolidated in a financial report (see chapter 11). Their budget should be annexed to the budget of the central government as well.

C. BEYOND DIRECT EXPENDITURE

1. Quasi-fiscal activities²⁰

Quasi-fiscal activities are financial transactions undertaken by the Central Bank or state-owned banks to achieve government policy goals. These operations include interest rate subsidies, support for ailing enterprises and financial institutions, payment of government debt, and financing of exchange rate losses incurred by the government. Accomplishing the desired goal through transparent subsidies in the budget rather than through quasi-fiscal operations is generally preferable. Also, a country's monetary authorities should concentrate on monetary policy and operations, and not get involved in activities that in effect substitute for fiscal operations through the budget. In any case, the quasi-fiscal operations of the Central Bank and other banking institutions should be scrutinized along with direct government expenditure programs and shown in the budget documents. At a minimum, a statement on the quasi-fiscal activities of the banking sector should be annexed to the budget. The production of transparent accounts from the Central Bank is also important since estimating the cost of quasi-fiscal operations is not a simple matter.

2. Government liabilities and contingent liabilities²¹

In addition to legal commitments, governments have other explicit or implicit commitments that can have an immediate or future fiscal impact. Fiscal risks and

uncertainties are increasing. The international integration of financial markets generates more abundant rapid, and volatile cross-border flows, and governments may become obliged to intervene to support the financial system. State guarantees and insurance schemes have become common. Privatization is often accompanied by implicit or explicit state guarantees.

Government liabilities can therefore be certain or uncertain (contingent), and explicit or implicit (see box 10). In descending order of fiscal predictability, these liabilities are as follows:

- *Explicit liabilities and commitments* are legally mandatory and predictable. This category includes, for example, budgeted expenditure programs, multiyear investment contracts, civil service salaries, pensions, and debt obligations;
- *Explicit and contingent liabilities* are legal or contractual obligations triggered by a discrete event that may or may not occur. This category includes, for example, state guarantees for loans contracted by non-central government entities (subnational governments, public and private enterprises) and state insurance schemes (for banking deposits, floods, crops damage, etc.). Often, the probability that the event will trigger the guarantee is high, since these guarantees are typically granted to support ailing enterprises or sectors in difficulties.
- *Implicit liabilities* represent an obligation or expected burden for the government that is not legal but arises from public expectations. For example, governments are expected to maintain public infrastructure, and to support a social security scheme, even not required to do so by law;
- *Implicit and contingent liabilities* are the least predictable category, representing a nonlegal obligation triggered by a discrete event that may or may not occur. For example, the government is generally expected to intervene if the banking sector risks bankruptcy, or the country faces natural

a catastrophe.

Generally in budgeting, decision making focuses on expenditure programs and, in part, on multiyear legal commitments, such as debt servicing. In most countries, no attention is paid in the budget to other long-term obligations and to implicit or contingent liabilities. When a country faces financial difficulties or is undergoing fiscal adjustment, there is often a tendency to overlook nonimmediate or nonexplicit fiscal risks. Sometimes, to solve immediate problems, an evasion strategy is developed that consists of substituting contingent liabilities for direct spending or making promises for the future to overcome immediate pressures. This tendency makes future problems worse than they would be if the realities were faced more forthrightly.

“Unfunded liabilities” are explained partly by the variety of sources of fiscal risk for central governments and by the fact that they are insufficiently taken into account when formulating the budget. Pension liabilities are demographically driven and are, in most countries, increasing steadily. Financing requirements for health care are rising in aging societies. Meanwhile, lack of funding for recurrent costs of investment cuts down the efficiency of the original investment, and government commitments and promises outside the budgetary systems reduce fiscal sustainability.

Sound budgeting and policy formulation requires a wider and more courageous approach, covering more effectively the fiscal risks faced by governments in the shortterm as well as in the longterm. Systems are needed to make governments both more aware of the financial impact of their decisions and more accountable. Most important, however, are political determination, leadership and effective communication of the fiscal realities to the public. Accordingly, the obligations arising from current or new expenditure programs and policy measures must be assessed realistically, whatever their nature (implicit or explicit, direct or contingent). This assessment is crucial in defining fiscal targets and making choices among alternative policies and expenditure programs. Fiscal risks should be part of this assessment. Explicit liabilities and contingent liabilities should be disclosed in financial statements (see chapter 10), and statements on debt and contingent liabilities presented along with the budget. Implicit and contingent liabilities cannot by definition be quantified or predicted

accurately; the reality of their existence, however, should add to fiscal prudence, and decision-making mechanisms should be in place to permit fast and efficient response if and when the event occurs.

Certain instruments reviewed in this volume can help in this assessment and disclosure. A multiyear expenditure approach permits assessing the fiscal sustainability of ongoing policy commitments over a medium-term period, as well as some implicit liabilities (such as the recurrent costs of investment projects; see chapter 12). Accrual accounting (either “modified” or “full”) gives a framework for assessing explicit liabilities (see chapter 10). However, these instruments are neither necessary nor sufficient for assessing fiscal risk. The key requirements are awareness of the existence of fiscal risks; assessment; disclosure; and explicit *consideration* of fiscal risks during the budgeting process.

Box 9	
Dealing with Fiscal Obligations and Risks	
Obligations and Risks	Possible Instruments
Explicit Liabilities and Commitments	
Budgetary outlays	Budget
Debt	Debt accounting Data annexed to budget
Entitlements	
Salaries	Multiyear expenditure programs
Pension liabilities	Accrual/modified accrual accounting
Explicit and Contingent Liabilities	
Loan guarantees	Notes to financial reports and the budget Assessment of fiscal risk
State insurance schemes (e.g., floods, crop failure)	- ditto -
Implicit Liabilities	
Forward costs of ongoing programs	Multiyear expenditure programs
Recurrent costs of investment projects	Public investment program or Multiyear expenditure programs
Hidden liabilities (e.g., pensions in public enterprises)	Assessment
Future health and social security financing	Assessment
Implicit and Contingent Liabilities	
Local government and public enterprise debts	Consolidated accounts/financial reports
Financial sector risks	Assessment
Social welfare functions	- ditto -
Environmental or natural catastrophe	- ditto -

Note: This list is merely illustrative and not exhaustive.

3. Loan guarantees

The most frequent explicit and contingent liabilities are loan guarantees. Guarantees can be provided by the government for loans undertaken by agencies, enterprises, and other autonomous agencies under its broad control as well as for private-sector corporations in selected situations. Guarantees can be provided for domestic or foreign loans. Loans to nongovernment entities by international financial institutions typically require a government guarantee.

While guarantees have long been recognized as an appropriate government instrument, they can have a significant impact on fiscal deficits, sustainability, and vulnerability. This became evident from the experience of many countries in Latin America and Africa in the 1980s, where most loans were defaulted by the borrowers. Debt servicing and repayment of these loans in default naturally had to be assumed by the government, thereby adding a lasting burden to an already stretched government budget.

In general, government guarantees are justified in cases where the borrower lacks the required creditworthiness (or where limited creditworthiness entails high borrowing costs), as long as their purposes are consistent with government objectives, programs, and policies of the government. When imperfect information gives potential lenders an inadequate picture of the borrower's creditworthiness, government guarantees remedy the market distortion and are appropriate from both an economic and a policy viewpoint. However, in practice, these guarantees are often granted without an assessment of the capacity of the beneficiary entity to reimburse the loan, or as favors to well-connected borrowers, and are not systematically recorded.

The expenditure equivalent of guarantees is difficult to estimate reliably, as it depends on a largely subjective judgment of the risk of default. However, the budget should at least include a *list* of guarantees that the government intends to grant and/or an aggregate monetary ceiling for these guarantees. (Appropriate management and accounting is also needed.) In several countries the government levies a fee when it

guarantees loans²². This procedure presents the advantage of creating a mechanism of registration and monitoring, and also constitutes to some extent an insurance payment in case of default. If the guarantee fee is proportionate to the risk of default (and the risk is assessed correctly) in the aggregate it will suffice to cover the cost. Of course, in this case the implicit subsidy element will disappear; but the purpose of guarantees is to offset lack of creditworthiness and not to subsidize credit.

Effective budget management calls for equally effective management of guarantees. First, there should be a system to compel consideration of the implications of the proposed guarantees, and to allow the subsidy element in such guarantees to be calculated. Second, there should be procedural safeguards to minimize the adverse impact of guarantees on the fiscal position. Third, there should be a system for monitoring the financial performance of the recipients of guarantees. Finally, there should be sufficient scrutiny and accountability to prevent the misuse of this instrument

A well-designed system to provide guarantees should recognize the important role of guarantees in the context of all other government policy instruments. As noted, direct expenditures, loans, guarantees, and tax incentives each offer some scope for pursuing a stated objective. A ceiling on guarantees could also be prescribed. Without such ceilings, liberal provision of guarantees could adversely affect the creditworthiness of the government itself and, as a consequence, could lead to higher interest costs in the medium term. Moreover, such ceilings induce a more rigorous scrutiny and thus promote competition among potential borrowers, channeling the guarantees to entities that are financially more sound. The risk element therefore needs to be computed and explicitly recorded and shown in the budget documents.

Finally, monitoring of guarantees, parallel to the budget system, would require a periodic review and anticipate possible defaults and ways of financing them. An initial important step would be the publication of data on guarantees as part of the budgetary information and of the completed accounts of the government.

4. Government lending

Government loans are another possible means of achieving government policy goals, and can substitute for direct spending. Therefore, loans should be decided in a transparent manner, submitted to the same scrutiny as direct spending, and appropriately shown in the budget.

Government lending is often directed to entities that cannot afford to borrow at commercial terms, either because these entities need to be subsidized or because the creditworthiness of beneficiary entities is weak (a typical example is lending for crop production or to state-owned enterprises). Government lending can also be used to leverage commercial lending and supplement it. This lending is frequent in developing countries since external loans that finance public-sector entities are granted to the Government to “on-lend” them to the beneficiary entity.

The fact that loans are (in principle) repayable can make government lending a more cost-effective instrument for achieving public policy than direct spending. However, lending can also be a way of avoiding budget constraints. Loans are often submitted to a weaker scrutiny than direct spending and do not have to be authorized by the legislature.

Typically, government loans include an interest subsidy²³ and present higher risks than loans granted by commercial banks. Concessional external loans granted to the government to be on-lent to public entities usually include a provision that the on-lending should be at commercial terms, to avoid creating distortions in the financial market. In practice, this provision is not systematically enforced. Exchange rate losses may be incurred and borne by the government, and risks of insolvency can be high.

Hence, the budgetary treatment of government lending should include the following:

- Since lending must be traded off against expenditure decisions, the lending program should be reviewed together with the expenditure programs during

budget preparation;

- Loans should be included in the budget, with a full explanation of their terms, and submitted to the authorization of the legislature;
- Interest subsidies must always be budgeted as an expenditure. Two approaches may be considered: (i) budgeting the discounted value of the subsidies when the loan is granted (as in the U.S.); or (ii) budgeting the subsidy according to the interest schedule. The first approach is preferable, since the subsidy is budgeted in the year the decision is made, but needs adequate technical capacity in financial analysis and accounting.
- To ensure accountability and allow review lending programs together with expenditure programs, lending must be included in gross terms in the budget.

5. Tax expenditures

Tax expenditures are another instrument of fiscal policy. Like government lending, they should be transparent and should be included in the budget. A tax expenditure is “the revenue foregone because of preferential provisions of the tax structure”²⁴ and covers the following:

- Exemptions, which exclude the revenues of a special group of taxpayers from the tax base;
- Deductions, which reduce the tax base by some expenses or a lump sum;
- Credits, which are deducted from the tax due (as opposed to deductions which reduce taxable income);
- Deferrals, or postponements of the deadline to pay taxes, without interest or penalties;
- Reduced tax rates for certain categories of taxpayers or activities.

Tax expenditures are aimed at achieving certain public policy objectives by providing benefits to qualified individuals or entities or by encouraging particular activities. They may also be intended to improve tax equity or offset imperfections in other parts of the tax structure. The same set of objectives (for example financial

assistance to families) can be achieved either through direct spending or through tax waivers or exemptions. In principle, spending a given amount is exactly equivalent to reducing the tax on the beneficiary by the same amount. In practice, tax expenditures and direct expenditures are handled separately.

To determine whether a particular tax measure generates a "tax expenditure," it is necessary first to establish the "normal" tax structure from which the measure departs. This is relatively easy when the tax expenditure corresponds to specific exemptions (e.g., a special income tax rate for agriculture activities), but when the whole tax structure is affected (e.g., differentiated income tax rate according to the family status of the taxpayer) the existence of a tax expenditure may be debated. There is also debate on the methodology for assessing the impact of tax expenditure, since some tax expenditures may have an impact different from direct spending, taking into account the changes in behavior of taxpayers.²⁵

Tax expenditures are granted through tax laws, in several countries, these expenditures are presented together with the expenditure budget, but are not submitted to the same system of internal control and legislative authorization as other expenditures. Therefore, tax expenditures are often an easy and less transparent way of granting special benefits to specific groups. In certain cases, the beneficiaries are less clearly identified than those who would benefit from direct spending. As a result, tax offsets can often give results that are completely different from the stated objectives. For example, high-income households can benefit more than the needier households from tax credits than from family allowances targeted to the low-income groups. Moreover, tax offsets (particularly on goods and services) create loopholes within the tax system itself.

Tax expenditures should be subject to an explicit trade-off against new spending initiatives and should be as transparent as possible. Ideally, as in the case of government lending, the direct impact of tax expenditures should be budgeted in gross terms both on the revenue and on the expenditure side. This approach can be adopted for tax expenditures that are easy to measure and monitor (such as tax refunds or tax offsets granted according to the provisions of a contract). However, since measuring

tax expenditures is difficult, this approach cannot be generalized.

Even though explicit budgeting of tax expenditures can be considered only in specific cases, an *assessment* of tax expenditures should be included in the regular process of budget decision making. For this purpose, a statement of tax expenditures should be produced regularly to allow a review of tax expenditure policy during budget preparation, and trade-offs between tax expenditures and direct spending. Some industrialized countries (e.g., Belgium, France, and the US)²⁶ annex such a statement to the budget document. This enhances legislative scrutiny of government policy.

D. KEY POINTS AND DIRECTIONS FOR REFORM

1. Key points

“General government” consists of the central government and subnational governments (state governments and local governments). The public sector includes the general government and all the entities that it controls (e.g., state-owned enterprises). Each government and public-sector entity should have its own budget. For accountability and financial control, reports should consolidate the financial operations of the general government and (to the extent possible) the financial activities of all entities controlled by the government.

For fiscal management, expenditure control and strategic allocation of resources among programs, the coverage of the budget should be comprehensive. The budget should include:

- Both revenues and expenditures of the government;
- All expenditures of the government, whatever the arrangements for managing some particular programs and the legal provisions for authorizing expenditures, and whatever the financing source.

Operational efficiency requires taking into account the specificity of expenditure

programs when designing budget management rules. When (but only when) there is a strong link between revenue and benefit, earmarking arrangements and user charges may be considered, to improve performance in public-service delivery.

Special arrangements for managing some programs should not impede expenditure control and efficiency of resource allocation:

- Extrabudgetary funds, special accounts, expenditures financed by external sources, etc., should be submitted to the same scrutiny as other expenditures;
- Funds, special accounts, autonomous agencies, etc., should adopt the same expenditure classification system as other programs;
- Transactions should be recorded in gross terms (whatever the coverage of the budget appropriation).

All policy commitments and decisions that have an immediate or future fiscal impact, or generate fiscal risks, (tax expenditures, contingent liabilities, loans, and quasi-fiscal expenditures) should be disclosed and scrutinized together with direct spending.

2. Directions in reforms

Priority actions should consist of laying the foundations required for any sound budgeting and policy formulation system, including:

- A comprehensive coverage of the budget;
- Assessment, disclosure, and review, together with expenditure decisions, of all policy decisions that have an immediate or future fiscal impact, such as contingent liabilities, lending, tax expenditures, and quasi-fiscal expenditures;

- An expenditure classification system that fits the needs of policy analysis and management and covers all government expenditures.

These actions should be carried out together with the priority actions aimed at improving budget preparation, execution, and accounting procedures (see chapters 4, 6, 7 and 10). They are a prerequisite for further improvements in the budget system.

Among these further improvements the following can be considered:

- Aside from the annual budget, instruments that facilitate an for better assessment of liabilities, contingent liabilities, and policy commitments. These instruments can include a modified accrual accounting system, or multiyear expenditure programming (see chapters 10 and 13);
- A performance-oriented approach (see chapter 15);
- Management arrangements for some expenditure programs (e.g. user charges, and earmarking where there is a strong revenue-benefit link, autonomous management for service delivery agencies contracting out) to improve their operational efficiency. However, these arrangements should not make the budget any less comprehensive or impede legislative accountability and control over expenditures in the aggregate.
- A classification of expenditure by activity and program, which allows performance indicators to be defined at an appropriate level.

¹ Ministère de l'Economie et des Finances "France's state budget", Paris, 1996.

² These definitions are drawn from the 1986 Government Finance Statistics (GFS) and the 1993 System of National Accounts (SNA). The comments on Social Security funds come from the 1993 SNA..

³ 1993 SNA, page 104.

⁴ In centrally planned economies, the demarcation between the activities of public enterprises and government activities was unclear, since state-owned enterprises were involved in public-services delivery.

⁵ See, for example, James Buchanan in *The Demand and the Supply of Public Goods*, Rand McNally, 1968.

⁶ For a discussion of this issue, see McCleary, 1991.

⁷ According to the 1993 ESCAP, in Thailand, extrabudgetary funds (advance spending, temporary deposits

of government agencies, foreign aid, etc.) covered more than 60% of the government expenditures reported by the Department of the Comptroller-General. However, the larger part of these expenditures concerned internal financial transactions and the accounting system allowed multiple accounting. The "true" fiscal operations accounted only for a small percentage of transactions made through these funds.

⁸ As in the Ivory Coast.

⁹ William McCleary, The earmarking of government revenue: A review of some World Bank experiences." *The World Bank Research Observer*, January 1991.

¹⁰ Ruper Pennant-Rae and Ian Heggie, Commercializing Africa's roads, "*Finance and Development*, 1995; and Ian Heggie, Managing and financing of roads: An agenda for reform, 1995.

¹¹ Barry H. Potter, Dedicated road funds: a preliminary view on a World Bank initiative, 1997.

¹² See William McCleary, "The earmarking of government revenue: A review of some World Bank experiences," *The World Bank Research Observer*, January 1991.

¹³ See Richard Hemming and Kenneth Miranda, Pricing and cost recovery," in Ke-young Chu and Richard Hemming, Public expenditure handbook, IMF, 1991.

¹⁴ See Humberto Petrei, "Budget and control," Inter-American Development Bank, 1998.

¹⁵ Drawn from OECD "User charging for government services," 1998.

¹⁶ David Heald and Gorge Georgiou, "Consolidation Principles and Practices for the Government Sector", University of Aberdeen, 1996.

¹⁷ As in several FSU countries.

¹⁸ See Premchand, 1983.

¹⁹ Notably in Continental Western Europe.

²⁰ See G.A. Mackenzie and Peter Stella, Quasi-fiscal operations of public financial Institutions, IMF, 1996; and David J. Robinson and Peter Stella, Amalgamating Central Bank and fiscal deficits," in M. Blejer and A. Cheasty, *How to measure the fiscal deficit*, IMF, 1993.

²¹ This section is drawn up largely from Hana Palackova, "Government contingent liabilities: A hidden risk to fiscal stability," World Bank, 1998.

²² See Premchand, 1983.

²³ Methods separating the pure loan from its grant component are reviewed in Michael A. Wattleworth, Credit subsidies in budgetary lending: Computation, effects, and fiscal implications," in IMF, *How to measure the fiscal deficit*, 1993.

²⁴ U. S. Office of Management and Budget (OMB); Statement of Federal Financial Accounting Standards (SFFAS) No. 7, 1996.

²⁵ The Federal Government Reporting Study, undertaken jointly by the Office of the Auditor General of Canada and the United States General Accounting Office in March 1986, had this to say about statements of tax expenditures: "Removal of a major tax expenditure might in fact have a negative impact on outputs and incomes in the economy, producing less additional tax revenue in total than the estimates in the table would suggest.... Tax expenditures may have a greater effect than direct aid in the form of grants, because selective measures directly increase after-tax income and grants would normally be taxed or would reduce deductible expense."

²⁶ See OECD, *Tax expenditures*, 1996.

CHAPTER 3. BUDGET SYSTEMS AND EXPENDITURE CLASSIFICATION

A. APPROACHES TO BUDGETING

Different countries have taken different approaches to, and several traditions exist, each with its specific features consistent with the overall administrative “culture.” The following should be read with this basic consideration in mind, although it is intended to describe generally valid principles and common ground.

1. Nature of legislative authorizations

a. *Basis of appropriations*

The nature of the authorization granted by the legislature depends both on the budget system and on the nature of the expenditure. Although there are exceptions (notably “permanent authorizations”), these authorizations are granted through appropriations, which are specific authorizations enabling the government and its agencies to spend money. The legal basis for appropriations is normally provided in statutory law. Such law should, however, avoid excessive detail, and procedural guidance should be provided by administrative law in order to permit incremented reform.

Appropriations may be grouped into the following broad categories:

- *Obligation-based appropriations* give rights to make commitments and to make cash payments according to these commitments, *without a predetermined time limit*. Such appropriations have their own life cycle and are not limited to one year. This system is no longer used for all expenditures, but may be used for special programs (e.g., in U.S., Philippines, or Micronesia).¹
- *Cash-based appropriations* give authority to make cash payments *over a limited period of time*, generally corresponding to the fiscal year. This system is the most widespread. In principle, appropriations define cash limits that cannot be

exceeded, but there are exceptions. At least for goods and services, they correspond also to a limit of entering into contractual commitments. They cover the *payments due*. In a few countries (e.g., the U.S.), the budget for a few selected programs includes multiyear budget authorizations.

- *Accrual-based appropriations cover full costs*, for the operations of a department and other increases in liabilities or decreases in assets (called expenses by accountants; see chapter 10). Full costs are the goods and services consumed (as opposed to acquired) over a period. Therefore, depreciation for physical assets, variations in inventories and variations in liabilities are added to actual payments to calculate the full costs of a program (see figure 10 in chapter 10).²

For personnel expenditure, accrual-based appropriations can also cover pension superannuation liabilities. For a subsidized loan, an accrual-based appropriation covers the actuarial value of the interest subsidy. For assets of national interest (i.e., roads), an accrual-based appropriation can include depreciation of these assets.

The distinction between assets of national interest and assets owned by a department is an important element in determining the running costs of a department, and consequently the appropriation for the activities of this department. In the same way, depreciation of assets shared by different programs must be divided among the programs. Determining full costs of a program requires adequate costs measurements systems (see chapter 10).

Figure 1 compares appropriations, commitments, and payments along these three categories of appropriation.

[Please see attached Figure 1.xls]

b. *Authorizations for multiyear programs*

A few countries (e.g. France) include in their budgets, aside from cash appropriations, *authorizations for forward commitment* for some categories of expenditures (mainly for investment). These authorizations for forward commitment authorize commitments covering a multiyear period, but annual appropriations are still required to make payments. In some developing countries, these are shown in the development/investment budget (e.g., Indonesia). They differ from *obligation-based appropriations* which also cover multi-year programs but are authorizations to pay as well as to commit.

In other countries, these authorizations for forward commitment are not included in the budget but are prepared by the government for internal management purposes. For example, in Australia they are defined as a share of the multiyear estimates (see chapter 13) and are approved by the Cabinet. In a few countries (e.g., the U.S.A.) the budget includes multiyear cash authorizations for some programs.

c. *Permanent appropriation/authorization*

Several countries include in their budgets permanent appropriations or authorizations for debt service, entitlements, etc., which is explained by the nature of obligations related to these categories of expenditures. As these expenditures are legally mandatory and recurrent, a different budgetary treatment is understandable. In some countries, for constitutional reasons, salaries of judges are permanent appropriations and are not submitted for legislative approval. However, generally the estimates of relevant expenditures that are to be incurred over the fiscal year are shown in the budget. This is required, whatever the nature of the authorization.

Some countries (e.g., France) distinguish between *restricted appropriations* which give a specific limit and *approximate appropriations* which cover expenditures that are obligatory but cannot be forecasted accurately (such as debt servicing).

d. Gross terms

As indicated above, to formulate and assess correctly the government policy and its activities—including its business activities—expenditures and revenues should be shown in the budget in gross terms, even if the authorization of the Parliament and the budget execution controls concern only netted appropriation (i.e., expenditures that exceed commercial revenues).

e. Annual rule

Budgets are almost always annual (although the “fiscal year” can be the calendar year or some other 12-month period). A shorter period would be disruptive for management; a longer period would be subject to an increasing margin of uncertainty. However, some programs are multiyear and, generally, making shifts in the composition of the budget needs time. The annual framework is generally insufficient for resource allocation and should be supplemented with specific procedures for multiyear commitments and multiyear expenditure estimates (discussed in chapter 13). The annual rule also induces distortions in management when strictly applied and when the carrying forward of expenditure is strictly forbidden (see chapter 6).

2. Basis of the budget

Budget systems can be classified according to the basis of appropriation defined earlier in section 1.a.

a. Cash Budgets

A cash-based budget is a budget where most of the appropriations are on a cash basis. Therefore, in a cash-based budget, appropriations define limits for payment and annual commitment, that is, financial obligations met within the fiscal year and the annual tranche of multiyear commitments (see chapter 6 for a discussion of what is a commitments).

A cash budget fits well the need for compliance and expenditure control. Commitments and payments are controlled on the basis of the authorizations of the Parliament. Macroeconomic objectives, such as the cash deficit, are directly linked to the appropriations.

b. Obligation-based budget

In an obligation-based budget, appropriations define cash and commitment limits, but for certain, there is no time limit for payment. An obligation-based budget needs to be complemented with an annual cash plan for the appropriations that are obligation-based.

c. Accrual-based budget

An accrual-based budget can be defined in two ways:

- A budget where appropriations are on an accrual basis and are *not* a limit for cash payment or commitment (e.g., the New Zealand budget). Cash payments are controlled, but through separate means rather than on the basis of the appropriations (see chapter 8).
- A budget that presents accrual information and projections of the balance sheet of the government, but where appropriations also define cash limits. Many budgets of local governments in developed countries are presented along these lines. In Iceland, the budget is presented both on cash and on accrual basis.

Generally, the term “accrual-based budget” refers to the former definition, which is adopted in this volume except where specified. Hence, cash payments and commitments cannot be controlled directly from accrual-based appropriations and separate additional mechanisms must be put in place to control cash.³

For appropriations, the distinction between cash-based and accrual-based budgets concerns mainly pensions, running costs and in New Zealand, other items such as “purchase of national assets (e.g. national parks, highways, parliament buildings)”. Currently, in New Zealand, transfers and “capital contributions to increase in investment in a department” remain appropriated on a cash basis.⁴ With respect to interest, there is no difference between an accrual-based appropriation and a cash-based appropriation.⁵

An accrual-based budget is aimed at fostering performance. Since full costs are budgeted, agencies have strong incentives for assessing their costs. On the other hand, the presentation in the budget of accrual information on liabilities or interests subsidies presents advantages for transparency and policy formulation. These two advantages are distinct, since improving the budgetary treatment of financial liabilities and subsidies does not require including depreciation into the Parliament’s authorization.

Despite these advantages, attempting to implement accrual budgeting in developing and transition countries would pose major problems. Before thinking of abandoning a cash budget system, the following elements must be considered:

- Accrual budgeting alters the traditional rules for compliance. Parliament’s authorizations would not be cash-commitment-based and would include depreciation. Moreover, for good services, there may be a time lag between the acquisitions and the payments, on the one hand, the consumption of goods acquired and the uses of appropriations on the other, (see chapter 10 for a more detailed discussion). Therefore, if appropriations are established on an accrual basis, it is essential to establish additional mechanisms for ensuring that cash is kept under control, both in budget preparation and in budget execution. Accrual budgeting has proven to be neutral or even good for fiscal discipline in New Zealand, since this country has effective internal cash controls also. In other countries, accrual-based appropriations must be seen as an abandonment of cash controls and therefore opening a new door to misappropriation and corruption.
- Accrual accounting presents advantages (see chapter 10). Accrual accounting does not necessarily mean accrual budgeting although there

terms are commonly confused. Accrual budgeting requires accrual accounting, but developing an accrual accounting system does not require abandoning the cash-based budget (e.g., the U.S. has implemented recently a full accrual accounting system, but has maintained its cash-budgeting system).

- Requirements for “full” accrual accounting, which is a prerequisite for accrual budgeting, are heavy, and a progressive approach to improving accounting would be to focus first on financial liabilities (i.e., to implement what is called a “modified accrual accounting system”).
- Improving cost measurement and assessing full costs is desirable. However, this is not easy and full cost estimates cannot be very accurate at the start. In developing countries, it would be quite questionable to begin with a government-wide exercise and define the use of appropriation on the basis of rough depreciation estimates.

Developing and transition countries should focus on consolidating their cash budget, improving their system for tracking the uses of appropriations (see chapter 6), and gradually improving their accounting system (see chapter 10). As discussed in chapter 15, they could also introduce some elements of performance orientation, as appropriate (not performance budgeting), but this does not at all require a change in the nature of appropriations.

Box 10
Clarifying Some Terms

A few years ago, the adjective accrual was often used in budgetary jargon to define expenditures at the delivery/verification stage. Currently, accrual is defined as in the Generally Accepted Accounting Principles (GAAP) of the accountants' profession. Therefore, the following the areas of confusion should be avoided:

- Expenses versus accrued expenditures. For operating costs, a budget on an accrual basis is does not show accrued expenditures. It shows accrued expenditures plus depreciation plus/less variations in inventories and losses plus/less advance payments.
- Accrual accounting versus "accrued) expenditures accounting. The expression expenditures accounting" which has been used in some countries, refers to the registration of expenditures at the delivery/verification stage. Monitoring expenditures at this stage is a key element for sound budgeting, and is strongly recommended, but if is not accrual accounting. (In theory, accounting for expenditures at the delivery/verification stage is the only way of assessing the arrears accurately. Accounting only for commitments over estimates arrears.)
- Accrual accounting versus modified accrual accounting. Some accounting systems that were called accrual accounting systems in the early 1980's should now be called "modified accrual accounting system" (see chapter 10), as "accrual accounting" for government corresponds today to commercial accounting. In this volume, the expression full accrual accounting is used instead of accrual accounting when necessary to avoid any confusion between "accrual" and "modified accrual.
- Operating deficit (deficit on an accrual basis) versus deficit on a commitment basis. A commitment refers to an order placed or a contract awarded. In budgetary jargon, the deficit on a commitment basis is often similar to the deficit on a cash basis plus change in arrears. It does not at all correspond to the operating deficit defined by accrual accounting principles (see chapter 10).

3. The traditional approach: Compliance budgeting

A major aim of the traditional budgeting system is to make the budget a tool for financial compliance. A cash-budget fits this aim.⁶ Within the budget, expenditures are classified by organization and object of expenditure (line item), e.g. transportation of things, full-time personnel, etc., to control the use of resources. Budgets prepared in this way are often very detailed and in some countries include several thousand line items.

Line-item budgets were (and in a number of countries still are) associated with an "input-oriented" budget preparation with detailed ex-ante controls and/or rigid appropriation rules (e.g. rules regulating or forbidding transfers between line items). However, these aspects can change country by country. In a number of countries, the control system is aimed only at avoiding transfers between personnel expenditure and other items, and detailed line items may be included in the budget for information only. Therefore, one should not confuse a justified criticism of an excessively detailed and rigid line-item budget with criticism of line-item budgeting itself.

A major criticism of the traditional budget system is that it does not deal with key issues of government objectives, their links to the budget, the services to be delivered by the government; the search for the most efficient combination of inputs to deliver services, etc. Thus, since the early 1950s, various performance/program budgeting reforms in both industrialized and developing countries attempted to address these issues. As reviewed briefly below, the results of these reforms have been usually disappointing compared with their costs, and in a few cases even counter productive.

In the 1980s, the focus changed to macroeconomic stabilization, and budgetary reforms were essentially aimed at making the budget an effective tool for fiscal policy. Several developing countries still imported performance/program budgeting approaches (with generally poor results), but PPBS was no longer the dominant international paradigm. As long as it is comprehensive and includes an appropriate economic classification, the traditional budget format fits well the requirements for macroeconomic stabilization. Currently, performance-oriented budgeting approaches are regaining popularity.

4. Performance/Program budgeting⁷

It is fundamental not to confuse performance orientation in the budget system, which can be fostered in a number of appropriate ways, with the specific system known as *performance budgeting*. In performance budgeting, the budget shows the purposes of the expenditure, the costs of the “programs” proposed for those purposes, and measurements and results under each program. Therefore, performance budgeting includes the following features:

- Government activities are divided into broad functions, programs, activities, and cost elements. A “function” corresponds to a broad objective of the government (e.g., promotion of agriculture). A “program” is a set of activities that meet the same set of specific objectives (e.g., development of crop production). An “activity” is a subdivision of a program into homogenous categories (e.g., irrigation project). Cost elements are the inputs, and costs are measured on an accrual basis. A criterion used to delimit the activity category is the level at which performance indicators can be elaborated and costs measured. The operational aims of each program and activities are identified for each budget year.
- Performance indicators and costs are established, measured, and reported. (In the 1950s, the aim was to establish standards and norms, again with highly doubtful impact.)

The hierarchy of “function,” “program,” and “activity,” is comparable to that of the government structure (“ministry,” “directorates,” and “divisions“ or projects). But there is no systematic relationship between the functional structure of the budget and the organizational structure of government. Indeed, a major problem with program budgeting is the disconnect between the program structure and the administrative structure⁸ and the resulting complexity, lack of “ownership”, and loss of accountability. Figure 2 shows the relationship between program/activity categories and other classifications.

[Please attached Figure 2.xls]

The first experience with performance budgeting on a wide scale was launched in 1949 in the U.S., following the recommendations of the Hoover Commission. Emphasis was put on full cost measurement, evaluation of workload, and unit costs. The 1951 U.S. budget included listings of the programs or activities by budget account and narrative statements of program and performance, some of them presenting workload and cost information, calculated on an accrual basis. The experiment was a failure and the U.S. abandoned it soon thereafter, although some of the lessons learned proved useful later and were incorporated into the budget reforms of the 1990s.

A generation before the emergence of the “New Public Management” (see annex V), a performance budgeting experiment was launched in 1954 in the Philippines, following the U.S. example. For fiscal year 1956, twelve government agencies adopted a performance budget model; detailed line items were abandoned and expenditures were presented in the budget by blocks corresponding to programs and projects. The system reverted back to the more traditional model, as a result of the constant complexities of the “performance budget” and some loss expenditure control. Currently, the resulting presentation is basically for information, showing capital and current expenditures for each agency and subordinate spending unit and performance indicators. The preparation of budget submissions focuses on programs rather than on line items. However, these changes in the budgetary decision-making process are more formal than real.

In the U.S., by 1964, 80 percent of federal agencies provided cost information in their budget requests. However, the need to take into account also the qualitative aspect of expenditure led to the Planning Programming Budgeting System (PPBS), launched in 1965. PPBS aimed at ensuring a better linkage between objectives and goals, programs and activities. In the planning phase, systems analysis was used to establish the objectives and identify related solutions. At the programming stage, means were reviewed and compared to the solutions identified at the planning stage. Sets of activities are grouped into multi-year programs, which are appraised and compared. Finally, the budgeting phase translates these programs into the annual budget.

The initial objective of PPBS was to integrate program budgets into budgetary decision making and to overcome administrative compartmentalization by making

programs independent of organizational affiliation. PPBS proved impossible to implement not only because of (predictable) bureaucratic resistance, but because reaching a perfect and indisputable rational organization of government objectives and activities is illusory. In addition, this approach muddled up ministers responsibilities and hampered accountability.⁹ Program budgeting and PPBS-like approaches were attempted over and over again in many developed countries in the late 1960s and the 1970s, but generally not for long and were abandoned in the 1980s.¹⁰

In the late 1970s, another experiment—Zero-Based Budgeting (ZBB)—was attempted in the U.S. as a reaction to the drawbacks of purely incremental budgeting (see Chapter 4). In a pure ZBB system all programs are evaluated each year and must be justified from scratch. The fact that resources have already been granted to a program does not necessarily mean that it must be continued. The ZBB approach is useful for occasional expenditure reviews, but is practically impossible to undertake each year for the preparation of the annual budget. In actual fact, ZBB was accommodated by focusing scrutiny on a few marginal programs. In any event, the U.S. Congress decided to review the traditional budget presentation and put aside the voluminous and complex ZBB documentation.

In developing countries, attempts to introduce program budgeting and systems to manage were been pursued in the 1980s, rarely drawing on the lessons of experience of the previous decade, and usually with the encouragement (or pressure) of international donors and enthusiastic endorsement of international consultants⁹. In Asia, aside from the Philippine experiment mentioned above, experiences in program/performance budgeting were carried out in India, Malaysia, Singapore and Sri Lanka. Results were uneven, and far from the initial ambitions of the proponents of the PPBS system in the 1960s. Experience was similarly unfavorable in Latin America (Petrei, 1998). As a result, (and probably for good reason) in developing countries where program budgeting was introduced, it has typically been sidelined and its role sharply reduced compared to the initial design. Quantitative program goals are defined, but “play no role in budget discussions, nor are they used to monitor the use of program funds” (Petrei, 1998, p. 391). Much the same has happened in Asia and the Pacific. On the positive side, these experiences have contributed in some countries to improve the presentation of the budget. Also, it is possible that they may have led to a somewhat greater performance

orientation by budget officials although, as noted, there is a variety of less costly ways to introduce greater focus in performance.

Box 11
Program Project Activity in the Philippines: An Example of Budget Presentation

Department of Health

A. Programs

I. General Administration and Support

II. Support to Operations

- a. Health information and health education services
- b. Health human resource development program
- c. Health policy and development program
- d. Department legislative liaison office
- e. Executive liaison and coordination
- f. International health relation
- g. National drug policy
- h. Essential national health research
- i. Support to regional health training centers
- j. Local government assistance and monitoring service

III. Operations

- a. Public health services
- b. Public health care program
- c. Health facilities and operations
- d. Standards, regulations, licensing and regulations, and other health facilities
- e. Provision of drugs and medicines, medical and dental supplies and materials, vaccines, reagents, and other biological supplies

B. Projects

I. Locally-Funded Projects

- a. Provision for construction, improvement, repair and rehabilitation/renovation and purchase of equipment of special hospitals, medical centers, sanitarium, regional hospitals, central office and regional field health offices and financial assistance to other health facilities on a priority basis.
- b. Acquisition of ambulance and other health related equipment
- c. Aid to Dr. Jose Rizal Memorial Foundation Hospital in Dasmariñas, Cavite

II. Foreign-Assisted Projects

- a. First Water Supply, Sewerage and Sanitation Sector Project (IBRD Loan No. 3242 PH)
- b. Philippine Health Development Project (IBRD Loan No. 3099 PH)
- c. Palawan Integrated Area Development Project (ADB Loan No. 1033/1034 PHI)
- d. Urban Health and Nutrition Project (IDA Loan No. 2506 PH)

Source: General Appropriations Act, Philippines, 1998.

5. Other performance-oriented approaches

a. *Increased flexibility*

Some countries (e.g., Australia, Sweden, Singapore) have recently introduced “block” appropriations which involve allocating a lump sum to line ministries or agencies, which are then free to determine the best mix of economic inputs to produce their services. Canada’s Envelope Budgeting System of the 1980s was in many ways a precursor of these block budgets.

While increased flexibility in budgeting is desirable in principle, without a hard financial constraint it is likely to lead to the “needs” mentality which is antithetical to good PEM (see chapter 4). Given a hard financial constraint, the appropriate degree of flexibility depends on the country’s context, especially the soundness of governance system and the accountability regime. Thus, for example, eliminating the separation between wage and non wage expenditure could have undesirable outcomes in many developing countries and transition economies, by leading to even greater overstaffing than is the case, even lower maintenance expenditure, and opening up new possibilities for corruption. Weak compliance may require accurate monitoring of budget execution of specific particular items (see chapter 6).

A number of developed countries have reduced the number of appropriations in their budget in to increase flexibility in project and management. This is desirable in a number of developing countries that define an appropriation for each subordinate spending unit within a ministry or a department, or for each project. However, the policy objectives should be clearly presented to the legislature and should not be altered during budget execution (e.g., it would be questionable to mix primary education and higher education into one appropriation or to allow unrestricted resource transfers between these two subsectors). But certainly, excessive detail in line-item classification and rigidity of rules lead to inefficiency and disempowerment without any corresponding advantage.

Some developed and developing countries have adopted a progressive approach to granting flexibility to line managers, linking it to some agreement on goals and performance. This approach is notably developed in Malaysia (see box 12). It could fit the situation of several developing countries or transition economies which do need to make their budget systems more flexible and efficient, while avoiding the risk of overruns in public spending, weaker expenditure control, or wider corruption.

Box 14
The Modified Budget System In Malaysia

The Modified Budgeting System (MBS) was first introduced in 1990. Under this system, the Controlling Officer is responsible for determining the performance of his department in terms of output and impact, which are recorded in the program agreement for his department. The program agreement is a document that records inputs, outputs and impact of an activity as agreed upon between the Federal Treasury and the department during budget execution.

To enable Controlling Officers to manage their resources more effectively, a generalized approach to expenditure control would be used. Controlling Officers are given greater powers in the utilization of the organizations resources. For example, they can transfer resources across activities within a particular program without prior approval from the Treasury. Input monitoring, however, is not abandoned.

Source: Tan Sri Dato' Seri Ahmad Sarji bin Abdul Hamid, Chief Secretary of the Government of Malaysia, "Improvements in the Public Service for the year 1992," 1993.

b. Instruments for measuring and improving performance¹¹

As explained in more detail in chapter 15, several countries have developed performance measurement systems. An emphasis is put on the "3Es", that is, Economy, Efficiency, and Effectiveness. Economy is "the acquisition of the appropriate quality and quantity of financial, human and physical resources at appropriate times and at the lowest cost concerned,"¹² and may be assessed through input measures and comparisons with norms and standards. Efficiency is the relationship between outputs and the resources used to produce them, and is measured by cost per unit of output. Effectiveness is the extent to which programs achieve their expected objectives, or outcomes. *As a general rule, performance should be measured by that mix of input, output, outcome that is appropriate to the specific sector in the country concerned during the relevant period.*

From the budgetary point of view, developing greater performance orientation calls for giving more responsibility to managers; developing realistic indicators; and cost measurements; implementing accrual accounting in the agencies that deliver services; and structuring the ministries' budget to set up performance indicators at the appropriate level (the activity or an agency sub program). However, performance orientation does not necessarily call for major changes in the budget system. Inputs are still important as a budgetary guideline; the link between performance and the budget is indirect and often inferential rather than direct and automatic; and budgetary pressure moves the use of performance indicators more to the ex-post evaluation.¹³ This assessment, drawn from the experience of developed countries, is even more applicable to developing countries, with their weaker governance system and administrative capacity limitation. Indeed, the confusion between performance orientation as the goal and performance budgeting as *one* means of fostering such orientation, has led to the costly introduction of program budgeting (or output budgeting) without any positive impact on performance orientation itself. In most developing countries, regardless of the budgeting innovations introduced, some form of line-item budgeting should be kept as an essential safeguard of the public resources.

c. *The “agency model” and the accountability framework*

Following the approach developed by the United Kingdom under its Next Steps program, some countries are developing an organizational model that separates the delivery of services and administrative tasks from policy formulation. By drawing a boundary around operational functions (such as payment of pension checks) and giving the task to a separate entity, the responsibilities and expected performance can be clearly specified and staff and managers can be made accountable for performance.¹⁴

In theory, this approach could improve efficiency in service delivery. However, caution is required before considering its implementation, especially in developing countries or transition economies. The “separate entity” can easily in practice deteriorate into extra-budgetary fund and disappearing budgets (see chapter 2 B.1). It is also questionable whether organizational reform is really needed to clarify mandates (e.g., compared with appropriate delegations of authority). Finally, there are risks for both

sound policy-making and effective implementation in an excessively rigid boundary between the two, with policy formulation increasingly isolated from realities of delivery of programs and services.¹⁵ No general statement can be made on these issues other than to emphasize the grave risk of importing these practices without careful consideration. Their applicability depends on experience, culture, and administrative capacity each country.

Several OECD countries have extended their accountability framework. The traditional accountability for financial compliance is maintained, but has been extended to accountability for efficiency and economy in operations and to some accountability for outcomes. Line ministers and/or agencies are accountable for their performance, assets and liabilities. Full financial disclosure is required from them. Each agency is viewed as a separate entity with its own accounts, and must produce annual financial statements that disclose its financial performance, assets, and liabilities.

d. Output budgeting

Output budgeting, which has been adopted in New Zealand, and, to some extent, in some Pacific Island countries, represents the culmination of the performance budgeting approach and, as such, carries all its advantages and risks. The data requirements, methodological difficulties, and demands on implementation capacity are vast. Output budgeting is based on the "principal-agent" paradigm, whereby the ministers are seen as principals and the executive agencies as their agents. "For example, the Police Commissioner contracts with the Minister of Police to provide a certain level of policing services, patrols, community security programs, road safety commercials, etc. The commissioner does not contract to lower the crime rate.¹⁶ The crime rate is affected by many variables beyond the control of the Commissioner."

In New Zealand, a single agency may have as many as 150 outputs (e.g. for the Treasury).¹⁷ Budgetary appropriations are defined by classes of output. Output classes are category of conveniences and are defined by the act as any grouping of similar outputs.¹⁸ They are more or less similar to what is called in other countries, a subprogram or activity. Appropriation management rules (transfers between classes, budget execution controls by the Auditor-General) are established at this level.

The number of appropriations is relatively high. There are about 500 to 700 appropriations (classes of output) in the budget.¹⁹ "One factor that explains the number of output classes is the effort to ensure that funds are spent on particular activities (such as managing contracts) and are not pooled with other administrative expenses."²⁰

The costs of outputs are determined on the basis of the costs of inputs. This mode of calculation and the number of output classes have not yet allowed the budgeting processes to be fully output-oriented.²¹ However, it is expected that some outputs will be classified into a class C where their costs would be based on output prices instead of input prices (e.g., benchmark prices).

As noted, the data, administrative, and transaction requirements of implementing an output-budgeting system are heavy, and include an accrual budgeting system cost measurements, contract negotiations between ministers and managers, and intensive monitoring of results, including the elusive factor of output quality. The benefits could be substantial in theory, but there is little evidence of a positive across-the-board impact of the approach, even in New Zealand.²²

The Ministry of Finance officials in most developed countries have considered output budgeting and concluded against recommending it. As for developing countries, the international consensus is that the approach is wholly unsuitable, although a few exceptions are conceivable.

B. EXPENDITURE CLASSIFICATION

1. The importance of a good classification system

Classifying expenditures is important in policy formulation and the identification of resources allocation among sectors, the identification of activities of the government and the level at which performance should be assessed (if a performance-oriented approach is developed; see chapter 14); the establishment of accountability for compliance with the Parliament's authorizations, policies, and performance; analysis; and day-to-day budget administration. An expenditure classification system provides a normative

framework for both policy decision making and accountability. The best-known classification systems are the functional “Classification of the Functions of the Government (COFOG),” developed by the United Nations, and the Government Financial Statistics (GFS) classification, developed by the IMF. Other classifications, however, can also be useful, as discussed below.

Expenditures must be classified for different purposes, such as: the preparation of reports that fit the needs of report users (policy decision makers, the public, the budget manager); the administration of the budget and budgetary accounting; and the presentation of the budget to Parliament.

Paradigms in public expenditure management often govern the organization of the expenditure classification system, but paradigms change from time to time. To respond to different demands and needs the solution is not to find the budget classification that fits a paradigm, but to identify elementary classifications that are needed. Undoubtedly, the function of these elementary classifications in the budget process will depend on the approach to public expenditure management, but the first step is to establish them in a coherent manner.

Expenditures should also be reported along the international standard classification, defined in GFS. However, it should be noted that the GFS manual provides guidelines on classification for reporting purposes only. They are not intended as budget or account classifications. Moreover, GFS focuses only on economic and functional reporting, while a budget classification needs to be an instrument for policy formulation, budget administration and accounting.²³

According to the different needs for policy formulation, reporting and budget management expenditures must be classified according to the following categories:

- *function*, for historical analysis and policy formulation (e.g., COFOG);
- *organization*, for accountability and budget ration;
- *fund* (source of financing, EBF-special accounts, if any)
- any other category needed for budget ration or to take into account special requirements;

- *economic* category, for statistics (GFS) and *object* (i.e., line item), for compliance controls and economic analysis;
- *program* and activity and output, for policy formulation and performance accountability (depending on the definition of these categories and on the approach to public expenditure management).

This section concerns only issues related to the classification of expenditures. Issues related to the organization of budgetary accounting are reviewed in chapter 5 and issues related to government overall accounting are reviewed in chapter 10.

2. The U.N. Classification of the Functions of Government (COFOG)

A functional classification organizes government activities according to their purposes (e.g., education, social security, housing, etc.). It is independent of the government organizational structure. A functional classification is important in analyzing the allocation of resources among sectors. A stable functional classification is required to produce historical surveys of government spending and to compare data from different fiscal years.

The Classification of the Functions of Government (COFOG) established by the United Nations is presented in the SNA and GFS manuals. The objective of COFOG is to give a standard classification for international comparisons. It consists of 14 major groups, 61 groups and 127 sub groups.²⁴ The COFOG, or at least its 14 major groups, is widely implemented in developing countries. Oftentimes, however, industrialized countries have their own functional classification, which may be either limited to about 10 to 15 functions, or much more detailed.

For developing countries that do not yet have their own functional classification, adopting COFOG instead of a customized classification presents significant advantages. It is already established and well-documented in the GFS manual. It facilitates international comparisons.

A country may desire to reorganize the COFOG classification, as it is considered in GFS.²⁵ In this case, a mapping table between COFOG and the country functional (and

program) classification or between the country organizational classification and COFOG should be established to allow reporting when needed under COFOG.

Public reports showing expenditures along functional categories should be prepared. They do not need to be excessively detailed, but should show at least government expenditures along functions similar to the 14 major groups of COFOG, completed by the most important groups (box 13).

Box 13**FUNCTIONAL CLASSIFICATION: Grouping of COFOG Functions as shown in GFS***Code**COFOGE***General public services and public Order**

- 1 General public services
- 3 Police order and safety affairs

2 Defense**Social Services**

- 4 Education affairs and services
 - 4.1 Preprimary and primary education
 - 4.2 Secondary education
 - 4.3 Tertiary
 - 4.4-6 Other
- 5 Health affairs and services
 - 5.1 Hospitals
 - 5.2 Clinics, practitioners
 - 5.3-6 Other
- 6 Social security and welfare
- 7 Housing, water supply. Sanitation
- 8 Culture and Recreational affairs

Economic Services

- 9 Fuel and energy affairs
- 10 Agriculture, forestry, fishing and hunting
- 11 Mining-Manufacturing-Construction
- 12 Transportation and communication
 - 12.1 Roads
 - 12.2-6 & 8 Other transport
 - 12.7 Communications
- 13 Other economic affairs and services

14 Expenditures not classified by major group

- NC Interests
- NC Intergovernmental transfers

3. GFS Economic classification

An economic classification of expenditures is required for budget analysis. Issues such as, the share of wages in government expenditures, and the weight of transfers to public enterprise, for example are crucial. At the very least, the economic classification must be fully consistent with the GFS economic classification of government expenditures. The object/line-item classification is more or less an economic classification, but, in many countries should be, revised or reorganized to be compatible with the GFS economic classification.

Reports based on GFS generally use net concepts, for “lending minus repayments,” “financing,” and “net surplus or deficit of departmental enterprises,” although the memorandum items of GFS include the gross flows. It must be stressed that these net items can be sufficient for macroeconomic analysis, but not for budget formulation and management. In the accountants' books, gross flows must be recorded. From the policy formulation point of view, the item “lending minus repayments” should be to separate loans, repayments, acquisition and sale of equity or assets detailed broken down (assets acquired for policy purposes are consolidated with lending in GFS)²⁶.

The SNA classification is different from the GFS. Full reporting along the SNA in preparing the national accounts is desirable. However, this issue is related to the implementation of an accounting system covering, besides the budgetary operations, the assets and the liabilities of the government (see chapter 10). GFS is moving to an accrual basis for reporting government expenditures and liabilities, in the interest of creating greater statistical comparability between fiscal and national accounts.²⁷

Box 14
GFS Economic Classification

Expenditures for goods and services
 Wages and salaries
 Employer contributions (pensions—social contributions)
 Other goods and services
Subsidies
Current transfers
Interest
 Domestic
External
Capital expenditures
 Capital expenditures
 Capital transfers
Lending minus repayment (1)
 Loans
 Repayment of loans
 Sales of assets
 Other

(1) Not presented in the 1986 version of GFS. Source: IMF.

4. Object (line-item) and input classification

For budget management purposes, the traditional budgets include an object classification (also called “line-item classification”).²⁸ This object classification groups purchases along categories used for budgetary control and monitoring, such as different categories of personnel expenditures, travel expenses, printing. For goods and services, the object classification is an input classification.

a. Relationship with an economic classification

As indicated above, the object (line-item) classification needs to be compatible with the GFS economic classification (with details for the item “lending minus repayment”). Often, for goods and services, this requires only to grouping the objects into sets of objects that fit the GFS classification. This can be done by reorganizing the object classification to make the objects a subcategory of GFS economic categories, or any other method of grouping. For transfers and other items, it may be necessary to provide break down of objects into homogenous categories that fit the GFS classification, but this concerns only few budget items, compared with goods and services.

The economic classification of development expenditures, which in several developing countries is distinct from the object classification, must also fit the GFS standard. In some countries, all development expenditures are classified as capital expenditures, although the development budget includes goods and services expenditures, while the recurrent budget includes capital expenditures.

A unified economic classification covering both the recurrent and the development budgets is needed. Subcategories of this classification can be specific to either the recurrent or the development budget, for example, transport of things in the recurrent budget and consulting services in the development budget. Nevertheless, both budget must share at least a basic economic classification that fits GFS.

Capital expenditures should be defined strictly according to the SNA standard. The SNA definition of capital expenditures does not correspond necessarily to the country's common definition of capital expenditures. This requires defining a subcategory that fits the SNA definition within the country's category, capital expenditures.²⁹

b. Management and control implications

The object classification is or was often associated with ex-ante detailed controls. A budget formulation focusing mainly on inputs and rigid appropriation management rules (i.e., rules for transfers between line items) leads to poor budgeting. In several countries, this requires revising appropriation management rules and often to rationalizing object classification. Budget execution control processes are discussed in chapter 6.

However, issues related to controls or line-item budgeting should not lead to abandoning input classification, which is required in any management system. For internal management, close monitoring of inputs is required. The Ministry of Finance does not need to review the allocation of resources between expenditures for paper and other supplies, but the managers of the spending units may need to do so.

Some expenditure items for which there are risks of arrears generation (such as utilities' services consumption) must be monitored centrally in many countries. Moreover, in some countries, rules for either protecting some items (such as electricity consumption) or on the other hand capping other categories of expenditures (e.g. mission of ministers abroad) are desirable. However, these rules should focus on what is necessary and are not supposed to be permanent. What can be a problem for compliance one year will not necessarily be a problem the following year.

Regarding aspects related to control, some line-item classifications are both too detailed and yet not adequately specified. The solution is not to increase the number of items, but to incorporate a special item temporarily into the classification whenever so required.

c. *Input classification for “expenses”*

The traditional object classification as well as the GFS economic classification concerns expenditures. Under an accrual accounting system, expenses instead of expenditures are posted. The economic classification must be complemented by categories proper to expenses (e.g., depreciation of physical assets, superannuation liabilities)³⁰.

5. Administrative classification

An administrative classification of expenditure (by governmental organization) is needed for clear identification of responsibilities in public expenditure management and also for day-to-day administration of the budget. Expenditures must be divided into separate sections for each ministry, department, or agency. The administrative classification of expenditures obviously needs to be tailored to the organizational arrangements for public expenditure management (e.g. the hierarchical levels within a line ministry that deal directly with the "Treasury"). The administrative classification should be organized along the different levels of responsibility and accountability in budget management (e.g., the entity that is accountable to Parliament, the administrative levels that deal with the Ministry of Finance for budget preparation).

In some countries, expenditures are presented by organization but not always at the same level of aggregation heterogeneous manner. For example, personnel expenditures are presented by ministry, while other current expenditures are presented by lower level government entities. This could be suitable for administration and controls, hampers the assessment of the running costs of the different department and agencies.

6. Program classifications

As discussed earlier, a program is a set of activities that meet the same set of objectives. Compared with COFOG functions, a classification by program takes into account the country policy objectives or administrative context.

In some developing countries, a classification of expenditures by program has been set up, often as part of attempts to implement a PPB system. To establish these programs, an exercise to establish the chain objective-program has sometimes been carried out. However, programs are often barely a nickname for an organization, or a sub-function of the COFOG, or only a grouping of individual investment projects, while the recurrent budget is presented in the traditional manner. Programs may be located within a line ministry or be a cross-ministries.

The major problem when preparing a program classification is avoiding both an overambitious approach that can not be implemented and an approach that would be limited to adding useless categories to the existing classification system. A classification by program can be recommended for different purposes, from developing a performance-oriented budgeting approach to increasing the readability of the budget. In the latter case, the COFOG classification can be program classification, provided that it is supplemented with other classifications dealing with special policy issues relevant to the country's policy context (e.g., an environmental program, a nuclear program).

The issue of reconciling of the program classification with the organizational structure of the government is one of the points that generated debates on the pros and cons of program budgeting and explains its failure. Actually, to set up performance indicators, accountability requirements suggest that the organization of programs and activities should fit the governmental structure. Programs should be defined by line ministries and could in a majority of cases, correspond to a major subdivision of this line ministry. Activities or subprograms should be defined in the most convenient manner to establish performance indicators (see chapter [performance]). The classification of expenditure by activity cannot be established from the top and must be prepared by relevant line ministries and agencies and then discussed with the Ministry of Finance.

Interministerial programs can be established for special cross-cutting issues. However, it is certainly not necessary to reorganize the whole budget classification system to take into account a limited number of interministerial programs. A table annexed to the budget showing which activities are covered by these intersectoral programs is sufficient for decision-making and for follow-up the program implementation.

7. Expenditure classification in an output budgeting system

Output budgeting requires distinguishing appropriations related to outputs from other appropriations. Thus, the New Zealand budget distinguishes the following seven classes of appropriation.³¹ "(i) output classes, e.g., policy advice, management of contracts, policing, custodial services, etc.; (ii) benefits, e.g., unemployment, domestic purposes, scholarships; (iii) borrowing expenses, e.g., interest expenses, premiums, borrowing, other finance costs; (iv) other expenses, e.g., restructuring costs, litigation costs, loss on sale of fixed assets, overseas development aid; (v) capital contributions, increase in investment in a department or an SOE to increase its output capacity or improve its efficiency; (vi) purchase and development e.g. state highways, national parks, Parliament Buildings of capital assets and; (vi) repayment of debt e.g., foreign currency debt repayment. Benefits and capital contributions are appropriated on a cash basis, borrowing expenses on an accrual basis, but this is also done in a majority of countries with a cash budget system. Outputs are appropriated on an accrual basis.

8. Other special classifications

In developing countries, expenditures must be classified by source of financing (domestic resources—consolidated fund and counterpart funds—loans, grants).³² EBFs or Treasury special accounts if any, need to be identified.

Other special classifications may be needed for managing the budget. For example, Parliaments often request a presentation of expenditures by region. This issue depends on the country context, but must be kept in mind when reviewing a budget classification system. An information system for budget management must be able to integrate classification requirements that were not expected when it was designed.

9. Implementation issues

a. Expenditure classification and budget management

From the budget management point of view, the most important issues related to expenditure classification are the following:

- *For tracking uses of appropriations (“budgetary accounting”),* organizing the books, coding the transactions, etc., it is necessary to define an expenditure classification that includes at least the administrative classification (possibly completed with a subdivision of spending unit by activity), funding (financing source, EBF, if any, etc.), and the economic-object classification.
- *For presenting the budget to the legislature,* it is necessary to define the appropriation, i.e., what is binding for the executive (e.g., the budget of a ministry, a program within a ministry, each individual object).
- *For managing the budget,* it is necessary to determine at which level rules for transfers between budget items (“virements”), controls, etc., are established (i.e. at line-item level, at economic category, at the level of programs, etc.). Sometimes, a “rationalization” of the object code has led to increased ex-ante controls or to their extension to the development budget, because additional line items have been introduced. A change in budget classification must include a review of appropriation management rules and of the impact of the change on the administration of the budget (appropriation management rules are discussed in chapter 5).

b. Administrative and institutional issues

Classifying expenditure requires first an identification of the technical and institutional constraints on reforming the system. Attention must be paid to the organization of the books and the information systems. For example, when interest is mixed with amortization, there is an obvious need to separate them, but even more important is the scrutiny of how the debt management office keeps its books. Also, badly designed or documented information systems can be an obstacle to reforming expenditure classification. Therefore, a review of current applications and software is generally required when reforming the expenditure classification system³³. On the other hand, software and application developments should not only be compatible with the existing classification but also allow further changes in classification.

Reforming expenditure classification cannot solve deficiencies in reporting caused by institutional arrangements. A powerful extrabudgetary fund will not want to show its expenditures along *any* classification, whatever the classification system.³⁴ Compatibility with COFOG, GFS, or anything else will not resolve deliberate and systematic misreporting. Bad, or badly-presented, information is useless under any classification. Institutional issues must be addressed as such.

c. Reporting along COFOG and coding

Changes in the organization of the books should focus on what is required to identify transactions properly. Often, a reform of the budget classification system attempts to include into the hierarchical nomenclature or the codes used in the day-to-day administration, the codes of all categories needed for reporting (COFOG, program, etc). Consequently, the coding system used to register the transactions becomes cumbersome and difficult to manage; when budget execution is not fully computerized. This has contributed to halting or delay the reform of the expenditure classification system in several countries. Fortunately, these cumbersome nomenclatures can be avoided, as explained below.

For example, countries that have a detailed administrative classification do not need to change the format of the books or the coding of their forms to report under COFOG. They need only to classify spending units along COFOG. (A similar suggestion is made in the SNA and GFS manuals³⁵). If a report on payments is available by division/project and if division/projects are classified along COFOG, it is possible to present the payments along COFOG simply by linking the report on payments and the table that classifies organizations along COFOG categories. This can be done easily with a personal computer and a spreadsheet. In a few special cases, where several functions are assigned to a spending unit, it is necessary to classify the activities of the relevant organizations along COFOG, but this does not require a major change in the classification structure.

A similar approach can be adopted for programs. Figure 3 shows the different expenditure classification subsystems needed for reporting and budget management, and the relationships among them. Crosswalks between the activity category and the

object and other categories needed for administration give the lowest common denominator of the expenditure classification subsystems.³⁶ The coding system used in the day-to-day administration of the budget must identify this lowest common denominator, but does not need to describe all its attributes. The activity can be attached to organizations, functions, and programs, but need not be attached to all these categories when coding the forms, vouchers, etc. A small addition to the administrative code is sufficient to identify the activity. Therefore, in the day-to-day administration of the budget, to present expenditures by program or along the COFOG classification it is sufficient to recorded for each transaction the administrative code, an activity code established by spending unit or project and, the object and financing source codes.

[Please see attached Figure 3]

In a number of countries, a hierarchical budgetary nomenclature (coding system) is used in the day-to-day administration of the budget. The nomenclature is organized as follows: line ministry → directorate → spending unit → object → the budget code including the administrative and object codes. Hierarchical, or decimal, coding helps in classifying homogeneous categories and is useful within a manual management environment, but it should be simple, and redundancies should be avoided. Within a computerized environment, on the other hand, hierarchical nomenclature is not very useful. The first task of an informatics expert when setting up a budget data base will therefore be to detail the hierarchical nomenclature in order to set up tables and link them by relationships. Each table should correspond to only one category of the budget classification system, and codes should be defined table by table, category by category.

C. PRESENTATION OF THE BUDGET

1. Major requirements

The budget submitted to the legislature should include all elements needed to assess budgetary and fiscal policy and present the appropriations according to the needs for legislative control by the Parliament. Revenues, expenditures, and the fiscal outturn should be presented together.

Concerning the expenditure side, one may distinguish: (i) a “main” presentation, on the basis of which appropriations are voted; and (ii) annexes that give additional information.

2. “Main” presentation of the budget

The main presentation of the budget includes estimates that show appropriations. In some countries, authorizations are granted through an “appropriation act, while in other countries, the appropriation is defined as a level of the expenditure classification system.

In the budget, the appropriations may or may not include sub-items for information only. Some countries present thousands of line items in the budget while others have very few. Thousands of line-items make the budget difficult to read and require summaries to make the presentation readable. The optimal number depends on country-specific factors, primarily on the rules governing transfers among these appropriations, and on the organization of the government.

Some countries limit, the number of appropriations to 20 or even less. However, most of these countries also have a detailed annual expenditure plan by organization, program, and economic category, which is either internal to the executive (as in China and Vietnam) or presented through various annexes to the budget. Two distinct situations may be found:

- In some countries, the presentation of the budget to Parliament is a pure formality. Where the executive has all the power, many of the issues discussed in this manual are not relevant, notably, the nature of appropriations, the comparison of cash controls with accrual-based controls, accountability rules, financial reporting, etc.
- In other countries (e.g. some FSU countries, before the current reforms), elements of the annual expenditure plan are discussed in Parliament committees. Line ministries go to the committees to negotiate items in expenditure plan prepared by the Ministry of Finance. The Parliament thus

plays an important role in budgetary bargaining. However, the lack of a comprehensive, formal, and public budget impedes sound decision making.

The main presentation of the budget should clearly identify responsibilities in budget management. The appropriations should be presented by line ministry and independent agency, and by their major subdivisions. In several FSU countries, the budget is or was presented by program instead by line ministry or agency. Reforms are currently under way to remedy this problem (e.g., Ukraine for instance, reformed its budget classification system in 1997).

In several developing countries, the recurrent budget is presented by line ministry but the development budget is presented by broad function, program, and project. This fits a planning implementing the development programs must be shown. Moreover, presenting development expenditures and recurrent expenditures together under the same administrative headings (but under separate appropriations) is required for an assessment of the overall budget of a line ministry or an independent agency. Therefore, within the main presentation of the budget, development projects should be seen as an administrative category, and classified by line ministry or independent agency.

3. The need for separate presentation of current and capital budgets

Administrative considerations are generally more influential than economic or policy considerations on the decision of whether a given expenditure is included in the current or the “development” budget. Procedures for administering the recurrent budget are generally not suitable to the management of some categories of expenditure, particularly expenditures by external sources and construction projects. Generally, regulations to implement the “development” budget are much more flexible than those for the recurrent budget.

Projects financed by donors are often of composite nature, and may include both current and capital expenditures, particularly in the social sectors. They have nevertheless a single project manager and are often submitted to special reporting requirements from donors. Thus, although the distinction between “recurrent” and

“development” expenditures is artificial and questionable, for accountability and management purposes aid-dependent countries are obliged to follow it in the presentation of the budget. This state of affairs would change only if donor requirements and the basic modalities of project-centered assistance are fundamentally changed, which could present vast advantages in terms of the development impact of the assistance and the functioning of the PEM system in developing countries.³⁷

Thus, for management purpose, in most aid-dependent countries “development” projects must be separated from other expenditures. However, presenting together development expenditures together with recurrent expenditures under the same administrative headings (but under separate appropriations) is required in order to assess the overall budget of a line ministry or an independent agency. In countries with dual budgeting, such unified presentation will not eliminate all the negative effects of dual budgeting processes discussed in chapter 4, but will facilitate scrutiny of sector budgets.

Within the “main” presentation of the budget, development projects should be seen as an administrative category, and classified according to line ministries or agencies. Therefore, in aid-dependent countries or in countries that have a dual budgeting system, the presentation could differ from the one mentioned earlier, as follows:

Ministry (or agency)

 Directorate (or other major administrative subdivision)

 Program (if any)

 Current expenditures

 Capital expenditures (items not included in the
 “development” expenditures

 “Development” expenditures (domestic/external resources)
 capital

 current

 memo: total current

 total current expenditures

 total capital expenditures

The approach adopted in transition economies is generally more “economic” than the “management approach” mentioned above. In these countries, the traditional “State Annual Investment Program” has a narrower coverage than the “development” budget of developing countries, and covers often only net investment, i.e. the creation of new capacities. Investments financed under the “State Annual Program” are (or were) included in the items “capital expenditures” of the budget together with other capital expenditures. Therefore, it is often difficult to compare the investment program with the budget. Where there is an investment program distinct from the budget, it is necessary to adopt a presentation of expenditures in the budget that allows the budget and the investment program to be compared.

Box 15
Development Expenditure: Appearance and Reality in South Asia

In most South Asian countries, separate authorization is given for a “development” budget. However, the differentiation between the current and capital components of this budget is formal and highly technical. Since legislators are rarely well-educated in the finer technicalities of budgeting (and are not supposed to be), and parliamentary staffs are not strong, it is very difficult for the legislature to discern the true amounts of capital expenditure and hence the breakdown between current and capital expenditure in the overall budget they are asked to approve.

A reclassification within the budget of Bangladesh and Nepal shows that in both countries, true government capital expenditure is systematically and substantially lower than the amounts in the development budget. In Bangladesh, for instance, out of the total public expenditure under the annual development budget of Tk 37.4 billion in 1987-88, as much as Tk 10.4 billion or 27.7 percent can be classified as non-investment expenditure, compared to the 16.4 percent of total public expenditure shown in the current budget.

Not only is capital expenditure overestimated at any given point in time, but the trends are obscured as well. Thus, development expenditure in real terms in Bangladesh declined at an annual average rate of one percent during 1982-87. However, true capital expenditure during this period actually contracted at a much higher average annual rate of 2.3 percent. The mirror image of this distortion is that current expenditure is typically underestimated. For example, in the late 1980s reported growth in Bangladeshi current expenditure was 4 percent, compared with the 5.2 percent shown by the economic classification of the budget.

Source: Adapted from *The Control and Management of Government Expenditure: Issues and Experience in Asian Countries*, ESCAP-UNDP Development Papers No. 13, 1993.

3. Presentation of capital expenditures

A unified presentation of the budget should not lead to neglecting the need for a clear distinction between capital and current expenditures. This issue should not be

confused with the debate on dual presentation of the budget or, even less so, with dual budgeting.

Some of the reasons given for keeping capital and current budgets distinct are questionable. Capital expenditures are not unique in contributing to future production. What is important for development is not only the volume of investment, but the efficiency of investment, as well as an adequate mix of both capital and current expenditures (e.g., teacher wages can affect the quality of education and future growth more than the number of new schools). Also, the static and mechanistic view of the relationship between investment and growth (usually identified with the Harrod-Domar model), has been shown long ago to be simplistic and often very misleading, especially because it focuses attention away from the issue of efficiency of investment and from implementation capacity problems. Furthermore, government borrowing policy should not be related only to the desired capital stock. An enterprise does prepare its borrowing plans according to profits expected from investments. But the government has to take into account the macroeconomic effects of policy. Both current and capital expenditures affect aggregate demand; and borrowing policy must be established by reference to macroeconomic and fiscal targets in their entirety, and not only to investment.

Nevertheless, a clear distinction between current and capital expenditures is necessary, for analytical purposes, transparency, and policy decision-making. In the first place, the distinction is needed for an assessment of the operating costs of government and the efficiency of government activities. Moreover, investment expenditure generates a stream of future costs and benefits and is analytically and financially different from expenditure whose effects are extinguished within a short period. Finally, developing a performance-oriented approach requires a separation between running costs and capital expenditures. Indeed, some developed countries (e.g., the U.S.) that have not traditionally made a clear separation between capital and current expenditure in the presentation of the budget are now considering the possibility of creating a separate capital account:

Although reducing the federal deficit and making wise decisions on investments that will foster economic growth are the most important contributions that the federal government can make to a healthy and

growing economy, the current budget structure, with its focus on short-term goals, does not meet these needs. If long-term economic growth is to be increased, the budget needs to focus on long-term decision-making. A federal investment budget component could help Congress and the President make better-informed decisions on federal spending on consumption versus investments for the future. GAO, recognizing the importance of the deficit to long-term growth, urges that such a component be established within the context of a unified budget framework striving to cut the deficit over an appropriate period. Setting investment targets in the congressional budget resolution could be a useful and feasible way to implement this concept.³⁸

4. Budget annexes and other documents

Annexes to the budget presented to Parliament are needed to give other presentations of appropriations needed to analyze the budget. For example, the following could be attached to the budget: (i) an annex by function; (ii) an annex by program, especially if there are multisectoral programs; (iv) if the main presentation, shows the breakdown between current and capital expenditures, an annex by development project/program (development budget); (v) if the main presentation already includes the “development” budget, an annex to show the true investment component; etc.

Appropriations should be compared with the appropriations of the previous year. An annex by function should show the growth of expenditures over several years (on the basis of actual budget execution).

Other documents can include: (i) narrative statements on each sector budget policy, presented by programs; (ii) performance indicators (see chapter 15); (iii) the presentation of the forward costs of multiyear projects; and (iv) if appropriate, multi-year estimates or a Public Investment Program (PIP) (see Chapter 12).

G. KEY POINTS AND DIRECTIONS IN REFORMS

1. Main issues

a. Nature of the budget

In a cash-based budget, most appropriations define a limit for cash payment and annual commitments. A cash-based budget fits well the needs for expenditure control and budget administration. It does not impede the development a performance-oriented approach to budgeting (see chapter 15) and an accrual or modified accrual accounting system (see chapter 10). It needs, however, to be supplemented by instruments for assessing and controlling forward commitments and the fiscal impact of policy decisions.

Few countries have recently developed accrual-based budgets, where appropriations for operation cover full costs (including depreciation). An accrual-based budget can provide spending agencies with a framework for improving performance. However, its implementation requirements are heavy and it requires additional mechanisms for controlling cash. Abandoning cash-commitment-based appropriations in developing countries and transition economies is not recommended.

b. Budget systems

The traditional approach of line item budgeting fits the need for expenditure control. However, when associated with an input-oriented approach in budget formulation and detailed expenditure controls, it impedes both performance and program prioritization.

To improve policy formulation, public expenditure management and performance it is necessary to focus more on result and policy objective when formulating the budget, to give needed flexibility in management to spending agencies, and to develop instruments for measuring performance (see chapters 5 and 15).

In developing such approaches countries should be aware of the risks of making over ambitious reforms that will prove to be ineffective and of disrupting the classic rules

for compliance.

c. *Expenditure classification*

An expenditure classification system is an instrument for policy formulation, budget analysis, accountability, and day-to-day administration of the budget. All government expenditures should be classified along the same standards.

The classification system should include: (i) a functional classification for policy analysis, and statistics and international comparisons; (ii) an economic classification and object classification for economic analysis, and eventually, management control; (iii) an administrative classification for accountability and budget administration; (iv) any other classification needed for budget administration (e.g., fund classification); (v) eventually, a program and activity classification for policy analysis and performance review.

The expenditure classification must allow reporting along international standards (GFS). However, GFS, which focuses on economic and functional reporting should not be confused with an expenditure classification system for managing the budget.

A classification by program and activity can be an instrument for policy analysis and assessing performance, but should follow the lines of responsibility, to establish accountability.

Appropriation management rules associated with the expenditure classification system should fit needs for expenditure control and give sufficient flexibility in management (see chapter 7).

The budget presented to the legislature must clearly show responsibilities in program management and policy choices among programs and/or sectors.

¹Such as for the Great Plains Conservation Program in the U.S. mentioned by Allen Schick in the federal budget".

² An accrual-based appropriation includes depreciation and is therefore different from an authorization to commit and an authorization to make a payment.

³ In New Zealand, there are two ex-ante controls of cash payments made by the center (the Crown) to departments they are initially authorized by a warrant issued by the Governor-General, countersigned by the Audit Office; the Audit Office checks off on all the amounts to be paid from the Crown bank account on a daily basis to ensure that there is legal authority for such payments.

⁴In New Zealand, appropriations for the investment of departments are cash-based. In Netherlands, granting of funds to departments for investem through a loan/saving mechanism not through a cash appropriation as in New Zealand, see Harman Korte in OECD, *Accrual accounting in the Netherlands and the United Kingdom*, 1997.

⁵ Except in theory, if the country is rescheduling debt. According to the definition given above, an accrual-based appropriation should include the interest to be paid *plus* the interests rescheduled.

⁶ An obligation budget would need to be complemented by an annual cash plan, as would an accrual-based budget.

⁷ In the literature on budget reforms, program budgeting is either considered as a form of performance budgeting or treated as a distinctive approach. This section relies, among others, on Premchand, (1983); GAO Performance budgeting: Past initiatives offer insights for GPRA implementation", 1997; and Robert M. Lacey, "Managing Public Expenditure", World Bank.

⁸ Emphasized among others by Petrei, 1998, p. 365 ff.

⁹ In Malaysia, programs were made coterminous with the responsibilities of one ministry, after earlier unsuccessful attempts to reorganize government function/activity; in the beginning of the 1990s, Malaysia moved to a new system named the "Modified Budget System".

¹⁰ The U.S. Department of Defense still uses PPBS methodology. The extent to which this is a useful exercise is still being debated.

⁹ The United Nations called Manual for Program and Performance Budgeting (1965) contributed to disseminating program budgeting in developing countries. As noted, the actual experience was disappointing and often counter-productive.

¹¹ See OECD, Performance management in government: Performance measurement and result-oriented management", 1994; OECD, "In Search of Results: Performance Management Practices," OECD, 1998.

¹² "Value for Money Auditing", The Canadian Institute of Chartered Accountants, 1995.

¹³ "In search of results, Performance management practices", OECD.

¹⁴ Drawn up from Codd, 1996.

¹⁵ Ibid.

¹⁶ Malcolm Bale-Tony Dale, Public sector reform in New Zealand and its relevance to developing countries."

¹⁷ Scott, 1996.

¹⁸ Allen Schick, page 75.

¹⁹ Ibid.

²⁰ Ibid. page 76. It should be noted that output-based appropriations are only one of the seven appropriation types in New Zealand.

²¹More consideration is given to line items in preparing and reviewing budgets than is commonly thought to be the case. Certain outputs, such as policy advice are budgeted in input terms, and managers indicated in interviews that their departmental budgets often are examined by Treasury Vote analysts in these terms... Moving from input to output prices would require major improvements in cost accounting, allocation and analysis", Allen Schick, The spirit of reform: Managing the New Zealand state sector in a time of change," State Services Commission, New Zealand, 1996.

²²Two contrasting approaches are in evidence in the recent developed countries' experience. "One is the managerial premise that those who are responsible for government programs and organizations should be sufficiently empowered to act so that they can be accountable for their performance; the other is the contractual theory that government should be organized to minimize opportunism and transaction costs in relationship between self-interest parties" (Schick, 1996). And an OECD study notes that some countries "seem to have confidence that 'letting managers manage' suffices; the United Kingdom and New Zealand have acted on the presumption that it is necessary to 'make managers manage,'" (OECD, 1997).

²³ See detailed explanations on the differences between budget/accounts classification and the GFS reporting classification in William Allan (IMF), "Budget Structure and the Changing Role of the Government" in *Budget reform in developing countries*, paper presented to a Seminar in New York, December 4-5 1997, United Nations, 1998.

²⁴ The last version of the SNA shows only the 14 major groups.

²⁵ GFS, for instance, notes: "There is a great deal of latitude for decisions as to the functions to be isolated and the way in which they should be grouped. Decisions made are never final but need to be reviewed periodically whether changing public demand and government priorities should be reflected in a changed classification. For example, the present concern (in the early '80s) with energy supply and conservation was the main motivation for creating a major group for fuel and energy. On the other hand, the classification does not yet contain a category relating to the protection of the environment since at the present time it does not seem possible to define and measure such a group."

²⁶ see William Allan, *op.cit.*

²⁷ IMF, *Government finance statistics manual: Annotated outline*, 1996.

²⁸ The U.S. object classification, for instance, includes: full-time personnel; other than full-time personnel; other personnel compensation; civilian persons benefits; benefits for former personnel; travel and transportation of persons; transportation of goods; rental payment to government agencies; other rental; communications and utilities; printing and reproduction; consulting services; other services; supplies and materials; equipment; land and structure; grants and subsidies; insurance claims and indemnities; interest and dividends. Allen Schick, *The federal budget*, Brookings Institution, 1995.

²⁹ For example, in New Zealand, military investments are included in the assets, while in the SNA they are classified as consumption. However, New Zealand publishes an additional statement consistent with the SNA methodology.

³⁰ For example, in New Zealand, the main classification by input (excluding transfers and capital expenses) showed in the external reports consists of the following categories: (i) operating expenses; (ii) personnel expenses (excluding pension); (iii) pension expenses; (iv) movement in unfunded pension liabilities; (v) depreciation of physical assets; (vi) depreciation of state highways; (vii) rental and leasing costs; (viii) loss on sale of assets; (ix) finance costs; (x) net foreign-exchange gains on liabilities; (xi) net foreign-exchange losses on assets (see IFAC Definition and recognition of expenses and expenditures, 1997).

³¹ "Putting it together", New Zealand Treasury, 1996.

³² Obviously, this classification is de facto implemented in every developing country. However, in one country this has been forgotten when implementing an expenditure management information system, that was supposed to control vouchers. Therefore, vouchers for cash payments were controlled by the computer on the basis of appropriations including forecasts of external financing.

³³ In a one country, once the budgetary nomenclatures were designed, it appeared impossible to classify personnel expenditures by division and directorate. However, the reason was that the payroll information system was badly documented and written in COBOL. The real problem was the information system and not the budget classification itself.

³⁴ This is a common problem in FSU countries, where the expenditure classification system is not compatible with COFOG.

³⁵ "For most other outlays [other than transfers and lending minus repayment], it will generally not be possible to use transactions as units of classification. Instead, COFOG codes will have to be assigned to agencies, program units, bureaus and similar units within government departments, "GFS page 143. Also see SNA , page 420. The SNA suggests for particular cases "an approximate division of the units outlays".

³⁶ In a relatively aggregated classification system, this lowest common denominator would be at the project/division level.

³⁷ An argument in this direction has been made for at least thirty years by scholars and development practitioners. See, for example, Schiavo-Campo and Singer (*Perspectives of Economic Development, 1970*).

³⁸ Investment Budgeting for the Federal Government Testimony, 11/09/93, GAO.

Chapter 4. THE BUDGET PREPARATION PROCESS

A. OBJECTIVES OF BUDGET PREPARATION

During budget preparation, trade-offs and prioritization among programs must be made to ensure that the budget fits government policies and priorities. Next, the most cost-effective variants must be selected. Finally, means of increasing operational efficiency in government must be sought. None of these can be accomplished unless financial constraints are built into the process from the very start. Accordingly, the budget formulation process has four major dimensions:¹

- Setting up the fiscal targets and the level of expenditures compatible with these targets. This is the objective of preparing the macro-economic framework.
- Formulating expenditure policies.
- Allocating resources in conformity with both policies and fiscal targets. This is the main objective of the core processes of budget preparation.
- Addressing operational efficiency and performance issues.

This chapter focuses on the core processes of budget preparation, and on mechanisms for aggregate expenditure control and strategic allocation of resources. Efficiency and performance issues are discussed in chapter 15. Operational efficiency questions directly related to the arrangements for budget preparation are discussed in Section D below.

B. THE IMPORTANCE OF A MEDIUM-TERM PERSPECTIVE FOR BUDGETING

The need to address all three objectives of public expenditure management—fiscal discipline, strategic resource allocation, and operational efficiency—is emphasized in chapter 1. This calls for a link between policy and budgeting and for a perspective beyond the immediate future.

Of course, the future is inherently uncertain, and the more so the longer the period considered. The general trade-off is between policy relevance and certainty. At one extreme, government “budgeting” for just the following week would suffer the least uncertainty but also be almost irrelevant as an instrument of policy. At the other extreme, budgeting for a period of too many years would provide a broad context but carry much greater uncertainty as well.² In practice, “multiyear” means “medium-term,” i.e., a perspective covering three to five years including the budget year.

Clearly, the feasibility in practice of a multiyear perspective is greater when revenues are predictable and the mechanisms for controlling expenditure well-developed. (The U.K., for example, has recently moved beyond a multiyear perspective to an outright three-year budget for most budgetary accounts.) These conditions do not exist in many developing countries.³ The dilemma is that a multiyear perspective is especially important in those countries where a clear sense of policy direction is a must for sustainable development, and public managers are often in sore need of some predictability and flexibility.⁴

The dilemma that a multiyear perspective is especially needed where it is least feasible cannot be resolved easily, but must not be ignored. On the one hand, to try and extend the time horizon of the budget process under conditions of severe revenue uncertainty and weak expenditure control would merely lead to frequent changes in ceilings and appropriations, quickly degenerate into a formalistic exercise, and discredit the approach itself, thus compromising later attempts at improvement. On the other hand, to remain wedded to narrow short-term “management” of public expenditure would preclude a move to improved linkage between policies and

expenditures. In practice, therefore, efforts should constantly be exerted to improve revenue forecasting (through such means as relieving administrative or political pressures for overoptimistic forecasts), and strengthen the linkages between policy formulation and expenditure, as well as the expenditure control mechanisms themselves. As and when these efforts yield progress, the time horizon for budget preparation can and should be lengthened. Because revenue-forecasting improvements and the strengthening of policy-expenditure links and expenditure control mechanisms are important in any event, efforts to achieve these can yield the double benefit of improving the short-term budget process at the same time as they permit expanding the budget time horizon to take account of developmental priorities.

Therefore, although in almost all countries government budgets are prepared on an annual cycle, to be formulated well they must take into account events outside the annual cycle, in particular the macroeconomic realities, the expected revenues, the longer-term costs of programs, and government policies. Wildavsky (1986, p. 317) sums up the arguments against isolated annual budgeting as follows:

short-sightedness, because only the next year's expenditures are reviewed;
overspending, because huge disbursements in future years are hidden;
conservatism, because incremental changes do not open up large future vistas;
and parochialism, because programs tend to be viewed in isolation rather than in comparison to their future costs in relation to expected revenue.

Specifically, the annual budget must reflect three paramount multiannual considerations:

- The future recurrent costs of capital expenditures;
- The funding needs of entitlement programs (for example debt service and transfer payments) where expenditure levels may change, even though basic policy remains the same;
- Contingencies that may result in future spending requirements (for example government loan guarantees (see chapter 2)).

A medium-term outlook is necessary because the time span of an annual budget is too short for the purpose of adjusting expenditure priorities and uncertainties become too great over the longer term. At the time the budget is formulated, most of the expenditures of the budget year have already been committed. For example, the salaries of permanent civil servants, the pensions to be paid to retirees, debt service costs, and the like, are not variable in the short term. Other costs can be adjusted, but often only marginally. The margin of maneuver is typically no more than 5 percent of total expenditure. This means that any real adjustment of expenditure priorities, if it is to be successful, has to take place over a time span of several years. For instance, the government may wish to switch from blanket provision of welfare services to targeted provision designed for those most in need. The expenditure implications of such a policy change stretch over several years, and the policy therefore can hardly be implemented through a blinkered focus on the annual budget.

Medium-term spending projections are also necessary to demonstrate to the administration and the public the desired direction of change. In the absence of a medium-term program, rapid spending adjustments to reflect changing circumstances will tend to be across-the-board and ad hoc, focused on inputs and activities that can be cut in the short term. (Often, these are important public investment expenditures, and one of the typical outcomes of annual budgeting under constrained circumstances is to define public investment in effect as a mere residual.) If the expenditure adjustments are not policy-based, they will not be sustained. By illuminating the expenditure implications of current policy decisions on future years' budgets, medium-term spending projections enable governments to evaluate cost-effectiveness and to determine whether they are attempting more than they can afford.⁵

Finally, in purely annual budgeting, the link between sectoral policies and budget allocations is often weak. Sector politicians announce policies, but the budget often fails to provide the necessary resources.

However, two pitfalls should be avoided. First, a multiyear expenditure approach can

itself be an occasion to develop an evasion strategy, by pushing expenditure off to the out-years. Second, it could lead to claims for increased expenditures from line ministries, since new programs are easily transformed into “entitlements” as soon as they are included in the projections. To avoid these two pitfalls, many developed countries have limited the scope of their multiyear expenditures estimates to the cost of existing programs, without making room for new programs.”⁶

Three variants of medium-term year expenditure programming can be considered:

- A mere “technical” projection of the forward costs of ongoing programs (including, of course, the recurrent costs of investments).
- A “stringent” planning approach, consisting of: (i) programming savings in nonpriority sectors over the planned period, to leave room for higher-priority programs; but (ii) including in the multiyear program ongoing programs and *only* those new programs that are included in the annual budget currently under preparation or for which financing is *certain*. Such plans include only a few new projects beyond their first planned year (e.g., the Public Investment Program prepared in Sri Lanka until 1998).
- The “classic” planning approach, which identifies explicitly new programs and their cost over the entire period. This includes “development plans” covering all expenditures, or many public investment programs currently prepared in several developing countries, as well as expenditure plans prepared in developed countries in the 1970s. Where the institutional mechanisms for sound policy decision making and for budgeting are not in place, this approach can lead to overloaded expenditure programs.

The feasibility of implementing these different approaches and their linkages with the annual budget depends on the capacity and institutional context of the specific country. However, the annual budget should always be placed into some kind of multiyear perspective, even where formal multiyear expenditure programming is not feasible. For this purpose two activities are a must: (i) systematic estimates of the

forward costs of ongoing programs, when reviewing the annual budget requests from line ministries; (ii) *aggregate* expenditure estimates consistent with the medium-term macroeconomic framework (see section C). It is often objected that estimating forward costs is difficult, especially for recurrent costs of new public investment projects. This is true, but irrelevant, for without such estimates budgeting is reduced to a short sighted and parochial exercise.

[Please see attached Figure 4.xls]

C. CONDITIONS FOR SOUND BUDGET PREPARATION

In addition to a multiyear perspective, sound annual budget preparation calls for making early decisions and for avoiding a number of questionable practices.

1. The need for early decisions

By definition, preparing the budget entails hard choices. These can be made, at a cost, or avoided, at a far greater cost. It is important that the necessary trade-offs be made explicitly when formulating the budget. This will permit a smooth implementation of priority programs, and avoid disrupting program management during budget execution. Political considerations, the avoidance mechanisms mentioned below, and lack of needed information (notably on continuing commitments), often lead to postponing these hard choices until budget execution. The postponement makes the choices harder, not easier, and the consequence is a less efficient budget process.

When revenues are overestimated and the impact of continuing commitments is underestimated, sharp cuts must be made in expenditure when executing the budget. Overestimation of revenue can come from technical factors (such as a bad appraisal of the impact of a change in tax policy or of increased tax expenditures), but often also from the desire of ministries to include or maintain in the budget an excessive number of programs, while downplaying difficulties in financing them. Similarly, while underestimation of expenditures can come from unrealistic assessments of the cost of unfunded liabilities (e.g. benefits granted outside the budget) or the impact of

permanent obligations, it can also be a deliberate tactic to launch new programs, with the intention of requesting increased appropriations during budget execution. It is important not to assume that “technical” improvements can by themselves resolve institutional problems of this nature.

An overoptimistic budget leads to accumulation of payment arrears and muddles rules for compliance. Clear signals on the amount of expenditure compatible with financial constraints should be given to spending agencies at the start of the budget preparation process. As will be stressed repeatedly in this volume, it is possible to execute badly a realistic budget, but impossible to execute well an unrealistic budget. There are no satisfactory mechanisms to correct the effects of an unrealistic budget during budget execution. Thus, across-the-board appropriation “sequestering” leads to inefficiently dispersing scarce resources among an excessive number of activities. Selective cash rationing politicizes budget execution, and often substitutes supplier priorities for program priorities. Selective appropriation sequestering combined with a mechanism to regulate commitments partly avoids these problems, but still creates difficulties, since spending agencies lack predictability and time to adjust their programs and their commitments.

An initially higher, but more realistic, fiscal deficit target is far preferable to an optimistic target based on overestimated revenues, or underestimated existing expenditure commitments, which will lead to payment delays and arrears. The monetary impact is similar, but arrears create their own inefficiencies and destroy government credibility as well. (This is a strong argument in favor of measuring the fiscal deficit on a “commitment basis”, see chapter 6.)

To alleviate problems generated by overoptimistic budgets, it is often suggested that a “core program” within the budget be isolated and higher priority given to this program during budget implementation. In times of high uncertainty of available resources (e.g., very high inflation), this approach could possibly be considered as a second-best response to the situation. However, it has little to recommend it as general practice, and is vastly inferior to the obvious alternative of a realistic budget to begin with. When applied to current expenditures, the “core program” typically includes

personnel expenditures, while the “noncore program” includes a percentage of goods and services. Cuts in the “noncore” program during budget execution would tend to increase inefficiency, and reduce further the meager operations and maintenance budget in most developing countries. The “core/noncore” approach is ineffective also when applied to investment expenditures, since it is difficult to halt a project that is already launched, even when it is “non-core.” Indeed, depending on strong political support, noncore projects may in practice chase out core projects. (See chapter 12 for a discussion of public investment programming.)

2. The need for a hard constraint

Giving a hard constraint to line ministries from the beginning of budget preparation favors a shift from a “needs” mentality to an availability mentality. As discussed in detail later in this chapter, annual budget preparation must be framed within a sound macroeconomic framework, and should be organized along the following lines:

- A top-down approach, consisting of: (i) defining aggregate resources available for public spending; (ii) establishing sectoral spending limits that fits government priorities; and (iii) making these spending limits known to line ministries;
- A bottom-up approach, consisting of formulating and costing sectoral spending programs within the sectoral spending limits; and
- Iteration and reconciliation mechanisms, to produce a constant overall expenditure program.

Although the process must be tailored to each country, it is generally desirable to start with the top-down approach. Implementation of this approach is always necessary for good budgeting, regardless of the time period covered. The technical articulation of this approach in the context of medium-term expenditure programming is discussed in chapter 13, for the annual budget.

3. **Avoiding questionable budgeting practices**

Certain budgetary practices are widespread but inconsistent with sound budgeting. The main ones are: “incremental budgeting,” “open-ended” processes, “excessive bargaining,” and “dual budgeting.”

a. Incremental budgeting

Life itself is incremental. And so, in part, is the budget process, since it has to take into account the current context, continuing policies, and ongoing programs. Except when a major “shock” is required, most structural measures can be implemented only progressively. Carrying out every year a “zero-based” budgeting exercise covering all programs would be an expensive illusion. At the other extreme, however, “incremental budgeting,” understood as a mechanical set of changes in a detailed line-item budget, leads to very poor results. The dialogue between the Ministry of Finance and line ministries is confined to reviewing the different items and to bargaining cuts or increases, item by item. Discussions focus solely on inputs, without any reference to results, between a Ministry of Finance typically uninformed about sectoral realities and a sector ministry in a negotiating mode. Worse, the negotiation is seen as a zero-sum game, and usually not approached by either party in good faith. Moreover, incremental budgeting of this sort is not even a good tool for expenditure control, although this was the initial aim of this approach. Line-item incremental budgeting focuses generally on goods and services expenditures, whereas the “budget busters” are normally entitlements, subsidies, hiring or wage policy or, in many developing countries, expenditure financed with counterpart funds from foreign aid.

Even the most mechanical and inefficient forms of incremental budgeting, however, are not quite as bad as capricious large swings in budget allocations in response to purely political power shifts.

b. “Open-ended” processes

An open-ended budget preparation process starts from requests made by spending

agencies without clear indications of financial constraints. Since these requests express only “needs,” in the aggregate they invariably exceed the available resources. Spending agencies have no incentive to propose savings, since they have no guarantee that any such savings will give them additional financial room to undertake new activities. New programs are included pell-mell in sectoral budget requests as bargaining chips. Lacking information on the relative merits of proposed expenditures, the Ministry of Finance is led to making arbitrary cuts across the board among sector budget proposals, usually at the last minute when finalizing the budget. At best, a few days before the deadline for presenting the draft budget to the Cabinet, the Ministry of Finance gives firm directives to line ministries, which then redraft their requests hastily, themselves making cuts across the board in the programs of their subordinate agencies. Of course, these cuts are also arbitrary, since the ministries have not had enough time to reconsider their previous budget requests. Further bargaining then takes place during the review of the budget at the cabinet level, or even during budget execution.

“Open ended” processes are sometimes justified as a “decentralized” approach to budgeting. Actually, they are the very opposite. Since the total demand by the line ministries is inevitably in excess of available resources, the Ministry of Finance in fact has the last word in deciding where increments should be allocated and whether reallocations should be made. The less constrained the process, the greater is the excess of aggregate ministries’ request over available resources, the stronger the role of the central Ministry of Finance in deciding the composition of sectoral programs, and the more illusory the “ownership” of the budget by line ministries.

c. *Excessive bargaining and conflict avoidance*

There is always an element of bargaining in any budget preparation, as choices must be made among conflicting interests. An “apolitical” budget process is an oxymoron. However, when bargaining *drives* the process, the only predictable result is inefficiency of resource allocation. Choices are based more on the political power of the different actors than on facts, integrity, or results. Instead of transparent budget appropriations, false compromises are reached, such as increased tax expenditures,

creation of earmarked funds, loans, or increased contingent liabilities. A budget preparation process dominated by bargaining can also favor the emergence of escape mechanisms and a shift of key programs outside the budget.⁷

A variety of undesirable compromises are used to avoid internal bureaucratic conflicts—spreading scarce funds among an excessive number of programs in an effort to satisfy everybody, deliberately overestimating revenues, underestimating continuing commitments, postponing hard choices until budget execution, inflating expenditures in the second year of a multiyear expenditure program, etc. *These conflict-avoidance mechanisms are frequent in countries with weak cohesion within the government. Consequently, improved processes of policy formulation can have benefits for budget preparation as well, through the greater cohesion generated in the government.*⁸

Conflict avoidance may characterize not only the relationships between the Ministry of Finance and line ministries, but also those between line ministries and their subordinate agencies. Indeed, poor cohesion *within* line ministries is often used by the Ministry of Finance as a justification for its leading role in determining the *composition* of sectoral programs. Perversely, therefore, the all-around bad habits generated by “open-ended” budget preparation processes may reduce the incentive of the Ministry of Finance itself to push for real improvements in the system.

d. *“Dual budgeting”*

There is frequent confusion between the separate presentation of current and investment budgets, and the issue of the *process* by which those two budgets are prepared. The term “dual budgeting” is often used to refer to either the first or the second issue. However, as discussed earlier, a separate presentation is needed. “Dual budgeting” refers therefore only to a *dual process* of budget preparation, whereby the responsibility for preparing the investment or development budget is assigned to an entity different from the entity that prepares the current budget.

"Dual budgeting" was aimed initially at establishing appropriate mechanisms for giving higher priority to development activity. Alternatively, it was seen as the application of a "golden rule" which would require balancing the recurrent budget and borrowing only for investment. In many developing countries, the organizational arrangements that existed before the advent of the PIP approach in the 1980s (see chapter 12) typically included a separation of budget responsibilities between the key core ministries. The Ministry of Finance was responsible for preparing the recurrent budget; the Ministry of Planning was responsible for the annual development budget and for medium-term planning. The two entities carried out their responsibilities separately on the basis of different criteria, different staff, different bureaucratic dynamics, and, usually, different ideologies. In some cases, at the end of the budget preparation cycle, the Ministry of Finance would simply collate the two budgets into a single document that made up the "budget." Clearly, such a practice impedes the integrated review of current and investment expenditures that is necessary in any good budget process. (For example, the Ministry of Education will program separately its school construction program and its running costs and try to get the maximum resources for both, while not considering variants that would consist of building fewer schools and buying more books.)

In many cases, coordination between the preparation of the recurrent budget and the development budget is poor not only between core ministries but within the line ministries as well. While the Ministry of Finance deals with the financial department of line ministries, the Ministry of Planning deals with their investment department. This duality may even be reproduced at subnational levels of government. Adequate coordination is particularly difficult because the spending units responsible for implementing the recurrent budget are administrative divisions, while the development budget is implemented through projects, which may or may not report systematically to their relevant administrative division. (In a few countries, while current expenditures are paid from the Treasury, development expenditures are paid through a separate Development Fund.) The introduction of rolling PIPs was motivated partly by a desire to correct these problems.⁹

Thus, the crux of the "dual budgeting" issue is the lack of integration of different

expenditures contributing to the same policy objectives. This real issue has been clouded, however, by a superficial attribution of deep-seated problems to the “technical” practice of dual-budgeting. For example, dual budgeting is sometimes held responsible for an expansionary bias in government expenditure. Certainly, as emphasized earlier, the initial dual budgeting paradigm was related to a growth model (Harrod-Domar et al) based on a mechanistic relation between the level of investment and GDP growth. *This paradigm itself* has unquestionably been a cause of public finance overruns and the debt crises inherited in Africa or Latin America from bad-quality investment “programs” of the 1970s and early 1980s. The implicit disregard for issues of implementation capacity, or efficiency of investment, or mismanagement, corruption and theft, is in hindsight difficult to understand. However, imputing to dual budgeting all problems of bad management or weak governance and corruption is equally simplistic and misleading. Given the same structural, capacity, and political conditions of those years (including the Cold War), the same outcome of wasteful, and often corrupt, expansion of government spending would have resulted in developing countries—dual budgeting or not. If only the massive economic mismanagement in so many countries in the 1970s and early 1980s could be explained by a single and comforting “technical” problem of budgetary procedure! In point of fact, the fiscal overruns of the 1970s and early 1980s had little to do with the visible dual budgeting. They originated instead from a *third* invisible budget: “black boxes,” uncontrolled external borrowing, military expenditures, casual guarantees to public enterprises, etc.¹⁰

Public investment budgeting is submitted to strong pressures because of particular or regional interest (the so-called pork barrel projects) and because it gives more opportunities for corruption than current expenditures.¹¹ Thus, in countries with poor governance, there are vested interests in keeping separate the process of preparing the investment budget, and a tendency to increase public investment spending. However, under the same circumstances, to concentrate power and bribe opportunities in the hands of a powerful “unified-budget” baron would hardly improve expenditure management or reduce corruption. On the contrary, it is precisely in these countries that focusing first on improving the integrity of the separate investment programming process may be the only way to assure that some resources

are allocated to economically sound projects and to improve over time the budget process as a whole.¹²

By contrast, in countries without major governance weaknesses, dual budgeting often results in practice in insulating current expenditures (and especially salaries) from structural adjustment. Given the macroeconomic and fiscal forecasts and objectives, the resources allocated to public investment have typically been a residual, estimated by deducting recurrent expenditure needs from the expected amount of revenues (given the overall deficit target). The residual character of the domestic funding of development expenditures may even be aggravated during the process of budget execution, when urgent current spending preempts investment spending which can be postponed more easily. In such a situation, dual budgeting yields the opposite problem: unmet domestic investment needs and insufficient counterpart funds for good projects financed on favorable external terms. Insufficient aggregate provision of counterpart funds (which is itself a symptom of a bad investment budgeting process) is a major source of waste of resources.

Recall that the real issue is lack of integration between investment and current expenditure programming, and not the separate processes in themselves. This is important, because to misspecify the issue would lead (and often has) to considering the problem solved by a simple merger of two ministries—even while coordination remains just as weak. A former minister becomes a deputy minister, organizational “boxes” are reshuffled, a few people are promoted and others demoted. But dual budgeting remains alive and well within the bosom of the umbrella ministry. When coordination between two initially separate processes is close and iteration effective, the two budgets end up consistent with each other and with government policies, and “dual budgeting” is no great problem. Thus, when the current and investment budget processes are separate, whether or not they should be unified depends on the institutional characteristics of the country. In countries where the agency responsible for the investment budget is weak, and the Ministry of Finance is not deeply involved in ex-ante line-item control and day-to-day management, transferring responsibilities for the investment budget to the Ministry of Finance would tend to improve budget preparation as a whole. (Whether this option is preferable to the alternative of

strengthening the agency responsible for the investment budget can be decided only on a country-specific basis.) In other countries, one should first study carefully the existing processes and administrative capacities. For example, when the budgetary system is strongly oriented toward ex-ante controls, the capacity of the Ministry of Finance to prepare and manage a development budget may be inadequate. A unified budget process would in this case risk dismantling the existing network of civil servants who prepare the investment budget, without adequate replacement. Also, as noted, coordination problems may be as severe between separate departments of a single ministry as between separate ministries. Indeed, the lack of coordination *within line ministries* between the formulation of the current budget and the formulation of the capital budget is in many ways the more important dual budgeting issue. *Without integration or coordination of current and capital expenditure at line the ministries' level, integration or coordination at the core ministry level is a misleading illusion.*

On balance, however, the general presumption should be in favor of a single entity responsible for both the investment and the annual budget (although that entity must possess the different skills and data required for the two tasks):

Where coherence is at a premium, where any consistent policy may be better than several that cancel each other out, where layers of bureaucracy already frustrate each other, and where a single budget hardly works, choosing two budgets and two sets of officials over one seems strange. The keynote in poor countries should be simplicity. Designs for decisions should be as simple as anyone knows how to make them. The more complicated they are, the less likely they are to work. On this basis, there seems little reason to have several organizations dealing with the same expenditure policies. One good organization would represent an enormous advance. Moreover, choosing the finance ministry puts the burden of reform where it should be—in the budgetary sphere.¹³

D. THE MACROECONOMIC AND POLICY CONTEXT

1. Macroeconomic framework and fiscal targets

a. Importance of a macroeconomic framework

The starting points for expenditure programming are: (i) a realistic assessment of resources likely to be available to the government; and (ii) the establishment of fiscal objectives. (There follows, of course, significant iteration between the two, until the desired relationship between resources and objectives is reached.)

As noted earlier, the capacity to translate policy priorities into the budget, and then to ensure conformity of actual expenditures with the budget, depends in large part on the soundness of macroeconomic projections and revenue forecasts. Overestimating revenues leads to poor budget formulation and therefore poor budget execution. (As mentioned earlier, this may sometimes be a deliberate ploy to evade the responsibility for weak budget management and discipline.)

The preparation of a macroeconomic framework is therefore an essential element in the budget preparation process. Macroeconomic *projections* are not simple *forecasts* of trends of macroeconomic variables. Projections are based on a definition of targets and instruments, in areas such as monetary policy, fiscal policy, exchange rate and trade policy, external debt policy, regulation and promotion of private-sector activities, and reform of public enterprises. For example, the policy objective of reducing inflation normally corresponds to targets such as the level of the deficit, and the specific instruments can include tax measures and credit policy measures, among others.¹⁴ Projections should cover the current year and a forward period of two to four years.

b. Fiscal targets and indicators

The establishment of explicit fiscal targets gives a framework for budget formulation, allows the government to state clearly its fiscal policy and the legislative and the public to monitor the implementation of government policy, and, ultimately, makes government politically as well as financially accountable. Fiscal targets and indicators should cover three areas: current fiscal position (e.g., fiscal deficit), fiscal sustainability (e.g., debt-, tax-, or expenditure-to-GDP ratios), and vulnerability (e.g., analysis of the composition of the foreign debt).

The summary indicator of *fiscal position* used most commonly is the overall *budget deficit on a cash basis*, defined as the difference between actual expenditure payments and collected revenues (on a cash basis) plus grants (cash or in kind).¹⁵ The cash deficit is by definition equal to the government borrowing requirements (from domestic or foreign sources) and is thus integrally linked to the money supply and inflation targets and prospects. The deficit is therefore a major policy target to ensure that the budget will be financed in a noninflationary way and without crowding out private investment, while keeping the growth of public debt under control. The cash deficit must always be included in the set of fiscal targets.

The cash deficit does not take into account payment arrears and floating debt. In countries that face arrears problems the *deficit on a cash basis plus net increase of arrears* is also an important indicator, and is very similar (but not necessarily identical) to the *deficit on a commitment basis*, i.e., the difference between annual expenditure commitments and cash revenues and grants.¹⁶ The IMF Code of Fiscal Transparency requires at least a memorandum reporting arrears, when the country does not use accrual or modified accrual accounting (which would systematically generate reports on overdue accounts; see chapter 10).

As discussed in chapter 6, the precise definition of commitment varies from one country to another¹⁷. Commitments include orders not yet delivered, may concern multiyear contracts, or, in some countries, be only the administrative reservation of appropriations. Therefore, when using the deficit on a commitment basis as fiscal indicator, it is necessary to specify what transactions are included in the expenditures

on a commitment basis. This indicator would be meaningless if it includes multiyear commitments and commitments that are merely reservations of appropriations. Moreover, to estimate arrears more accurately, orders not yet delivered should be separated from actual expenditures (“accrued expenditures,” or “expenditures at the verification stage”). As discussed in chapters 6 and 10, this requires an adequate accounting system for tracking the uses of appropriations.

The *primary deficit* (on either a cash or a commitment basis) is the difference between noninterest expenditures and revenues and grants. As a target for budget policy, it does not depend on the vagaries of interest rates and exchange rates, and is therefore a better measure of the government’s fiscal adjustment effort.

In high-inflation countries, to take into account the impact of inflation on the stock of debt, a frequent indicator is the *operational deficit*, which is equal to the deficit on a cash basis less the inflationary portion of interest payment.¹⁸

The *current deficit* is the difference between current revenue and current expenditure. It is by definition, the “government saving,” and thus, in theory, the contribution of government to investible resources and economic growth. However, since the current spending of a government may be as important for growth as capital spending, the macroeconomic meaning of this indicator should be interpreted with care.

Depending on the circumstances, it may also be necessary to isolate once and for all the fiscal results from other operations, as, for instance, the sale of public assets, or a special recovery of tax arrears.¹⁹

[Please see attached Table 2.xls]

It is essential to underline that the broad objective of fiscal policy is not a specific level of deficit, per se, but a fiscal position that is *sustainable* in light of policy goals and likely resource availability. Indicators of *fiscal sustainability* include the ratio of debt to GDP, tax to GDP, net unfunded social security liabilities. The calculation of the deficit on an accrual basis and the assessment of the net worth of the government allows a

better assessment of liabilities and therefore their impact on sustainability (see chapter 10). However, huge movements in net worth can be caused by valuation changes in assets such as land, that the government has no immediate intention of liquidating. Hence, "net worth measures could be dangerous if used as indicators for near-term fiscal policy."²⁰

An assessment of *fiscal vulnerability* is also needed, especially in countries that benefit from short-term capital inflows. Especially relevant to Asian countries affected by the financial crisis that began in 1997; such an assessment could be based on the analysis of the maturity of government debt, the volume of usable foreign exchange reserves, etc. There is no question that the standard deficit measures may indicate a healthy fiscal situation which is in reality fragile. However, as shown by recent developments, guidelines for assessing fiscal vulnerabilities are doubtful and unclear. This question is related to the perennial and difficult issue of "early warning systems" to predict the probability of an impending fiscal or financial crisis. It may well be that such early warnings are feasible and appropriate. Among the thorny difficulties, however, there is the risk of a self-fulfilling prophecy, where the early warning itself could cause financial markets to become concerned and hence spark a crisis. Thus, on the "balance" of the debate, against any real crisis that an early warning system has predicted accurately, one should place other crises, that might not have happened were it not for the warning itself.

c. *Preparation of a macroeconomic framework*

A macroeconomic framework typically includes projections of the balance of payments, the real sector (i.e., production), the fiscal accounts, and the monetary sector. It is a tool for checking the consistency of assumptions or projections concerning economic growth, the fiscal deficit, the balance of payments, the exchange rate, inflation, credit growth and the share of the private and public sectors on external borrowing policies, etc.²¹

Preparing a macroeconomic framework is always an iterative exercise. A set of “initial” objectives must be defined to establish a preliminary baseline scenario, but the final framework requires a progressive reconciliation and convergence of all objectives and targets. Considering only one target (e.g., the fiscal deficit) in this iterative exercise risks defining other important targets as de facto residuals.

“General government” (see chapter 2) should be considered when preparing the fiscal projections and defining the fiscal targets, but the fiscal targets should also be broken down between central and local government. In some decentralized systems, by law a fiscal target cannot be directly imposed on subnational and local government. In those cases, it is necessary to assess the feasibility of achieving it by means of the different instruments under the control of the central government (such as grants, control of borrowing). However, the constraints on running fiscal deficits are typically much tighter on subnational entities than they are on central government. The main reason is the central government’s capacity to regulate money supply. Therefore, in some federal systems (e.g., the U.S.) many states have their own constitutionally mandated requirement of an annual balanced budget.

Fiscal projections should cover the consolidated account of the general government and quasi-fiscal operations by the banking system. Future expenditures related to contingent liabilities as a result of government guarantees should be assessed (see chapter 2). In a majority of developing countries, it is desirable to prepare “consolidated accounts of the public sector,” to identify financing requirements for the public sector as a whole. Very often, however, only the central government is included, giving a misleading fiscal picture and the temptation to “download” the fiscal deficit onto local government entities. This practice is conducive neither to sound fiscal policy nor to the subsidiarity structure appropriate to the specific country. Unfortunately, governments and international financial institutions have paid insufficient attention to this problem.

The degree of sophistication of fiscal projections depends on the technical capacities within the country and the availability of data and appropriate tools. Sophisticated

models can be useful. Nevertheless, since the major objective is to set a general frame for formulating macroeconomic objectives and checking their consistency, the preparation of a macroeconomic framework does not necessarily require sophisticated modeling techniques. On the contrary, these techniques may give a sense of misplaced concreteness and a “forecast illusion” which may hamper the practical value of the framework.

Using simple “quasi-accounting” models would already represent significant progress in many countries.²² Such models include mainly accounting relations (e.g., GDP plus net imports equals consumption plus investment) and only a limited number of behavioral relations defined by simple ratios (e.g., consumption, income), without resorting to econometric techniques. The models are also easier to use in discussions on fiscal policy, whereas the outputs of a sophisticated econometric model depend on the approach adopted by the modeler, and the process is necessarily more opaque. In any case, forecasting revenues should be based on detailed analyses and forecasts by individual tax rather than on the aggregate outputs of a macroeconomic model.

The problems revealed by the projections (e.g., lack of consistency between economic growth targets and monetary policy) must be discussed among the agencies involved in macroeconomic management. The preliminary baseline scenario gives the macroeconomic information needed for preparing sectoral and detailed projections, but these projections usually lead in turn to revising the baseline scenario. Such iterations should continue until overall consistency is achieved for the macroeconomic framework as a whole. The iteration process is not only necessary for sound macroeconomic and expenditure programming, but is also an invaluable capacity-building tool, to improve the awareness and understanding of involved agencies—and therefore their cooperation in formulating a realistic budget and implementing it correctly.

[Please see attached Figure 5.xls]

The preparation of a macroeconomic framework should be a permanent activity. The

framework needs to be prepared at the start of each budget cycle to give adequate guidelines to the line ministries. As noted, it must then be updated throughout the further stages of budget preparation, also to take into account intervening changes in the economic environment. During budget execution, too, macroeconomic projections require frequent updating to assess the impact of exogenous changes or of possible slippage in budget execution.

In addition to the baseline framework, it is important to formulate variants under different assumptions, e.g., changes in oil prices. The risks related to unexpected changes in macroeconomic parameters must be assessed and policy responses identified in advance, albeit in very general terms, of course.

The importance of good data cannot be underestimated. Without reliable information, the macroeconomic framework is literally not worth the paper it is written on. This includes the collection of economic data and the monitoring of developments in economic conditions (both of which are generally undertaken by statistics bureaus) as well as the monitoring and consideration of changes in laws and regulations that affect revenue, expenditure, financing and other financial operations of the government.

2. Aggregate expenditure estimates

Typically, a macroeconomic framework is at a very aggregate level on the expenditure side, and shows total government wages, other goods and services, interest, total transfers, and capital expenditures (by source of financing). Assumptions and underlying policy objectives therefore concern the broad economic categories of expenditures, rather than the allocation of resources among sectors. Moreover, transfers or entitlements are not reviewed in sufficient detail and assumptions on future developments are not compared with continuing commitments. Thus, when elaborating a fiscal framework on the basis of the overall macroeconomic framework, estimates of the impact of the assumptions and the aggregate fiscal targets on the composition of expenditure, by sector or economic category, are required to assess whether the fiscal targets are realistic and sustainable, and to

determine the conditions to meeting these targets.

Therefore, the preparation of aggregate expenditure estimates could help in assessing the sustainability of expenditure policy, and thus improve the budget preparation process (notably when defining expenditure ceilings for the various sectors). These estimates could cover: (i) the forward costs of large investment projects; (ii) projections for the more important entitlements; and (iii) aggregate projections of other expenditures, by function and broad economic category. These estimates are less demanding in terms of capacity and institutional process than the formal Medium-Term Expenditure Framework (MTEF) described in chapter 13, but could be a step toward the implementation of a comprehensive MTEF. Indeed, this step is mandatory if some *sectoral* multiyear expenditure programming exercise is carried out (covering only investment or a few sectors), to prevent inconsistency between the sectoral program and the macroeconomic framework, or the crowding out of expenditure in noncovered sectors or categories.

Focusing only on technical issues while neglecting the fundamental question of the division of administrative responsibility inevitably produces a weak or inoperative macroeconomic framework. Some major considerations in this respect are discussed in chapter 5.

3. Consolidating the fiscal commitments

a. Making the macroeconomic projections public

While the iterative process leading to a realistic and consistent macroeconomic framework must remain confidential in many of its key aspects, when the framework is completed it must be made public. The legislature and the population at large have a right to know clearly the government policy objective and targets, not only to increase transparency and accountability, but also to reach a consensus within civil society. While such a consensus may take additional time, and require difficult debates, it will also be an invaluable foundation for the robust and effective implementation of the

policy and financial program. A good example is provided by the government of Hong Kong, China, which annexes its medium-term forecast to the annual budget speech (box 16 and annex VII).

Box 16
Medium-Range Forecasts: The Example of Hong Kong, China

The Medium Range Forecast (MRF) is a projection of expenditure and revenue for the forecast period based on forecasting assumptions and budgetary criteria. To derive the MRF, a number of computer-based models that reflect a wide range of assumptions about the factors determining each of the components of government's revenue and expenditure were used. As summary is shown here, a fuller description is in Annex VII.

Assumptions relating to developing expenditure and revenue forecast over the medium-term period are the following:

- estimated cash flow of capital projects
- forecast completion dates of capital projects and their related recurrent consequences in terms of staffing and running costs
- estimated cash flow arising from new commitments resulting from policy initiatives
- the expected pattern of demand for individual services
- the trend in yield from individual revenue sources
- new revenue measures in 1998-1999

In addition to these assumptions, there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy:

- Maintain adequate reserves in the long-term
- Expenditure growth should not exceed the assumed trend growth in GDP
- Contain capital expenditure growth within overall expenditure guidelines
- Revenue projections reflect new measures introduced in this year's budget

To summarize, the MRF of Hong Kong is shown below: (in \$Hk billion)

	Forecast years			
	<u>1998-1999</u>	<u>1999-2000</u>	<u>2000-2001</u>	<u>2001-2002</u>
Revenue	192,680	211,390	242,900	271,330
Expenditure	182,480	200,740	227,830	258,570
Surplus	10,200	10,650	15,070	12,760
Total public expenditure	288,890	315,830	354,060	393,980
Gross domestic product	1,497,880	1,690,740	1,908,420	2,154,130
Growth in GDP (nominal)	12.9	12.9	12.9	12.9
(real)	5.0	5.0	5.0	5.0
Public expenditure as a percentage of GDP	19.3	18.7	18.6	18.3

Source: Medium Range Forecast of Hong Kong, The Internet, August 8, 1998.

In some countries, government projections are submitted to a panel of independent and respected experts to ensure their reliability, while preserving the confidentiality required on a few sensitive issues. In other countries, the projections are validated by the Auditor General (e.g., the United Kingdom and the Canadian province of Nova Scotia²³). The independence of the Auditor General adds credibility to the projections. However, any other form of participation of audit offices in the budget formulation process would be questionable. In any event, manipulation and alteration of forecasts would soon reduce the government's credibility and hence its influence.

b. Binding fiscal targets?

Several countries have laws and rules that restrict the fiscal policy of government ("fiscal rules").²⁴ For example, an earlier golden rule stipulated that public borrowing must not exceed investment (thus mandating a current budget balance or surplus). In some cases, the overall budget must be balanced by law (as in subnational government in federal countries). In the European Union, the Maastricht Treaty stipulates specific fiscal convergence criteria, concerning both the ratio of the fiscal deficit to GDP and the debt/GDP ratio. (The former has been by far the more important criterion.) One frequent criticism of such rules is that they favor creative accounting and encourage nontransparent fiscal practices. When they are effectively enforced, nondiscretionary rules can also prevent governments from adjusting their budgets to the economic cycle.²⁵ Aside from the special case of European integration, one may generally consider that, in countries with fragile coalition governments, fragmented decision making, and legislative committees acting as a focus for periodic bargaining, setting up legally binding targets may be appropriate. In other countries, however, binding targets could in effect predetermine the budget before its preparation even begins.²⁶

In contrast with an approach based on rigid targets, other countries (e.g., New Zealand) do not mandate specific fiscal targets, but refer to criteria such as prudent levels and reasonable degrees. It is left to the government to specify the targets in a Budget Policy Statement, which presents total revenues and expenses and

projections for the next three years. This statement is published at least three months before the budget is presented to Parliament, and is reviewed by a Parliament committee but not formally voted by Parliament.²⁷

Box 17
The New Zealand Fiscal Responsibility Act

Enacted in 1994, the New Zealand Fiscal Responsibility Act offers a comprehensive legal framework for formulation and conducting fiscal policy in general, and for incorporating a long-term orientation in the budget process in particular. While many OECD countries have similar practices in place, the Fiscal Responsibility Act is an example of these practices being enacted into law.

The primary objective of the Fiscal Responsibility Act was to entrench sound fiscal policies and make it difficult for future governments to deviate from them. There are two provisions of the Act: (i) a regime for setting fiscal objectives that focuses attention on the long term; and (ii) an extensive system of fiscal reporting with unique mechanisms to ensure its credibility and integrity. The extensive reporting required by the act serves two purposes. First, it serves to monitor the consistency of the government's fiscal actions with its stated fiscal objectives. Second, it brings general transparency to government finances by mandating the disclosure of all relevant fiscal information in a timely manner.

The act requires two specialized reports: the Fiscal Strategy Report and the Pre-Election Economic and Fiscal Update. The Fiscal Strategy Report, which is presented to Parliament along with the budget, assesses the consistency of the policy framework contained in the budget with the short-term fiscal intentions and long-term fiscal objectives outlined in the Budget Policy Statement. The Pre-Election Economic and Fiscal Update contains the three-year forecasts of all key economic and fiscal variables. Both reports contain two statements of responsibility, one by the Minister of Finance and one by the Secretary to the Treasury (a civil servant). These statements of responsibility aim to clarify the roles of politicians and civil servants in producing reports and give a greater role to civil servants in producing them, thereby increasing the overall credibility of the reports.

Source: "Budgeting for the future," OECD working paper, 1997.

More important than specifying ex-ante targets and general criteria is to ensure that institutional arrangements and processes favor coherence among resource constraints, fiscal objectives, and expenditure programs. This broader issue involves the mechanisms for policy formulation, the budget preparation process, the role of the Ministry of Finance in budgeting, and the development of appropriate instruments for reviewing expenditures within a longer period than the annual budget.

Box 18

A Good Macroeconomic Coordination Practice: The “Gang of Four” in Thailand

The Thai system of budgeting is highly centralized. It embodies a longstanding set of arrangements, rules, and procedures that together help exert discipline on aggregate fiscal management. It grants very little autonomy to line agencies over their budgets, and imposes weak accountability on them for their performance.

The hallmark of the Thai budgeting system is aggregate fiscal discipline. A “gang of four” interacts to control the level of spending and thus the deficit: the National Economic and Social Development Board (NESDB), the Ministry of Finance (MOF), the Bank of Thailand (BOT), and the Bureau of the Budget (BOB) in the Prime Minister’s Office. The gang of four is responsible for formulating the macroeconomic framework that serves as the basis for the aggregate expenditure ceiling. It also determines for the most part the ministerial ceilings. Prioritization is largely a function of the gang of four. It ensures that the budgetary requests of line agencies are consistent with the objectives of the five-year development plan. The gang of four’s control over aggregate allocations to agencies and to expenditure categories implies that it exerts considerable leverage over priority setting.

In Parliament, the Budget Scrutiny Committee chaired by the Minister of Finance evaluates the government’s proposal. Cabinet members can propose amendments to the government’s proposal but seldom make significant changes in allocations to line agencies because of limited technical capability to evaluate such proposals. Politicians can alter the allocation of line agencies. After a series of deliberations and negotiations, the committee submits the budget bill to Parliament. The Parliament almost always accepts the bill.

Source: Campos and Pradhan, “Budgetary institutions and expenditure outcomes, 1996.

4. Policy formulation

a. *Importance of policy formulation*

The budget preparation process is a powerful tool for coherence. The budget is both an instrument of economic and financial management and an implicit policy statement, as it sets relative levels of spending for different programs and activities. However, policy decision making is complex and involves different actors in and outside the government. It is a technocratic illusion to embed all policy formulation within the budget process (as to some extent was the ambition of the PPBS; see chapter 3). However, a coherent articulation should be sought between the policy agenda (which should take into account economic and fiscal realities) and the budget (which should accurately reflect the government's policy priorities).

The budget process should both take into account policies already formulated and be the main instrument for making these policies explicit and “operational.” However, policies must be defined outside the pressure of the budget process. Making policy *through* the budget would lead to a focus only on short-term issues and thus to bad policy, since the policy debate would be invariably dominated by immediate financial considerations. (This is frequently the unfortunate outcome in developing countries with weak capacity faced with financial difficulties.) In earlier times, medium-term development plans were intended as the instrument for setting up government strategy. However, these plans were rigid, invariant, and usually out of sync with financial realities. Paradoxically, therefore, they indirectly led in practice to the same dominance of short-term financial considerations. Organizational arrangements are discussed in chapter 5.

b. *The policy-budget link*

A bridge between the policy making process and the budget process is essential to make policy a breathing reality rather than a statement of wishes. For this purpose at least two clear rules must be established.²⁸

The resource implications of a policy change should be identified, even if very roughly, before a policy decision is taken. Any entity proposing new policies must quantify their effects on public expenditure, including the impact both on its own spending and on the spending of other government departments.

The Ministry of Finance should be consulted in good time about all proposals involving expenditure before they go into ministerial committee or to the center of the government and certainly before any public announcements are made.

Within the budget formulation process, close cooperation between the Ministry of Finance and the center of government is required, at both the political and the technical level. The role of the center is to ensure that the budget is prepared along the lines defined; to arbitrate or smooth over conflicts between the Ministry of Finance and line ministries; and to assure that the relevant stakeholders are appropriately involved in the budget process. (This is a major challenge, which can only be mentioned here but requires care and commitment on a sustained basis.) An interministerial committee is needed to tackle crosscutting issues and review especially sensitive issues. And, most importantly, each entity involved in the budget process must perform its own role in a responsible fashion, and be given the means and capacity to do so.

c. Reaching out: The importance of listening

Consultations can strengthen legislative scrutiny of government strategy and the budget. Legislative hearings through committees and subcommittees, particularly outside the pressure environment of the annual budget, can provide an effective mechanism for consulting widely on the appropriateness of policies (issues related to the role of the legislature are discussed in chapter 5) .

The government should try to get feedback on its policies and budget execution from the civil society. Consultative boards, grouping representatives from various sectors in society, could discuss government expenditure policy. On crucial policy issues

government can set up ad hoc groups. Preparing evaluation studies and disseminating them, conducting surveys, etc. provides information to stakeholders and the civil society and helps the government receive reliable feedback. User surveys and/or meetings with stakeholders and customers when preparing agencies' strategic plans or preparing programs can enhance their effectiveness. Finally, and most concretely, in countries with weak budget execution and monitoring mechanisms, only mechanisms for eliciting feedback from far-flung citizens can be effective in revealing such malpractices as "ghost schools," shoddy infrastructure, incomplete projects, thefts, and waste. Such mechanisms are often resented by the executive branch, but should be seen by governments (and external donors) as remarkably cost-effective monitoring devices, and encouraged and supported as such.

However, although these consultations must have an influence on budget decisions, a direct and mechanical linkage to the budget should be avoided. As noted, the budget preparation process needs to be organized along strict rules so that the budget can be prepared in a timely manner while avoiding excessive pressure from particular interests and lobbies. Participation, like accountability, is a relative, not absolute, concept.

E. RESOURCE ALLOCATION AND OPERATIONAL EFFICIENCY

As stressed earlier, budget preparation is an iterative process between the Ministry of Finance and spending ministries. Therefore, it is a combination of a top-down approach, with the Ministry of Finance giving guidelines or communicating instructions to spending ministries, and a bottom-up approach, with spending ministries presenting requests for budget allocation to the Ministry of Finance. Either approach followed in isolation would have adverse effects: ["A budget created from the bottom-up may lead to excessive spending and instability, if not carefully organized and subject to pre-established limits. By contrast, a highly centralized exercise introduces rigidities and loses the vision of those who are close to the service recipients (Petrei, 1998, p. 399). The articulation of the top-down and bottom-up approach is crucial since it determines how priorities and fiscal targets will be taken into account over the budget preparation

process.

1. Top-down approach

As previewed earlier, the starting points for budget preparation are a clear definition of fiscal targets and a strategic framework consisting of a comprehensive set of objectives and priorities. Thereafter, strong coordination of the budget preparation is required to achieve the necessary iteration and to avoid major departures from the initial framework.

Giving a hard constraint to line ministries from the start of budget preparation favors a shift from a “needs” mentality to an “availability” mentality. Moreover, to translate strategic choices and policies into programs, line ministries require clear indications on available resources. Finally, a hard constraint increases the de facto authority and autonomy of the line ministries, weakening the claim of the Ministry of Finance to a role in determining the *internal* composition of the line ministries’ budget. (The same is true of each line ministry vis-à-vis its subordinate agencies.)

This calls for notifying spending agencies of the initial budget ceilings and preferably in absolute terms, or at least through the provision of accurate and complete parameters. These ceilings may be defined either at the very beginning of the dialogue between the Ministry of Finance and the line ministries, or after a first iteration when line ministries communicate their preliminary requests. In practice, two variants are found in countries that have good financial discipline. In some, line ministries are notified of the sectoral ceilings at the very start of the budget preparation process. Other countries, where budget preparation may last more than ten months, establish ceilings in two steps. In the first step, some flexibility is left to line ministries to translate guidelines in terms of budget envelopes. Then, after a brief review and discussion of the preliminary requests, the Ministry of Finance notifies the line ministries of the binding ceilings. In countries with strong government cohesion and stable and well-organized arrangements for budget preparation, the two variants are equally workable, since financial constraints are more or less taken into account by line ministries when preparing their preliminary request. Moreover, when budget

preparation lasts nearly one year²⁹ it would be very difficult to set definite ceilings at the start of the process.

However, in countries where fiscal discipline and government cohesion are not firmly established (as in most developing countries), adopting a gradual approach to building financial constraints into the budget preparation process could mean a simple comeback to a fully open-ended process. Therefore, the notification of definite budgetary envelopes at the beginning of the budgetary process is highly desirable in these countries.

Coordination and consistency of budget policy with overall economic and social policy is a central concern of Cabinet, although the Ministry of Finance must play the key role in analysis and formulating recommendations.

Generally, the Ministry of Finance should be responsible for setting the sectoral ceilings, but it should of course coordinate with the center of government, which must also review the ceilings in detail and approve them. In some countries, the sectoral ceilings are discussed within interministerial committees; in other countries, proposed ceilings and guidelines for budget preparation are submitted to the Cabinet. Where responsibilities for budgeting are split between a Ministry of Finance and a Ministry of Planning, the preparation of sectoral expenditure ceilings must be undertaken by a joint committee including at least the two ministries. The institution responsible for overall financial management should coordinate the setting of the sectoral ceilings to ensure that they fit the aggregate expenditure consistent with the macroeconomic framework.

2. Bottom-up approach

Line ministries are responsible for preparing their requests within the spending limits provided. Depending on the severity of the fiscal constraint and the organization of the budget preparation process, additional requests from line ministries could be allowed for new programs. However, the principal request should be consistent with the notified ceilings or guidelines, and costs of programs included in the additional

requests should be clear and fully adequate for proper implementation, without any underestimation. Naturally, no request for new programs should be entertained without a clear demonstration of its purpose and, where appropriate an estimate of the demand for the services to be provided.

Line ministries' budget requests should clearly distinguish: (i) the amount necessary to continue current activities and programs; and (ii) proposals and costing for new programs.

Before deciding to launch any new expenditure program it is necessary to assess its forward budget impact. This is particularly important for development projects and entitlement programs, which may generate recurrent costs or increased expenditures in the future. This assessment is required whether or not a formal exercise of multiyear expenditure programming is carried out. For this purpose, requests must show systematically the forward annual costs of multiyear or entitlement programs, and the Ministry of Finance should take into account the forward fiscal impact of these programs when scrutinizing the budgetary requests from line ministries. Estimates of future costs related to multiyear commitments could be annexed to the overall budget document. These estimates would facilitate the preparation of the initial ceilings for the next budget.

In addition to their budget requests, the submission from the line ministries should include: (i) a brief policy statement spelling out the sector policies and expected outcomes; (ii) where applicable, realistic and relevant performance indicators, including results from the previous period and expected performance for the future; (iii) a statement of how the objectives will be achieved; (iv) proposals for achieving savings and boosting efficiency; and (v) clear measures for implementing the proposals effectively.

Line ministries must coordinate the preparation of the budget of their subordinate agencies and give them appropriate directives. The submission of budget requests from subordinate agencies, in general, should meet the same criteria as noted above for line ministries' requests.

3. Negotiation

Once it receives the requests of line ministries, the Ministry of Finance reviews their conformity with overall government policy, and compliance with the spending limits; reviews performance issues; and takes into account changes in the macroeconomic environment since the start of budget preparation. Almost always, these reviews lead the Ministry of Finance to suggest modifications in the line ministries' budget requests. Negotiation follows.

Formal negotiation between the Ministry of Finance and line ministries can take the form of a budgetary conference. Professional staff from the Ministry of Finance and line ministries should also hold informal meetings to avoid misunderstandings and minimize conflicts. Major differences of opinion will normally be referred to the center of government, depending largely on the relative balance of administrative and political power between the Ministry of Finance and the specific line ministry concerned.

4. Preparing expenditure ceilings

In preparing the sectoral expenditure ceilings, the following elements must be taken into account:

Macroeconomic objectives and fiscal targets;

The results of the review of ongoing programs for the sector;

The impact of ongoing expenditure programs on the next budget, and their degree of rigidity (notably expenditures related to continuing commitments, such as entitlements);

The strategy of the government concerning possible shifts in the intersectoral distribution of expenditure, and the amount of resources that could be allocated to

new policies as well as service demand projections where appropriate.

Preparing these initial ceilings is largely an incremental/decremental exercise. Budgets are never prepared from scratch. Debt servicing, multiyear commitments for investment; pensions and other entitlements; rigidities in civil service regulations; and the simple reality that government cannot stop at once all funding for its schools, health centers or the army, etc, limit possible annual shifts to perhaps 5-10 percent of total expenditures. In theory, this percentage could be higher in developing countries than in developed countries (where the share of entitlements is higher). But in practice, because of earlier overcommitments the room to maneuver is often even lower in developing countries. If one excludes emergency or crisis situations, when preparing the budget the government should focus on new policies, savings on questionable programs, and means of increasing the efficiency of other ongoing programs. It is clear, once again, that any significant policy shift requires a perspective longer than one year and some advance programming, in whatever form that is appropriate and feasible in the specific country.

a. *A subceiling for capital expenditure?*

As discussed earlier, a separate budget preparation process for capital and current expenditure (“dual budgeting”) presents problems, but a separate *presentation* is desirable. Aside from that question, however, should separate ceilings for capital and current expenditures be set at the start of the budget preparation process? The answer depends on the sector concerned.

Obviously, if only a global ceiling is set, line ministries would be able to make trade-offs between their current spending and their capital spending, and if separate ceilings are set, the distribution between current and capital spending is fixed for each sector. In certain sectors, such as primary education, it is generally preferable to leave the choice between current and capital spending partly to line ministries, since both current and capital expenditures are “developmental,” and line ministries presumably know better than the Ministry of Finance what would be the most efficient allocation of resources within their sector. However, in some cases, the sector budget depends

largely on the decision of whether or not to launch a large investment project. For example, the budget of a Ministry of Higher Education would largely depend on the decision whether to construct a new university. Because such large investment projects are a government policy issue, not only a sectoral policy issue, separate ceilings would be appropriate in these cases. Depending on circumstances and fiscal policy issues, separate subceilings may also be needed for other expenditure items, such as personnel expenditures and subsidies.

b. Efficiency “dividends”

In recent years, Australia demanded from each spending unit, efficiency dividends, i.e., required savings in their ongoing activities (around 1.5 percent annually). On the surface, this practice may look like the typical (and undesirable) across-the-board cuts made by the Ministry of Finance when finalizing the budget. However, there are two major differences: (i) efficiency dividends are notified early in the process and within a coherent multiyear expenditure framework; and (ii) the allocation of savings among activities and expenditure items is entirely the responsibility of the spending agencies, which alleviates the arbitrary nature of the approach. Savings “measures are much more likely to be implemented within the ministry when the line ministry itself is arguing for them rather than when they are set by the central agencies”, with the knowledge and skills of the program agency being devoted to criticism and obfuscation”.³⁰ This approach appears to have achieved effective results in Australia during 1985-90. Sweden has adopted a similar approach.³¹

In developed countries, the potential for fiscal savings and efficiency improvements exists. Before considering introducing efficiency dividends in developing countries, the country context must be carefully reviewed. Efficiency dividends differ from across-the-board cuts only if there are adequate technical capacities in line ministries and a willingness to make their own hard choices. In those developing countries where the current budget is too inadequate to allow departments even to function normally (and the capital budget is determined largely by donor funding), the real question is not how to generate a gradual increase in efficiency, but how to restructure the public expenditure program by eliminating questionable programs altogether (and/or

increase tax collection). Certainly, in the long run, the savings from the efficiency dividends system may be expected to weaken.³² And, where evaluation capacity is weak, the risk that the efficiency dividends are achieved by diminishing service or program quality are very real. However, this practice may be an invaluable aid to introducing greater performance orientation in a complacent administrative system, and triggering more structural improvements.

5. The role of multiyear estimates in budget preparation

We discussed in section B the importance of a multiyear perspective for budgeting. When fully integrated into the budget process, rolling multiyear expenditure programming can contribute to enhancing the preparation of the annual budget. As discussed in detail in chapter 13, in some developed countries (e.g., Australia and Denmark) multiyear expenditure estimates prepared the previous year are the starting point of the budget preparation process. Budgetary negotiations focus on new policies, with costs of ongoing programs being updated only on technical grounds based on the multiyear estimates prepared the previous year. In the U.S., the Office of Management and Budget and the Congressional Budget Office prepare five-year projections.

A possible interrelation between the preparation of multiyear estimates and the preparation of the annual budget is presented in figure 6. When launching budget preparation, the multiyear estimates prepared the previous year are used to assess constraints related to existing policy commitments. This assessment and estimate of the financial constraints give the basis for estimating initial expenditure ceilings that frame the preparation of sector requests. Then, the multiyear expenditure program is updated and rolled over when preparing the budget. This process ensures both that the initial ceilings are prepared appropriately and that forward costs of programs are taken into account when preparing the budget.

Box 19

The Role of Multiyear Estimates In Budget Preparation

Australia

To start budget preparation, the Department of Finance updates the forward estimates and establishes the baseline projections which include only the estimated costs of approved programs in the absence of policy change. Using these projections, the Cabinet indicates the broad aggregate targets for the budget and forward years. Decisions made by the Government in the budget process are added to the baseline forward estimates which do not include any allowance for policy changes. Budget decisions focus therefore on incremental adjustments -up or down- to the baseline.

Denmark

When the budget is passed by Parliament in December, an appendix to the Appropriation Bill contains projected expenditures for each of the next three years at the same price and pay basis as the appropriations. Work on the next budget starts shortly thereafter. The budget department in the Finance Ministry adjusts the multiyear projections to the pay and price assumptions to be used in preparing the next budget. In February, the Minister of Finance proposes to the Cabinet a set of net spending ceilings, one for each minister, and the new aggregate target. These ceilings set the framework for the drafting of budget proposals in the various ministries. In effect, the ceilings define an expenditure block for each ministry, allowing a significant flexibility in arranging its budget proposals. After this, negotiations on the budget focus on accommodating new expenditures and cutback options for ministries that have difficulty keeping within the agreed limits.

Drawn from OECD, "Budgeting for results," 1995.

Unfortunately, a "rolling" program is often only cosmetic, with attention really focused only on the first budget year. For a rolling approach to be genuine and thus effective, the key steps would be the following:

The Ministry of Finance updates the costs of the MYEs prepared the previous year, taking into account expected developments in economic parameters, budget execution and expenditure reviews. In carrying out this task, it consults line ministries to get appropriate information, including on changes in the level of demand for services but the exercise is made on a technical basis, without interference or "bargaining" for additional resources.

Taking into account policies, implementation problems, and possible improvements in efficiency, the Ministry of Finance identifies savings that can be made on ongoing programs over the planned period.

Once the global envelope for the annual tranches of the MYE is established, the annual envelopes for new programs are set.

The sectoral distribution of the annual envelopes for new programs is determined, in conformity with government priorities, by the Ministry of Finance or by an

interministerial committee, consulting the line ministries when necessary.

For the planned period, annual sectoral ceilings are communicated to line ministries, distinguishing ongoing programs and envelopes for new programs. Depending on the context, they may also include other elements, such as estimated costs of large investment projects, funds to be reserved to finance the counterpart costs of ongoing projects, and caps on personnel expenditures.

Line ministries are free to identify realistic new savings on ongoing programs, and to recapture the corresponding resources within the limits of the ceilings.

Requests from line ministries are reviewed by the Ministry of Finance, then in joint committee.

This approach requires the preparation of sound cost estimates and discipline in budgeting and decision making. chapter 13 describes in detail the Medium-Term Expenditure Framework. Even if a full-fledged MTEF covering all expenditures is not feasible, linkages between a rolling investment program (or even only estimates of future costs of ongoing programs), and annual budgeting can be established. A multiyear approach permits reconciling the reality that budgeting is inevitably incremental in large part, with the need for significant shifts in the composition of public expenditure.

Box 20
Use of Computer Technology in Budget Preparation: Singapore

The Budget Operations Support System (BO\$\$), the computerized system of Singapore, incorporates the budget allocation rules that compute the percentage share of the GDP to be allocated to the various ministries on the basis of the centrally controlled financing formula. The allocation should be shared between recurrent and development expenditures. The BO\$\$ produces the draft budget spreadsheets for each ministry by splitting its aggregate allocations down to cost-center and account code levels. Once this is completed, the Budget Division of the Ministry of Finance (MOF), at the start of the budget cycle, distributes diskette files of the following to each ministry::

The detailed actual expenditure for the past two financial years

The appropriations and the revised estimates for the current year

The preliminary provisions for the budget year

Each ministry will then decide how the provisions should be distributed most appropriately among programs, activities, cost centers, and line items of expenditure. The individual ministry will upload its proposed budget to the MOF through BO\$\$, which will check whether the target allocations have been exceeded and highlight any significant variations. The highlighted aspects of the ministry's proposal will be analyzed and reviewed by the budget officers as the basis for preparing their reports for the annual budget review meetings between the MOF and the permanent secretaries of ministries.

Source: Joon Chien Doh, "Budget management and budgeting: The Singapore approach," in Naomi Caiden, *Public expenditure and financial administration in developing countries*, Jai Press, 1996.

F. Key Points and Reform Priorities

1. Key Points

The budget formulation process should aim at: (i) ensuring that the budget fits macroeconomic objectives and that expenditures are under control; (ii) allocating resources and programs in conformity with the government's policy objective; and (iii) assuring conditions for operational efficiency.

Hard choices and trade-offs must be made explicitly when formulating the budget. Postponing such decisions until budget execution does not allow a smooth implementation of priority programs, and is disruptive for program management.

The budget is the mirror of government policies. Mechanisms for formulating sound policies and ensuring the policy-budget link are essential. They include:

Coordination mechanisms for policy formulation within the government;

Consultations with the civil society;

Adequate means to the Legislature for scrutinizing policies and the budget (e.g. organization of Parliament committees);

Regulations to discipline policy formulation and reinforce the budget-policy link, notably (i) systematic review of resource implications of a policy change; (ii) superiority of the budget above other regulations, for fiscal issues; and (in some countries) (iii) regulation of powers of the legislature for amending the budget.

The preparation of a macroeconomic framework should be the starting point of budget preparation. The macroeconomic framework should show the fiscal targets (deficit, total expenditures, revenues, etc.). The degree of sophistication of projections depend on technical capacities within the country, but every country should frame the budget

preparation within a macroeconomic framework.

The macroeconomic framework should be based on realistic assumptions, without overestimating revenues or underestimating compulsory expenditures. It is necessary to assess continuing expenditure commitments and to identify measures for achieving the fiscal targets.

To commit the government explicitly and to establish accountability, the fiscal targets and macroeconomic projections should be published.

Financial constraints and policy choices must be built into the expenditure programming process. Budget preparation (and the preparation of any expenditure program) should be organized as follows:

A top-down approach which consists of: (i) defining aggregate resources available for public spending over the planned period, and therefore preparing a sound macroeconomic framework; and (ii) establishing annual sectoral spending limits that fit government priorities and notifying the line ministries of these spending limits;

A bottom-up approach which consists of formulating and costing sectoral spending programs for the planned period within the sectoral spending limits; and

Iteration and reconciliation mechanisms to ensure cohesion between these two approaches.

Budget preparation consists of the following activities: (i) preparation of the macroeconomic framework; (ii) preparation of a budget circular, which gives guidelines for the preparation of sector budgets and preferably announcing expenditure ceilings by sector; (iii) preparation of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the Ministry of Finance; and (v) finalization of the draft budget.

To choose among alternative programs and to prepare their implementation plan,

spending agencies need to know the amount of resources allocated to their sector. Spending limits should be announced early in the programming process. Since they are accountable for sectoral policy and performance, line ministries should be responsible for the preparation of their sector budgets, within the policy framework and hard financial constraints established by the government.

Countries where the conditions are conducive should consider the implementation of a multiyear expenditure programming approach.

The above weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Reforming budget processes is not a sufficient condition for addressing all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- As discussed in chapter 2, the coverage of the budget should be comprehensive, and decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions related to tax expenditures, lending, and guarantees and other contingent liabilities). This is required to optimize allocation of resources, and would limit conflict avoidance as well.
- Financial constraints must be built into the start of the budget formulation process, through the preparation of a fiscal framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policymaking coordination mechanisms that fit the country context are

needed, with particular attention to the budget-policy link. The fiscal impact of policy decisions must be systematically assessed (see section C).

- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority for designing these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting, see discussion in chapter 12).
- Line ministries should assess, when relevant to their mandate, the level of demand for the services they provide and changes therein

2. Directions of reform

The above weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Reforming budget processes is not a sufficient condition for addressing all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- As discussed in Chapter 2, the coverage of the budget should be comprehensive, and decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions

related to tax expenditures, lending, and guarantees and other contingent liabilities). This is required to optimize allocation of resources, and would limit conflict avoidance as well.

- Financial constraints must be built into the start of the budget formulation process, deriving from the preparation of a fiscal framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policymaking coordination mechanisms that fit the country context are needed, with particular attention to the budget-policy link. The fiscal impact of policy decisions must be systematically assessed (see section C).
- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority for designing these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting, see discussion in chapter 12).

Countries should develop appropriate policy *coordination mechanisms* that fit the institutional, constitutional, and political context. Participation of civil society through consultations mechanisms should be sought.

Budget preparation in every country should be framed within a *medium-term macroeconomic framework*, covering three to five years, to assess fiscal sustainability. The degree of sophistication of projections depends on technical capacities within the country, and could be progressively improved by the

development of economic models for macroeconomic forecasting. However, the development of these tools should not be a prerequisite for preparing a macroeconomic framework.

The macroeconomic framework should be supplemented by projections of aggregate expenditures by function and broad economic category, to assess its realism and to identify policy requirements and constraints in achieving the fiscal objectives.

Budget preparation should be organized along the lines mentioned above. Notifying initial spending limits early in the budget preparation calendar and increasing the responsibilities of line ministries in budget preparation are generally needed, although the implementation approach needs to be tailored to the country's institutional context. Close coordination in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from funds, etc.) is required, whatever the administrative arrangements. In countries where responsibilities for the capital budget are separated from responsibilities for the current budget, joint reviews of the two components of the budget are required at *each stage* of budget preparation and at each administrative level.

Budget preparation should be systematically placed into a multi-year perspective. This requires:

at least,

- developing the preparation of aggregate expenditures estimates by function and broad economic category along the lines suggested above;
- reviewing the forward costs of programs when preparing the budget

at a further stage

- preparing multiyear expenditure programs framed by a macroeconomic framework and strictly linked with budget preparation, and including only programs/projects for which financing is certain;

- ensuring that the multiyear programs focus on ongoing policies, and that new policies are decided only during the preparation of the annual budget;

As a final stage

- preparing a formal MTEF (see chapter 13) with the same coverage and in the same degree of detail as the budget (at least by program and projects, and broad economic category). To achieve this objective effectively a progressive approach can be considered. Aid-dependent countries should start by detailing the forward costs of investment projects financed by external sources (“Public Investment Program”; see chapter 12). Other countries could focus on the more costly items, e.g., entitlements, large investment projects/programs, or major specific sectors. These partial programs, as noted, must be framed by projections of aggregate expenditures, by function and broad economic category.

¹ We avoid the term “stages” because the process is also iterative, and a well-prepared budget consistent with policy objectives and financial requirements calls for extensive back-and-forth interaction between steps and between the persons involved.

² The reader versed in statistical inference will recognize here the familiar trade-off, for a given sample size, between the precision of a statistical estimate and its probability of being right, with narrow-band estimates being more precise but less likely to include the true value for the population, and wide-band estimates more likely to be correct but more vague as well.

³ Thus, the Philippines was led by the Asian financial crisis and the attendant uncertainties to move in 1998 from a quarterly cash release system to a monthly release system. Although not strictly applicable to the discussion here, which pertains more to expenditure programming than to budget execution, the example does illustrate the particular uncertainties affecting public expenditure management in developing countries.

⁴ Such a perspective has been referred to at various times as “indicative multiyear budgeting,” “medium-term public expenditure programs,” “multiyear estimates,” and “medium-term expenditure framework” (MTEF). The MTEF designation is currently used more frequently and will be used here as well. Also, an MTEF has a number of specific characteristics, described in the next section.

⁵ These concerns also force government to decide whether to contract out a service.

⁶ OECD, 1995.

⁷ “In Japan, where bargaining takes place in respect of the main budget account, greater controls are exercised by the Finance Ministry on the Fiscal Investment Loan Program, involving substantial borrowed funds and outside the traditional budget” (Premchand, 1983).

⁸ Budgeting by norms and formulae also reduces conflict, and has the advantage of simplicity. Whether it results in good allocation and efficiency depends largely on whether the formulae are appropriate and used to facilitate estimates and budget preparation, rather than mechanical straight jackets.

⁹ “Aside from the legacy of the planning practices of the past, other factors contributed to dual budgeting, such as pressure or recommendations from donors or IFIs. The desire of donors to “enclave” their projects, to minimize risks of mismanagement and maximize provision of counterpart funding, has also increased the fragmentation of the budget system. For example, at the recommendation of IFIs, Romania attempted in 1993-1997 to implement an investment coordination unit outside the Ministry of Finance, to prepare the capital budget and screen projects through its own investment department. A frequently debated issue in the World Bank is the tendency to “enclave...inherent in any project-centered approach to lending. But they reduce the pressure on government to reform, and they may weaken domestic systems by replacing them with donor-mandated procedures”, (World Bank, *Helping countries combat corruption*, 1997).

¹⁰ Sometimes, in countries with poor governance, the spending-developmental approach of the Ministry of Planning is opposed to the thrifty-financial approach of the Ministry of Finance. Again, reality is inconvenient: it is the financial authority that approves extrabudgetary loans, releases cash beyond spending limits, grants the guarantees, etc.

¹¹ See Tanzi (1995).

¹² What evidence does exist is in conflict with the hypothesis that separate investment budgeting has been fiscally expansionary. In 1990-1994, countries participating in structural adjustment programs had slightly *lower* capital expenditure relative to total expenditure, and higher current expenditure, than countries not undergoing adjustment. (Participating countries also had a much lower military spending and civilian wage bill.) This took place at a time when these countries were in effect required by the donors to have a separate investment programming process.

¹³ Adapted from Caiden and Widalvsky, *Planning and budgeting in poor countries*, 1990.

¹⁴ See Jeffrey M. Davis, *Macro-economic adjustment: Policy instruments and issues*, IMF Institute, 1992; S. Rajcoomar and Michael Bell, “Financial programming and policy: The case of Sri Lanka”, IMF, 1996.

¹⁵ Although the fiscal accounts may yield either a surplus or a deficit, the term deficit is used here for convenience and because it is in deficit situations that fiscal adjustment may become necessary.

¹⁶ When interest is rescheduled, the consolidated accounts established on a commitment basis do not show the amount of interest that must be paid in cash, since rescheduled interest is included. The presentation of the accounts should therefore include a memorandum item showing the interest and amortization to be paid.

¹⁷ See also B.H. Potter and J. Diamond, “Guidance for Fiscal Economists,” IMF, 1998, pp. 33-34 and p. 38.

¹⁸ See Tanzi, Mario Blejer and Mario Tejero, Effects of inflation on measurement of fiscal deficit: Conventional versus operational measures, in Blejer and Cheasty, 1993. This measure is not to be

confused with the "operating deficit", defined under accrual accounting as the change in net worth (similar to the notion of deficit in private business). These concepts are reviewed in Chapter 7.

¹⁹ Other deficit measures occasionally used are the "full employment deficit", i.e., the estimated deficit that would exist if the economy were operating at maximum capacity (theoretically measuring the purely cyclical component of the actual deficit), and the deficit including quasi-fiscal operations of the Central Bank.

²⁰ The deficit as an indicator of government solvency: Changes in the public sector net worth," in Blejer and Cheasty op.cit.

²¹ For a brief and readable summary, see the article by the main architect of the model, Jacques Polak, in the December 1997 issue of *Finance and Development* (see also Annex III).

²² For example, the RMSM-X, a model used by the economists of the World Bank. See case studies in Luc Everaert, Fernando Garcia-Pinto, and Jaime Ventura, A RMSM-X model for Turkey, World Bank, 1990; Luis Serven, A RMSM-X model for Chile, World Bank, 1990.

²³ National Audit Office, U.K., "Audit of assumptions for the July 1997 budget projections," presented to Parliament by the Chancellor of the Exchequer, June 19, 1997; Auditor General of Nova Scotia, Canada, "Report to the House of Assembly on the estimates of revenue for the fiscal year 1997-98 used in the preparation of the budget address," Auditor General's Office, 1977.

²⁴ Fiscal policy rules are presented in George Kopits and Steven Symansky, "Fiscal policy rules," IMF, 1998.

²⁵ See Tamim Bayoumi and Barry Eichengreen, Restraining yourself: Fiscal rules and stabilization," IMF, 1994.

²⁶ Binding targets must not be confused with the need to provide aggregate expenditure ceilings to all line ministries and agencies at the start of the budget preparation process.

²⁷ See OECD, *Budgeting for the Future*, 1997. The New Zealand Treasury notes in its presentation of the Fiscal Responsibility Act: New Zealand was changing its electoral system from a First Past to a Mixed Member Proportional (MMP) system. This shift created inherent uncertainty over future fiscal management. The Fiscal Responsibility Act served to reduce some of this uncertainty."

²⁸ See R. Allen, *Assessing policies and their implementation: The United Kingdom experience*," in OECD, 1996.

²⁹ Or longer in the U.S.

³⁰ G.L.R. Dixon, "Budgeting institutions and expenditure outcomes in Australia, World Bank.

³¹ See Allen Schick, *Modern budgeting*, OECD, page 100.

³² "[In Australia] during the first five years of reform, ending with the 1989/90 financial year, Commonwealth spending declined from 29.8 percent of GDP to 23.7 percent. More recent data indicate, however, that the upward climb in public spending has resumed. Commonwealth outlays were 26.7 percent of GDP in 1993/94, three full percentage points higher than they were four years earlier. Without further investigation, one cannot determine whether this rise has been due to cyclical factors or to behavioral changes that emerged only after departments learned how to manipulate the new system to their advantage," Alan Schick, *The changing role of the Budget Office*, 1987.

Chapter 5. ORGANIZATIONAL ISSUES IN BUDGET PREPARATION AND THE BUDGET APPROVAL PROCESS

A. *Organizational Issues in Budget Preparation*

1. Institutional Mechanisms for Policy Formulation

An overall strategic framework should underpin the formulation of sectoral policies provided that it is a genuine and concrete strategy, rather than a generic “mission statement”, or rhetorical vision. Within this framework, line ministries and agencies could prepare their own strategic plans, including: (i) their mandate, consistent with statutory requirements; (ii) a set of outcomes; (iii) the approaches to achieving these outcomes; (iv) a description of how activities and process will be used to achieve these objectives; and (v) a broad cost estimate. Performance plans can then be derived for these strategic plans (issues related to performance are discussed in chapter 15). Such strategic planning is not a static exercise or an occasional event, but a dynamic and inclusive process. If done well, strategic planning is continuous and provides the basis for everything the organization does each day. Regrettably, in many cases the exercise degenerates into bureaucratic formalism, where matrices, long-term vision and logical frameworks substitute for clear thinking rather than being used as instruments to make it explicit. A good practical rule in preparing (and evaluating) a strategic framework is: keep it simple.

There is no blueprint for the organizational arrangements for policy formulation. In all cases however, the relationship between government levels must be established by law. The common requirement is that they must ensure coherence and close coordination among the different actors. The “center of government”, i.e., depending on the country, the Prime Minister’s office, the President’s office, etc., should coordinate the policy formulation process. It must be able to set up policy priorities, coordinate interministerial committees, act as arbiter, launch and coordinate the preparation of strategic plans by sector ministries (or intersectoral committees for cross-cutting policy issues). The center of government therefore needs strategic planning capacity, which could consist of a small group of advisers relieved of day-to-day government coordination activities (but systematically in contact with the operational organs). In

several developing countries, a dual policy decision-making process exists, since government is coordinated both by the President's office and the Prime Minister's office. In these cases, a clear demarcation of their respective roles is needed.

Line ministries should be responsible for policy making within their portfolios. This obvious principle bears underlining because it is so often violated—either by excessive intervention from the center on sector policy issues, or from the Ministry of Finance on sector budget issues, or from the Ministry of Planning when selecting sectoral projects included in the investment program or from donors lobbying in favor of pet projects, and/or from the line ministry itself seeking to evade responsibility by using any of the above as excuses.

The effectiveness of the line minister in coordinating sector policy can also be impeded by internal organizational arrangements within the line ministry itself. Thus, for example, in countries where substantial cuts have been made in the ministry's own current and investment budget, an autonomous fund that benefits from earmarked revenues or a state-owned enterprise in the sector can be much more powerful than the relevant minister.

As discussed in chapter 15, policy formulation can to an extent be separated from the delivery of the corresponding services. This can help avoid “capture” of the policy function by vested administrative interests. Moreover, in many developing and transition countries, decoupling policy advice from service delivery, without giving increased resources to the central departments responsible for policy advice, makes for fragmentation and inconsistency in the formulation of sector policies, since in effect these policies end up being formulated by the entities responsible for delivering the services. The typical outcome is that the Ministry of Finance deals directly with the service delivery entities when preparing the budget and the line ministry is barely involved or even informed—a different variant of “capture”.

Australia has been successful in implementing super-ministries (“portfolio ministries”). These portfolio ministries were made responsible for defining priorities in their respective sectors under tight resource constraints. This organizational arrangement facilitates adjustments in the composition of expenditure programs.

Putting complementary programs under one portfolio highlights the need for trade-offs and gives room to finance new priorities through offsetting savings, while complying with the resource constraint. However, in other countries, a super-ministry could simply be the a grouping of “junior” ministries, adding an unnecessary layer of decision making to the machinery of government, tending to make policy formulation more complex.

Interministerial committees are needed to deal with cross-cutting policy issues (e.g., employment, environment), to coordinate policy areas that are covered by several ministries; or deal with special problems (e.g., regional issues). Setting up task forces can be a flexible way to tackle some special issues, provided that a specific sunset clause—is set and resolutely enforced. The administrative landscape in most countries contains several such entities, still surviving long after the need for their establishment has disappeared.

A cohesive civil service “culture” is important for policy coordination. Especially, problematic are systems where mobility is constrained not only by the usual obstacles, but also by the existence of several different professional “streams” with no possibility of moving between them. Normally, a system whereby officials move among ministries is better able to produce policy coordination than a system in which civil servants spend most of their careers in the same ministry. However, in cases where government is weak across the board and civil servants are incompetent or corrupt, greater mobility may simply serve to generalize incompetence or corruption, eliminate “pockets” of efficiency or honesty, and make reform that much harder.

Circulation of information within the government is crucial. Because it is often seen as an asset to be traded, *information will simply not flow by itself*. Formal and robust mechanisms are needed to ensure it, such as systematic consultation with other ministries, clear rules for circulation of draft decisions before Cabinet meeting, guidelines for documenting decisions, appropriate rewards or penalties. But restraint must be exercised to keep communications relevant and avoid the information overload that hampers genuine communication almost as much as inadequacy of information. Committees dealing with cross-cutting issues at different administrative levels generally facilitate the circulation of information, but must not be allowed to dilute

the line ministries' responsibility in their own areas.

Formal and clear communication and clearance channels are important to avoid implementation problems and misunderstanding, particularly in countries where personalized networks are important. The Cabinet must clearly be the locus where decisions are made; initiatives from ministries should be submitted to the center of government; initiatives that affect the public finances to the Ministry of Finance; and decisions must be systematically documented and formally communicated.¹

Box 21
Key Prerequisites for Well-Functioning Cabinet Systems

An ADB study analyzed cabinet processes and procedures in six countries—Australia, Great Britain, Malaysia, Philippines, Singapore and Sri Lanka. It defined four broad criteria for good cabinet performance: efficiency, effectiveness, accountability and transparency.

The study showed that Cabinet systems seem to be more effective where:

- Extensive interministerial coordination takes place when proposals are prepared;
- Implementation of Cabinet decisions is tracked, through monitoring or other follow-up systems;
- Budgetary resources for implementing Cabinet policies are identified at an early stage of the policy process;
- The Cabinet as a whole takes and stands by decisions collectively;
- The Secretary to the Cabinet (or equivalent position) has the trust and confidence of the Prime Minister or President;
- The staff of the Cabinet/Secretariat is composed of highly respected, competent, experienced, and discrete professionals;
- Ministers and their Permanent Secretaries communicate openly and regularly;
- The number of Cabinet ministers is small, thus simplifying the task of coordination. Leaner Cabinets tend to allow for greater policy cohesion, as well as more efficient meetings;
- Cabinet business forecasting systems are in place;
- The cabinet agenda is limited to a few tough decision items; other routine or low-priority decisions are delegated to permanent secretaries and other line ministry officials;
- Real deliberation over most policy issues has taken place at the committee level before the issue is brought to the full Cabinet for ratification;
- Cabinet memoranda are well-written and concise, with clearly stated objectives and recommendations;
- Cabinet meeting minutes which briefly summarize decisions are conveyed clearly and quickly;
- Cabinet office or other staff brief the meeting's Chairperson (President or PM, or Minister, in the case of committee meetings) before each meeting;
- Cabinet office staff are motivated and regulated according to professional standards;
- Policy proposals are presented as multiple or preferred choices for decision by elected officials rather than as single options recommended without alternative by appointed officials;
- Extensive consultation on policy issues takes place among politicians and technocrats in both formal and informal settings;
- Mechanisms for public consultation are established;
- Written procedures guide the preparation of policy proposals and the implementation of policy decisions, and these procedures are open to public scrutiny; and
- The Cabinet office (or another part of the head of state's office) ensures that the government communicates clearly to the public the rationale for important and/or controversial policy decisions.

Source: Asian Development Bank, Case studies on central mechanisms for policy formulation, coordination and implementation in the Asia Pacific region (RETA 5685), June 1998.

2. Distribution of responsibilities for the macroeconomic framework

Generally, preparing macroeconomic projections should involve directly the agencies responsible for macroeconomic issues, normally the Ministry of Finance, the Central Bank, the Treasury Department, the Ministry of Planning (if any), the Statistics Bureau, and, as the occasion requires, sector ministries.

In some countries, a single agency is responsible for preparing of the macroeconomic framework (with the Central Bank normally responsible for its own monetary and balance-of-payments projections). In other countries, the responsibility for macroeconomic projections is fragmented, with the Ministry of Finance responsible for fiscal projections, the Ministry of Planning for projections for the real sector, the Statistics Bureau for short-term projections for the real sector and price forecasts. In these cases, the macroeconomic projections are simply the collected forecasts from different agencies. For administrative and bureaucratic reasons, whichever agency is responsible for putting together these forecasts is usually reluctant to amend them or to request revisions. The immediate result is lack of consistency of the projections and poor dialogue within the government on policy issues. The indirect result is greater influence by the external financial institutions involved in financing the requirements of the adjustment program. When responsibility is fragmented, therefore, it is essential for the country's policy autonomy to set up an inter-ministerial committee with the authority to scrutinize the different sets of projections, assess their realism and consistency, and require changes—with the assistance of a competent technical secretariat.

Another problematic situation arises when the agency responsible for the preparation of the macroeconomic framework is separated from the entity responsible for overall budget management. The argument in favor of such an arrangement is that it relieves the agency responsible for the macroeconomic framework from the pressures of day-to-day administration of the budget, thus allowing medium-term strategy to be better taken into account. In practice, however, this often disconnects the preparation of the macroeconomic framework from immediate issues, and transforms it into a pro-forma exercise, while the real issues are addressed elsewhere (typically during meetings between the IMF and the Central Bank and the Ministry of

Finance). Understandably, this encourages a mechanistic and lackadaisical attitude to macroeconomic projections, and the tendency to blame difficulties with budget implementation on the poor quality of someone else's forecasts.

Some developing countries have been successful in establishing good coordination mechanisms for the formulation of macroeconomic policy. In other countries, whatever the distribution of responsibilities for preparing the official macroeconomic framework, the Ministry of Finance must have the internal capacity to review the macroeconomic projections, assess the risks associated with the different macroeconomic and fiscal scenarios, and prepare its own macroeconomic scenario to serve as a basis for comparison and reality check.

3. Distribution of responsibilities in annual budget preparation

Different actors are involved in budget preparation: the center of government, the Ministry of Finance (which consists of both the Ministry of Finance and the Ministry of Planning in many developing countries) central departments of line ministries and, within line ministries, subordinate spending agencies. The quality of the budget depends largely on the mode of coordination that is established among these different actors.

The distribution of responsibilities in budget preparation should fit the distribution of responsibilities within the government. It should be established in the budget rules or guidelines, along clear lines in order to establish unquestioned rules for compliance and accountability in budget execution. The organization of the executive branch of government in most countries suggests a distribution of responsibilities along the following lines: ²

- The center of government is not directly involved in the practical aspects of budget preparation, but plays a key role in the budgetary process, to ensure that it is carried out along the lines defined and arbitrate and smooth over any conflict that may appear among the actors, and assure participation by the relevant stakeholders.

- The Ministry of Finance has the leading role in budget preparation. It needs sufficient powers to ensure that both fiscal targets and policy objectives are taken into account at every step. It prepares fiscal targets and strategic prioritization among sectors; establishes guidelines for preparing sector programs and for preparing line ministries' requests; scrutinizes those requests; and drafts the budget. However, the Ministry of Finance should not become the only player in the process. The budget should not drive policies. The Ministry of Finance has to facilitate decisions on major policy choices and allocation of resources among sectors, not make those decisions. The Ministry of Finance has to review and screen requests, not prepare them, directly or indirectly, as is the case in "open-ended" budget preparation and incremental budgeting.
- Line ministries are responsible and accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and their sectoral budgets as well, but within the framework established by the government. Moreover, they (and not the center or the Ministry of Finance) should have the technical capacities and information needed for trade-offs among ongoing programs and appraise new programs. In turn, line ministries are responsible for formulating guidelines for their subordinate agencies and scrutinizing their draft budgets.
- Subordinate agencies should prepare their budgets within the guidelines provided by their immediate direct authority. Often, powerful agencies prefer to deal directly with the Ministry of Finance; this hampers the definition of consistent sector policies.

Most developed countries have organized the distribution of responsibilities in budget preparation along the above lines. In developing countries, by contrast, the role of the Ministry of Finance in budget preparation can be more extensive and can strongly interfere in the preparation and the composition of the sectoral budgets. In countries with poor governance, subordinate agencies may see the Ministry of Finance as a protector against the confiscation of resources by "advisers" to the minister or by

the line ministry's central departments.³ The informal network of technicians from the Ministry of Finance and the line ministries may try to use the complexity of a line-item budget to protect some sectors or items. However understandable this may be, this defensive approach generally gives poor results. Bad policies and weak governance cannot be corrected at micro-level by insulating temporarily a specific budget line item or subordinate agency.

4. The budget timetable

a. Budget circular

A budget circular generally introduces the budget preparation process to spending agencies. It is often a routine affair, giving deadlines for the presentation of line ministries' requests and some general recommendations.

For a sound budget preparation process, the budget circular should state clearly the fiscal targets and the policies proposed. Ideally, a budget circular should include the following elements:

- a statement of the macroeconomic and financial situation;
- the overall deficit target and expected resources;
- budget priorities;
- sectoral budget ceilings;
- allocations for continuing policies and programs (for this, a rolling expenditure programming process is required);
- an indication of the expenditure savings expected in ongoing programs;
- the format of the line ministries' budget requests (presentation of sector policy, performance indicators, etc.);
- specific recommendations on program/projects;
- guidelines for the preparation of the sector programs (i.e., minimum requirement in terms of economic analysis to support a proposed investment project);
- economic parameters such as the expected inflation rate and the exchange rate;

- the organization of the budget preparation process (calendar, forms to be completed, etc.).

b. Budget preparation calendar

For sufficient iteration between the top-down and the bottom-up approach, adequate time is needed, notably to allow line ministries to prepare their budgets and identify measures to comply with the ceilings.

In several developed countries, the budget circular for the next year is sent to spending agencies soon after the start of each fiscal year. Therefore, budget preparation starts nine to ten months before the budget is presented to the legislature. In the United States, taking into account the special role of Congress, the budget preparation takes about 18 months.

In some developing countries, budget preparation is sometimes starts early but the sectoral ceilings are announced much later, and across-the-board cuts or arbitrary choices have to be made at the last minute.

The optimal length of the budget calendar is difficult to establish, and depends on the country context. On the one hand, a short calendar (or a short time between the notification of ceilings and the deadline for presentation of the budget requests) does not allow line ministries and subordinate agencies to prepare their program properly, or leaves no time for the needed negotiations. On the other hand, a lengthy process could lead to a budget based on out-of-date estimates of economic and fiscal parameters, which in addition could not take into account the results of the execution of the previous year's budget.

Unfortunately, countries with unstable and hard-to-forecast parameters (such as high-inflation countries) are precisely those countries that need more time to make the hard choices among their programs. Generally, a budget preparation period starting six months before the deadline for presentation of the budget to the legislature is appropriate in developing countries, but there is no hard rule, and no substitute for custom-tailoring the budget calendar to the specific country.

Box 22
Possible Timetable For Budget Preparation

Month	Phase
T-8	The macroeconomic framework is prepared.
T-7	Ceilings are determined by sector (for the annual budget <i>and, if prepared, MYE or PIP</i>); Cabinet approves strategy.
T-6	Budget circular is released.
T-4	Line ministries submit budget (<i>with forward cost estimates</i>)
T-3	Budget requests are reviewed and negotiated between MOF and individual line ministries (<i>and MYE or PIP</i>). <i>In dual budgeting systems, reviews are made jointly by MOF and Ministry of Planning.</i>
T-1	Budget is submitted to the legislature
T	Month when budget is approved by legislature

Partly drawn from Guidance for Fiscal Economists on Public Expenditure Management, FAD.

B. DISTRIBUTION OF RESPONSIBILITIES BETWEEN CENTRAL AND LOCAL GOVERNMENT

This volume is of necessity focused on central government expenditure. Nevertheless, certain key issues related to the fiscal relationship between national and subnational levels of government must be considered. As mentioned in chapter 2, each governmental entity (central government, states, municipalities, etc.) should have its own budget, enacted according to the provisions stipulated in the Constitution or by law. However, there are strong linkages between the budget of the central government and the budgets of subnational governments, which require particular attention when preparing the budget of the central government.

1. “Fiscal federalism”: Key issues

The degree of devolution, assignment of expenditures and revenue arrangements should be tailored to the country context and depend on policy and

political issues. However, central government budget managers need to be aware of the key principles that should govern these arrangements.

From an efficiency perspective, the Oates “decentralization theorem” states that: “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision.” Similarly, the European Union has adopted the “principle of subsidiarity”, for the assignment of responsibilities among its members. According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government.

Decentralization is a very complex matter, both in general and for the management of public expenditure. It is generally desirable for efficiency, local accountability, and participation. These criteria must be balanced with other elements, such as spatial externalities, economies of scale, overall fiscal efficiency (e.g., more generous public services in one region would encourage people to move there, even if economic opportunities may not exist), regional equity, and the redistributive responsibilities of the government. In developing and transition countries, the administrative capacity of subnational governments, and the administrative and compliance costs of decentralization must be taken into account when assigning expenditures among levels of government. Political issues and, in a number of countries, ethnic or nationality problems cannot be ignored, either.

The literature on fiscal federalism discusses these issues and gives hypothetical and real-life examples of expenditure assignment.⁴ It also presents various contradictory points of view on the desirable degree of decentralization. The need for some increased fiscal decentralization is generally admitted. Many observers, however, stress the risk of loss in expenditure control, increased corruption, and inefficiencies in resource allocation that would result from hasty decentralization, even when theoretically justified.⁵

Box 23
Fiscal Management in Federal Systems

In the 1980s, Argentina and Brazil faced similar problems, with subnational deficits adding to excess public deficits and high inflation. In the 1990s, both countries continued with fiscal decentralization and with the struggle to bring about macroeconomic stability. Argentina had greater success, partly because it imposed a harder budget constraint on the public sector at the national level and it had stronger party control of the subnational governments and of the national legislators. For restraining local and state borrowing, getting the right incentives for subnational governments and particularly for its creditors, in Argentina, proved more effective than central government rules, in Brazil (Steven Webb and William Dillinger, 1998).

In the People's Republic of China, the implementation of the Budget Law in 1994 strengthened the basis for fiscal operations. Central approval of local budgets was abolished, and budgetary procedures were clarified, requiring the local and central budgets to be formulated in a consistent macroeconomic framework. Local governments were disallowed from financing any deficits through bond issues, bank borrowing, or grants from the central government. They were required to run balanced budgets or to use accumulated budgetary surpluses and extrabudgetary funds to finance deficits (IMF WP/97/129).

In any event, tax and revenue arrangements should be in conformity with expenditure assignments, and should take into account efficiency issues in tax administration. Such arrangements may include: (i) tax assignment, i.e., assignment of certain taxes to subnational governments; (ii) tax-sharing agreements; (iii) revenue sharing, whereby a share of a pool of tax revenue is given to the subnational levels of government; (iv) unconditional grants; (v) conditional "block grants", i.e., transfers from the central government subject to certain conditions or standards of service delivery; (vi) targeted grants for a specific purpose or project. Among the various possible alternatives, the Australian Grants Commission System has much to commend it. It has successfully equalized access to basic social services, while preserving the incentive of each state to provide the services more efficiently, and largely depoliticizing the contentious issue of federal-state revenue sharing.

2. Broad principles

Whatever the degree of devolution appropriate to the country, the framework that governs the relationships between the central and local governments and arrangements for budgeting should be clear and efficient. As noted at the outset, a legal framework should govern the relationship between the different levels of the

government. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to assure smooth intergovernmental fiscal relations. Such mechanisms could operate through specialized bodies. In India, Australia, and Sri Lanka, for example, a Financial Commission deals with financial relationships between the central government and the other levels of the government; in Germany, a second chamber of Parliament with state representation contributes to intergovernmental policy coordination; and specialized sectoral coordination councils are common in many countries.

For transparency and efficiency of management:

- Each level of government should have clearly assigned responsibilities, regardless of what those responsibilities are assigned to government as a whole (see Box 24). Overlaps should generally be avoided, and long “concurrent lists” of shared responsibilities are particularly ambiguous.
- Fiscal and revenue-sharing arrangements between the central and local governments should be stable. They may be amended from time to time, but renewed bargaining each year should be avoided at all costs.
- Subnational governments need to have a sound estimate of these resources before preparing their budgets. In some countries (e.g., Ukraine in 1996-97), local governments have to wait for the draft budget of the central government to be finalized before preparing their own budgets. Such lack of predictability hampers both efficiency and fiscal control at local levels. Without an indication of the level of resources to be transferred to them, subnational governments cannot adjust their expenditures to fiscal constraints. Accordingly, forecasts of revenues should be transmitted to local governments as soon as these are set, and estimates of grants to local governments need to be prepared early in the budget process of the central government.
- Incentives for increased efficiency are needed. Often the central government makes transfers to subnational governments when they make

economies in public spending or improve their own tax collection. This evidently does not stimulate them to seek economies in service delivery or improve tax collection. Subnational governments must be allowed to benefit from savings they make, at least in a large part. (The same argument was made in chapter 2 with respect to commercial revenue of state agencies.)

- It could be desirable to agree on multi-year “contracts” between the central government and local governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include performance criteria, minimum standards for services rendered by local government, etc. They would define relationships in a transparent manner and would ensure predictability. As for any contract, of course, the utility of this arrangement would depend largely on how well it is monitored and respected.
- National law should provide standard accounting and budgeting rules for subnational governments.

Box 24
Defining China's Expenditure Assignments

To date, China has failed to work out a law that clearly defines expenditure responsibilities for different levels of government. Existing expenditure assignments are murky, and often, motivated by political expediency, shift between levels of government in ad hoc ways. The central government may shift its own expenditure responsibilities to provincial governments in times of difficulty and provincial governments may use their broader responsibilities to bargain for a larger share of revenue. Intergovernmental bargaining has weakened budgetary planning and control and contributed to the instability of China's fiscal system. Without first reaching decisions on expenditure assignment, the Chinese authorities have found it difficult to reform tax assignment rules and revenue-sharing mechanisms between the central and provincial governments.

Expenditure assignments between the provincial government and lower-level authorities, such as municipal and county, are even more vague. Local governments are often forced to take the responsibility that should be undertaken by higher-level government, accentuating the mismatch between local revenue and local expenditure responsibility. The lack of specificity and the unpredictability built into the current system of expenditure assignments have given rise to budgetary uncertainty for the central government and made fiscal planning an impossible task for provincial and local authorities, hence adversely affecting the supply of public goods and services in both quantity and quality.

Source: Reforming China's Public Finances, Ehtisham Ahmad, Gao Qiang & Vito Tanzi (editors), IMF, 1995.

For expenditure control and strategic allocation of resources:

- Fiscal targets should cover the *general* government.
- Revenue assignment should be fully consistent with expenditure assignment. Sufficient resources should be assigned to subnational governments to allow them to fulfill their duties. When new duties or responsibilities are transferred to subnational governments, compensatory measures should be provided on the revenue side. On the other hand, of course, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.
- "Downloading" the fiscal deficit should not be permitted (defining fiscal targets for general government would help avoid this problem). When balancing its budget, the central government should avoid passing its

financial problems to subnational governments through cuts in intergovernmental transfers or increased expenditure assignments, without compensatory measures. To do so would either not change the aggregate borrowing requirements of the *general* government, or generate arrears.

- Special mechanisms are needed to control local government borrowing (see Box 25 for arrangements in various countries).
- In case of local government budget overruns or accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, local authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited period of time until the situation is stabilized. (An exception should be explicitly provided for instances when the overrun or arrears are directly related to a downloading of central fiscal problems, as mentioned above.)
- A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal control and audit for subnational governments should be similar to those of the central government. This leads one back to the central question of local government administrative capacity, and hence the issue of the degree of decentralization.
- For policy analysis (as well as fiscal targets of general government), it is necessary to consolidate the expenditure of the different levels of government especially in decentralized systems and federal countries. It would be very difficult to know what is spent on key sectors based only on the account of the central government. For this purpose, local governments and central government should have a common functional and economic classification of expenditures.

Box 25
Arrangements for Controlling Subnational Government Borrowing

Country	Local and municipal authorities/ Debt limits
<i>United States</i>	All local governments must have a balanced budget. Most states have either a constitutional or a statutory requirement for a balanced budget.
<i>Canada</i>	No formal restrictions. Market mechanisms are in place.
<i>United Kingdom</i>	A balanced budget is required.
<i>Sweden</i>	A balanced budget is required. Local and municipal governments are responsible for their own debt.
<i>Australia</i>	The Australian Debt Council determines the total public debt and the distribution between the different government levels, but in practice market mechanisms operate.
<i>New Zealand</i>	Generally speaking, local governments must finance current expenditures with revenues for the same year.
<i>Argentina</i>	The provinces may contract debt both internally and externally. The Central Bank oversees the impact on the financial system, and the Ministry of the Economy oversees maximum external interest rates.
<i>Brazil</i>	The Federal Senate sets overall limits to the amount of debt that states, the Federal District, and the municipalities can contract, and establishes the rules and conditions for their external and internal credit operations.
<i>Chile</i>	Municipalities and state-owned enterprises are able to contract loans for special projects. But this requires a law that must also indicate how the loan is to be repaid.
<i>Colombia</i>	According to constitutional regulations, local government's debts may not exceed their ability for repayment. A law is in place that establishes graduated authorization procedures according to debt levels.
<i>Mexico</i>	The states may not, in any case, directly or indirectly contract obligations or loans with foreign governments, companies, or private parties; or loans that must be repaid in foreign currency. States and municipalities may contract loans only when they are for productive public investments.
<i>Venezuela</i>	Local and municipal entities may not contract loans without the authorization of federal authorities.

Source: Ter-Minassian, T. (1996) and Petrei, 1998.

C. APPROVAL OF THE BUDGET AND THE ROLE OF THE LEGISLATURE

1. Presentation of the budget to the legislature

The enactment of the budget should not merely be a formal exercise carried out to comply with the Constitution. The legislature is, generally, the appropriate locus of overall financial accountability. Naturally, the role of the legislature should be to approve future actions rather than to rubber-stamp decisions already taken. Thus, the budget should be presented to the legislature in a timely manner, that is, two to four months before the start of the fiscal year, to allow budgetary debates to be completed before the start of the fiscal year.

In some countries, the budget is submitted to the legislature after the start of the fiscal year, owing to unavoidable delays in budget preparation, change in the composition of the Cabinet, or pending financial negotiations with IFIs. However, in other countries, delay is institutionalized. In Nepal, the budget is presented systematically to Parliament only days before the beginning of the fiscal year. Therefore, Parliament has to authorize the government to spend immediately one-sixth of the appropriations presented in a Budget Bill that it has not yet scrutinized. In China, the National People's Congress (NPC) does not meet to approve the budget until after the commencement of the fiscal year.⁶ As a result, it is asked to approve appropriations for a budget that is already being implemented.

Under special circumstances delays may be justified. The organic law (or law on the budget system) should therefore include provisions authorizing the executive to commit expenditures before the budget is approved, under specified circumstances. These provisions should be based on the budget of the previous year, rather than on a budget that has not yet been scrutinized (e.g., an authorization to commit each month up to one-twelfth of the appropriations of the previous year, as in the continuing resolution used by the U.S. Congress when the budget is not approved before the start of the fiscal year in October). In all cases, care must be taken lest these special provisions are abused and become a systematic way to sidestep the normal budget process.

Members of the legislature have different preferences regarding the manner in which resources are allocated and are subject to a variety of pressures from their constituents. The sum of these various preferences and related claims can generate a systematic tendency to increase expenditure during budget debates (a phenomenon known as “log-rolling”). Accordingly, many countries have adopted procedural rules to regulate and limit legislative debates on the budget. These rules cover (i) the sequence of voting on the budget; and (ii) the legislature’s powers to amend the budget. In parliamentary systems with a clear majority of one party,⁷ the budget prepared by the executive is routinely approved by the legislature; indeed, failure to approve the budget is equivalent to a vote of no confidence and normally results in the resignation of the government.⁸

To enforce ex-ante fiscal discipline, in several countries the budget is voted in two phases: the overall amount of the budget is voted first, and appropriations and allocation of resources among ministries are voted only in the second phase.⁹ This procedure is aimed at protecting the aggregate expenditure limit and the overall fiscal target. The real impact of this procedure is unclear since legislators can anticipate the incidence of the overall amount of the budget on their pet programs before the first vote and decide the overall amount accordingly.¹⁰ However, reviewing aggregate expenditures and revenues together has the advantage of allowing the legislature to discuss macroeconomic policy explicitly.

Legal powers of the legislature to amend the budget vary from one country to another. Three situations are possible:¹¹

- *Unrestricted power* is the ability of the legislature to vary both expenditure and revenue in either direction, without the consent of the executive.¹² Presidential systems fit this model, although the “power of the purse” granted to the legislature is counterbalanced by a presidential veto (e.g., in the U.S. and the Philippines). This implies substantial legislative influence on the first two objectives of PEM (fiscal discipline and expenditure allocation) as well as some indirect influence on the third (practical management).

- *Restricted power* is the power to amend the budget within set limits, often relating to a maximum increase in expenditures or decrease in revenues. The extent of these restricted powers varies from country to country.¹³ In the United Kingdom, France, and British Commonwealth countries, Parliaments are not allowed to propose amendments that increase expenditure and have very restricted powers. By contrast, Germany allows such amendments, but only with the consent of the executive. This implies very limited legislative influence on resource allocation and (indirectly) on operational management.
- *Balanced budget power* is the ability to raise or lower expenditures or revenues *as long as* there is a counterbalancing measure to maintain the budget balance. This intermediate arrangement concentrates legislative influence on resource allocation.

Limits on the power of the legislature to amend the budget are particularly needed where legislature debates lead systematically to increased expenditures, as recently the case in a number of FSU countries. The budget organic law should stipulate that legislative actions that increase expenditures can take effect only if these expenditures themselves are authorized in the budget or its supplementary acts. However, these limits should never hamper legislative review of the budget. In some countries, the budgetary role of the legislature may need to be increased rather than limited.

Strong and capable committees enable the legislature to develop its expertise and play a greater role in budget decision making. Generally, different committees deal with different facets of public expenditure management. For example, the Finance /Budget Committee reviews revenues and expenditures; a Public Accounts Committee assures legislative oversight; sectoral or standing committees deal with sectoral policy and may review sector budgets. Coordination between the activities of these committees should be effective. In countries where the role of the legislature in amending the budget is significant, amendments are prepared by committees rather than proposed on the floor by individual members.¹⁴

Time allocated for the legislative budget process and, within this process, for committee reviews is important for a sound scrutiny of the budget. Legislative budget deliberations last up to 75 days in India; in the German *Bundestag* they may last up to four months; in the U.S. Congress, sometimes even longer.

The legislature and its committees should have access to independent expertise for proper budget scrutiny. In India, for example, parliamentary committees are supported with secretarial functions and legislators have access to the Parliament library and associated research and reference services; the U.S. Congress benefits from competent staff of the appropriations committees as well as the services of the large and well-equipped Congressional Budget Office, and is assisted by the General Accounting Office with audits and information on program compliance and performance.

Committees should also have access to administrative information. In Germany, the budget committee interacts quasi-permanently with government departments through regular departmental briefings and expenditure reports. In India, the Public Accounts Committee receives reports and departmental accounts and revenue receipts from the Comptroller and the Auditor General (although this concerns the oversight function of the Parliament, rather than budget policies). Regular consultations between the administration and the legislative committees on budget policies and their implementation would strengthen the capacity of the legislature to review the budget.

D. KEY POINTS AND DIRECTION OF REFORMS

1. Key points

Responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined and delimited:

- The center of government (Prime Minister, President office, etc) coordinates policy formulation and arbitrates any conflict in budget preparation.

- The Ministry of Finance prepares guidelines, scrutinizes requests and ensures the coordination of the budget preparation process, and the overall consistency of the budget with policy and macroeconomic objectives.
- Line ministries and agencies are responsible for preparing their sector programs and budgets, within the policy framework decided by the government.

Assignment of expenditures to *subnational government* should be established on clear bases, and arrangements for revenues should follow expenditure assignments. When preparing its budget, the central government should avoid passing down the deficit to subnational governments. Any increased expenditure assignment must be balanced with compensatory measures on the revenue side.

To ensure both efficiency and fiscal discipline, incentives and sanctions are needed. Subnational governments should benefit from savings they make, but protective measures are required in case of mismanagement or budget overruns.

2. Directions of reform

The legislature is the appropriate locus of overall financial accountability, and adequate means should be given to the legislature to review policies and the budget:

- The budget should be presented to the legislature in a timely manner, to allow its proper scrutiny and the completion of budgetary debates before the beginning of the fiscal year.
- Legislative committees should have adequate resources.
- Aggregate revenue, expenditure, and fiscal targets should be reviewed together.

In order to contain pressures to increase expenditures, limits on the powers of the legislature to amend the budget may be needed (e.g., any amendment that increases expenditures or decreases revenues should be accompanied by a counter-

balancing measure to maintain the initial deficit target). The legal framework should stipulate that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or its supplementary acts.

¹ In France, for example, their function is exercised systematically by the General Secretariat of the Government.

² If one except the U.S. system, where legislature has an extensive role in the budget preparation process.

³ In February 1997, in a seminar on budget management in Yaounde Cameroon, the strongest opposition to increased responsibilities of line ministries in budget formulation and execution came from the heads of remote spending units, who feared losing the support of the Ministry of Finance in getting at least minimal budgetary resources.

⁴ See Shah, 1994, and Ter-Minassian, 1997.

⁵ See Prudhomme, 1995.

⁶ Ahmad, et al, 1995.

⁷ E.g., in Italy last year.

⁸ E.g., in Italy in late 1998.

⁹ For example, in the U.S. since the Budget Act of 1974, and in France, etc.

¹⁰ See Alesina and Perotti, 1996.

¹¹ Drawn up from Krafchik and Wehner, 1998.

¹² In the U.S., congress restricts its own power through the annual Budget Resolution setting spending targets for congressional committees. In 1990, for example, Congress prescribed that new benefits in entitlements could be provided only to the extent that other entitlements would be cut or new revenues raised. However these are self-imposed restrictions, which can be lifted at any time by legislative action, and are thus different from the restriction imposed from outside the legislature.

¹³ See von Hagen and Harden, 1996; —, 1992; Milesi-Ferretti, 1996.

¹⁴ In the US, the annual Budget Resolution (which, as a resolution, does not require the President's approval) contains an overall spending target or cap.

Chapter 6. ASSURING COMPLIANCE IN BUDGET EXECUTION¹

A. OBJECTIVES OF BUDGET EXECUTION

1. Importance of budget execution

Budget execution is the phase where resources are used to implement policies incorporated in the budget. It is possible to implement a well formulated budget; it is not possible to implement well a badly formulated budget. Good budget preparation comes first, logically as well as chronologically. However, budget execution processes do not come down simply to mechanisms for ensuring compliance with the initial programming. Even with good forecasts, unexpected changes in the macroeconomic environment will occur during the year, and need to be reflected in the budget. Of course, changes should be accommodated in a way that is consistent with the initial policy objectives to avoid disrupting the activities of agencies and project management. Successful budget execution depends on numerous other factors as well, such as the ability to deal with changes in the macroeconomic environment, and the implementation capacities of agencies. Budget execution involves a greater number of players than budget preparation, and calls both for assuring that the “signals” given in the budget are transmitted, and for taking into account feedback from actual experience in implementing the budget.

Hence, budget execution calls for: (i) ensuring that the budget will be implemented in conformity with the authorizations granted in the law, both in the financial and policy aspects; (ii) adapting the execution of the budget to significant changes in the macroeconomic environment; (iii) resolving problems arising during implementation; and, (iv) managing the purchase and use of resources efficiently and effectively. A budget execution system should ensure compliance with budgetary authorizations and should have adequate monitoring and reporting capabilities to be able to identify budget implementation problems promptly while giving flexibility to managers.

2. The budget execution system

A budget execution system should meet the three major objectives of a public expenditure management system, presented in chapter 1 (aggregate expenditure control, strategic resource allocation, and operational efficiency). Its procedures should be appropriately balanced to avoid or resolve conflicts between these objectives.

Aggregate expenditure control requires defining fiscal targets, and is therefore largely concerned with budget preparation (chapter 4). Budget execution procedures must therefore ensure that fiscal targets are effectively enforced and that managers comply with the budget authorized by the legislature.

The focus of traditional budget execution system is compliance, through detailed input controls to ensure that there will be no overruns and that the composition of the budget will not be altered during budget execution. This approach is aimed at assuring fiscal discipline, but generally poses two different sorts of problems. On the one hand, as noted earlier, excessively detailed controls are time-consuming, make the budget rigid, and do not give managers the flexibility needed to implement their budget efficiently. On the other hand, traditional controls are not even sufficient to assure fiscal discipline. They often focus on cash payments for supplies, while the most crucial problems are often found elsewhere (overstaffing, entitlements, arrears on utilities services consumption, etc.). For compliance, ex-post audits and sanctions and internal management systems are as important (and in many cases more important) than traditional budgetary control (internal control and audit is discussed in chapter 9).

1. To implement policies and programs in the most efficient and cost-effective way, the line ministries and agencies should be given adequate flexibility to manage their resources within the policy framework of the budget. This flexibility concerns the composition of the inputs needed to carry out a given activity and the allocation of resources among projects that meet the same set of objectives (within the same program). However, it should not alter the policies stated in the budget voted by the Legislature or hamper stabilization objectives.

2. Overspending and underspending

Overruns are sometimes caused by noncompliance of budget managers with the spending limits defined in the budget, when committing expenditures. Since cash allocated to spending units for appropriated expenditures is generally controlled, these overruns turn into arrears generation. Overruns are often the result of off-budget spending mechanisms (payments from special accounts, “below-the-line” accounts, etc.). In some countries, the expenditure process can be so cumbersome that “exceptional procedures” have been created to bypass them. Payments made through these exceptional procedures are not controlled against the appropriations and are therefore an important cause of overruns. Lack of compliance can be addressed through strengthening the audit system, and the reporting system, and ensuring the effectiveness of the basic budget execution controls reviewed below. A comprehensive coverage of the budget is required (see chapter 2). Exceptional procedures should be avoided, but in a number of countries this requires simplifying the system of control.

Overruns can be caused by deficiencies in budget preparation. Elements such as continuing commitments for investment and entitlements, or the impact of the inflation rate on wages are in some countries poorly taken into account when preparing the budget. Also, particular interests and political pressures may affect budget preparation, budget enactment and budget execution. In some countries, the executive or the Parliament adopts decrees and laws that have a financial impact on the budget even if they do not concern the budget directly. As discussed in chapter 4, regulations are needed in this area. The Ministry of Finance himself must review any regulation or draft decision that can have a fiscal impact. However, in some cases the Minister of Finance may cause the overruns (e.g., through spending from special accounts or unconsidered borrowing for projects). Sound budget preparation processes and adequate institutional arrangements are a prerequisite to avoiding overruns. But in some countries with bad governance, seeking solutions on the technical side could be illusory.

In a number of developing countries, the budget is underspent. This does not necessarily mean that there is good fiscal discipline in these countries. In some countries with bad governance, underspending of the official budget may coexist with off-budget spending. The underspending problem concerns the official budget and, particularly but not only, its development component. It is a very old problem. In the 1970s, expenditure plans prepared in a number of developing countries were underspent.² The execution of several development budgets and nonwage expenditure items in recurrent budgets currently present the same feature.

In a majority of cases, underspending, as well as overruns, is related to insufficiencies in budget preparation and program preparation. An overestimated budget and unrealistic projections of revenues lead to remaking the budget during budget execution. In a majority of developing countries, the Ministry of Finance is empowered to control the budget execution, through the Treasury and budget advisors/financial controllers. Therefore, when budget preparation is poor, insufficiencies in budget preparation are addressed through repetitive budgeting.³ After the budget is approved, the Ministry of Finance relies on its own views in preparing the budget implementation plan. A monetary committee reviews the revenue situation and may decide that only half of what the official budget actually calls for will be released. There is a budget but funds are released from a core budget known only to the Ministry of Finance, etc.⁴ Instruments that are required to ensure fiscal discipline and cash management can be disruptive to program implementation.

Concerning the development component of the budget, underspending is often related to insufficiencies in project/program preparation. Optimistic financial planning that does not take into account the time needed for procurement or for the mobilization of external funds is frequent. Development expenditures are difficult to plan accurately, but adequate flexibility to reallocate funds from projects that are delayed to projects that are proceeding well could allow satisfactory implementation of the overall expenditure program. Programming investment needs to consider the availability of domestic resources. Including projects in a development budget only on the basis of the availability of donor funds leads to an underspent development budget. Moreover, in some countries, cash-flow budgeting⁵ is a means for the Ministry of Finance to take

control over a development budget that it has not prepared. As discussed in chapters 3 and 4, close coordination between core agencies is imperative during budget preparation, to address any conflicting issues during this phase.

Any analysis of budget execution and the instruments for controlling budget execution needs to cover issues related to budget preparation, and to take into account both the risks of disruptive repetitive budgeting and the requirements for cash control and compliance control. The importance of these aspects depends strictly on each country context.

B. THE EXPENDITURE CYCLE

1. Stages of the expenditure cycle

Once the budget is adopted by the legislature, the expenditure cycle consists of the following phases:

- *Allocation of appropriations/release of funds to spending units.* Funds may be released through notification of cash limits, issue of warrant, funds transfers to imprest accounts, etc. In some countries, the release of funds includes two steps: (i) *apportionment* by the central budget office, which consists of defining which part of the appropriation the line ministries and spending decision units can use; and (ii) *allotment* by the line ministries and main spending decision units, which consists of allocating apportioned appropriations to subordinate spending units.⁶
- *Commitment.* The commitment stage is the stage where a future obligation to pay is incurred. A commitment consists of placing an order, awarding a contract, etc., for the services to be received. It entails an obligation to pay only if the third party has complied with the provisions of the contract. However, as discussed in section B2, the precise definition of “commitment”, in the budgetary sense, varies from one budget system to another, and depends on the economic category of the expenditure.

- *Acquisition/Verification (or certification)*. At this stage, goods are delivered and/or services are rendered and their conformity with the contract or order is verified. Assets and liabilities of the government are increased and recorded in the books, if the country has an accrual accounting system. Expenditures at the verification stage are called accrued expenditures in some countries (e.g. in the U.S.). Accrued expenditures should not be confused with full costs or other expenses for which certain appropriations within an accrual budgeting system are used (see chapter 10). Expenditure at the verification stage entails a liability, and arrears are the difference between expenditures at the verification stage and payments.
- *Payment*. At this stage, payments are made. Payments can be made through various instruments: checks, cash disbursed, electronic transfers, debt instruments, barter agreements, deduction from taxes, cash vouchers, etc. Payments through barter agreements, deduction from taxes and cash vouchers are questionable. Payments through deduction from taxes, are frequent in some FSU countries, but have negative consequences on both tax collection and competition among suppliers. Barter agreements impede competition among suppliers. Cash vouchers should generally be seen as an administrative stage in the expenditure cycle, rather than as a payment, especially when they are not paid immediately. Payments through checks are, in a majority of countries recorded when checks are issued. Comparisons with bank statements should be systematic. When the float of unpaid checks is significant, payments must be reported on the basis of checks paid.

[Please see attached Figure 8.xls]

2. What is a commitment?

In the budgetary jargon, depending on the nature of the expenditure and the country, a commitment (or an obligation) corresponds either to the commitment stage

as defined above, or to the verification/acquisition stage, or to an administrative reservation of funds in anticipation of their use. Some countries, e.g., the U.S., distinguish the (administrative) commitment" which is a reservation of funds, from the obligation, which corresponds to an order placed, contract awarded, service received, or similar transaction that will require payment.⁷

The distinction between the commitment stage and the verification stage concerns mainly investment expenditures and the purchase of supplies. For debt service, personnel expenditures, transfers, and also some categories of goods and services expenditures (such as electricity consumption, telephone), the commitment in the budgetary sense corresponds to the expenditure at the verification stage (monthly wage bill, interest payment due, phone bill). For these categories of expenditure, the obligation to pay comes from an event upstream to the commitment in the budgetary sense (disbursement of a loan, recruitment, phone call, etc.).

In budget systems, for multiyear contracts, a commitment, in the budgetary sense, may correspond to the commitment of the entire contracts, or to an annual tranche of the contract, or to actual expenditures. In this manual, when it is necessary to distinguish a multiyear commitment from its annual tranche, the expressions forward commitment and annual commitment are used. The legal commitment corresponds to the contract, not to the annual commitment.

C. ASSURING FINANCIAL COMPLIANCE

1. Who's in charge? Organizational aspects of budget execution

The decision to carry out a program authorized in the budget must be taken by the relevant line ministries, as is the case in most countries. However, in some countries, controls from the central ministries can interfere in sector policy.

There are also problems concerning the distribution of responsibilities between the central departments of the line ministries and their subordinate agencies. In some countries, continuous interference by the central departments in the management of

projects and programs impedes the effective implementation of these programs. In other countries, powerful agencies implement programs without reporting to their ministries. There is a need to clarify the distribution of responsibilities within line ministries to ensure that the central departments are fully responsible for coordinating sector policy and that subordinate agencies, projects, etc., carry out their activities under the supervision of the central departments without permanent and disruptive interferences from central departments in day-to-day administration. This last point is particularly important and difficult to solve in aid-dependent countries. The fact that projects are a pocket of prosperity within a destitute ministry often leads to the diversion of project resources to cover the running costs of the ministry's departments.

Budget execution covers both activities related to the implementation of policies and tasks related to the administration of the budget. Both central agencies and the spending agencies are involved in these tasks. The distribution of responsibilities in budget organization should be organized according to their respective areas of responsibility and accountability.⁸

The responsibilities of central agencies⁹ are the following:

- Concerning budget administration, administering the system of release of funds, monitoring expenditure flow, preparing in-year budget revisions, managing the central payment system (if any) or supervising government bank accounts, administering the central payroll system (if any), the consolidating accounts and preparing progress reports;
- Concerning policies, reviewing progress independently or jointly with spending agencies, identifying policy revisions where appropriate, and eventually proposing to the Cabinet reallocations of appropriations within the framework authorized by Parliament and the Legislature.

The responsibilities of spending agencies are the following:

- Concerning budget administration, allotting of funds among their subordinate units, making commitments, purchasing and procuring goods and services, verifying the goods and services acquired, preparing requests for payment (and making payments, if the payment system is not centralized), preparing progress reports, monitoring performance indicators, and keeping books,
- Concerning policy implementation, periodically reviewing the implementation of the program (including the monitoring of performance indicators), identifying problems and implementing adequate solutions, and reallocating resources among sector programs (but within the policy framework of the budget).

When several central agencies are involved in the supervision of budget execution, close coordination among these agencies is required and their respective functions should be clearly delineated. In particular, when the department responsible for administering payments is separated from the ministry responsible for budget preparation (the Ministry of Finance), and even when the Budget Department and the Treasury Department are attached to the same ministry, coordination between the departments responsible for budget preparation and execution is often insufficient. Budget revisions and reallocation of resources among sectors should be under the responsibility of the ministry and department responsible for budget preparation. The Treasury should provide them with all the needed information on budget execution.

2. Release of Funds

To ensure effective budget implementation, the authority to spend must be given to agencies on time. Funds should be released in conformity with budget authorizations. However, for cash management, the releases of appropriations must be regulated. Special issues related to cash management issues and the preparation of cash plans are reviewed in chapter 6. As discussed below, sound cash management does not mean “cash budgeting” or “cash rationing”.

a. *Day-to-day cash rationing*

In some countries, funds are released to line ministries through day-to-day cash rationing¹⁰ because of fiscal problems or an overestimated budget. Where a centralized Treasury system exists, this mechanism consists of an ad hoc selection of agencies to which cash will be transferred or a selection of the invoices to be paid. In some countries, this selection is made by a committee or a group composed of the Treasury Head, the Minister of Finance, and the Prime Minister. The “effective cash budget” formulated implicitly through this process is substituted for the authorized budget. Making budgets on a daily basis through such mechanisms violates informal contracts in budgeting, between the central agencies and the spending agencies, and the policy commitments stated in the budget.

Under cash rationing mechanism, funds are often released on emergency and political grounds, discarding the priorities defined in the budget. The budget resulting from these day-to-day decisions may be quite different from the budget approved by the Parliament. Moreover, cash rationing can not solve the problems it is meant to solve, since spending agencies can continue to make commitments according to the budget. They accumulate arrears, but comply with budget procedures. Such situations are (or were) met in several transition economies (e.g., China, Ukraine,).

b. *Budget implementation plans and cash plans*

To release appropriations, many countries slice the budget into four quarterly parts, or release one-twelfth of the budgeted amount every month, or prepare a budget implementation plan. Whatever method is adopted, the system for releasing funds should ensure effective and efficient implementation of the budget and avoid generating of arrears. Hence, the following elements need to be taken into account:

- To prepare the implementation of programs, agencies should know in advance the funds that will be allocated to them;

- Funds must be released in due time, without delay. In case of cash problems, the plan for releasing funds must be revised, but the revised plan should be communicated to the line ministries instead of making a nontransparent revision by delaying the release of funds.¹¹
- Particular attention must be granted to agencies located in remote areas. This needs adequate planning of the releases of funds and good coordination within the Ministry of Finance and/or within the line ministry between the central departments and regional offices.¹²
- Regulating cash flows without regulating of commitments generates arrears. In many cases when monthly cash limits are established, it is unclear whether spending units are allowed to make commitments up to the ceiling given in the budget appropriations or up to the monthly cash limits.
- Financial needs of ongoing commitments must be taken into account;
- Adjustment of commitments needs time. Imposing monthly limits is generally more of a regulation of cash through float than a regulation of commitments, since even for goods and services, a month may be too short to adjust commitments. In an emergency situation (e.g., as in Asian countries in 1998) or when budget preparation is insufficient, monthly cash limits are preferable to day-to-day cash rationing. If no measure is implemented to address the root of the problems, both mechanisms would generate arrears;
- An in-year distribution of payments related to investment expenditures is not steady and depends on various factors such as contractual payment schedules or, physical advancement of works.

In some countries, warrants are issued at the start of budget execution to authorize the government to implement the budget. These warrants are submitted to an ex-ante visa of the National Auditor.¹³ The relevance of this procedure is questionable,

since these warrants do not concern expenditure or cash release decisions, but only an allocation of funds already decided. However, these "somewhat ceremonial" or "pompous"¹⁴ procedures are purely formal and are not a factor of delay.

c. Sequestering

Sequestering is the cancellation of appropriations by the Ministry of Finance. The legislation should allow the Ministry of Finance to sequester appropriations to make clearly adjustments instead of adjusting cash plans. When sequestering appropriations, ongoing commitments must be taken into account. Although this instrument is needed in special circumstances, sequestering has the inconvenience of diminishing predictability.¹⁵

d. Release of cash within an accrual budgeting system¹⁶

Controlling cash on the basis of appropriations voted by the Parliament is ineffective in an accrual budgeting system. Appropriations for running costs include a provision for depreciation. If spending agencies are allowed to make payments up to the limit defined by these appropriations, total cash payments would exceed cash resources, or is the difference between appropriations and depreciation. Therefore, specific mechanisms that fit the nature of the appropriations must be implemented.

In New Zealand, both the Treasury and the Auditor-General perform an ex-ante external control on cash flows.¹⁷ Control makes use of accrual-based appropriation, a cash plan agreed between the Treasury and spending agencies, and monthly monitoring reports of the use of appropriations prepared by the departments and transmitted to the Treasury and the Audit Office.¹⁸ These ex-ante controls cover the global cash needs of a department, but are not specified by individual appropriations.

Within an accrual budgeting system, the preparation of cash plans and the control of cash releases need a strong accounting system since these mechanisms are not directly based on the appropriations. Central agencies (the "Ministry of Finance") must have adequate technical capacity to assess whether future depreciation would

cause appropriations to be exceeded or not. Such as a system could be difficult to implement in developing countries especially in countries where the budget processes are dominated by bargaining (see further discussions of accrual budgeting in chapter 7).

3. Compliance controls

The basic compliance controls during budget execution are the following:

- *At the commitment stage (financial control)*, it is necessary to verify that (i) the proposal to spend money has been approved by an authorized person; (ii) money has been appropriated for the purpose in the budget and sufficient funds remain available in the proper category expenditure; and (iii) the expenditure is proposed under the correct category.
- *When goods and services are delivered (verification)*, the documentary evidence that the goods have been received and that the service was actually performed must be verified.
- *Before payment is made (accounting control)*, it is necessary to confirm that (i) a valid obligation exists; (ii) a competent person has signified that the goods have been received and that the service has been performed as expected; (iii) the invoice and other documents requesting payment are correct and suitable for payment; and (iv) the creditor is correctly identified.
- *After final payment is made (audit)*, it is necessary to examine and scrutinize any expenditure and report any irregularity. Issues related to audit are discussed in chapter 9.

Generally within any organization, there is a separation of duties for authorizing expenditures, approving contracts and placing orders, certifying that goods have been received and that services have been provided as specified, and authorizing payments though some of these activities may be performed by the same person. In most cases,

however, the same person does not make the payment and perform the other activities or control them. This arrangement allows better internal control.

Within governments, this separation of duties may govern the distribution of responsibilities between the spending agencies and the core agencies (Ministry of Finance, Financial Comptroller, etc.). Depending on the country, controls may be either internal to the relevant line ministries or performed by a central ministry (Ministry of Finance, Financial Comptroller Office, etc).

4. Payment and Accounting Controls

Arrangements for payment processing and accounting control vary from one country to another. In many countries, a Paymaster Office is responsible for making accounting controls and payments. This office is also generally responsible for cash management, and forms the Treasury Department, but there are exceptions.¹⁹ In other countries, payments are processed by line ministries, but cash and bank accounts are controlled by the Treasury Department which is responsible for cash management. Therefore, issues related to whether accounting controls should be centralized or not, which are reviewed below, should be distinguished from issues related to cash management, reviewed in chapter 8.

a. Limits of accounting controls

Many budget systems focus on accounting control to ensure compliance. This approach is insufficient. Accounting controls can prevent blatant cases of misuse of appropriations. However, whatever their organization, accounting controls do not prevent the accumulation of arrears since obligations are made upstream. They do not prevent the commitment of expenditures that are not authorized in the budget.

b. Centralized external controls

Central payment systems ensure that accounting is done by a staff of qualified accountants, and allow the central agencies to see to it that payments are appropriately

documented and that every expenditure fits the purpose stated in the budget. This explains why such centralized controls are sometimes seen as the cornerstone of fiscal discipline.

In several countries, notably in transition countries, spending units maintain accounts with commercial banks and deal directly with their banks when making payments. This has the advantage of avoiding delays in payment processing that are caused by ex-ante external controls in some countries.²⁰ However, this arrangement could impede fiscal discipline since commercial banks could grant overdraft facilities to spending units and the Ministry of Finance cannot monitor payment transactions, and idle balances are kept in the bank accounts of line ministries. External controls between the spending units and the commercial bank or centralized payment system would be a good way solving this problem.

However, such approaches have inconveniences. Premchand, for instance, offers the following comments:

It may be recalled that some countries abandoned the traditional treasury systems as the banking system became more efficient. The spending agencies were given enhanced financial powers to issue checks and make payments through direct arrangements with the banks. The reintroduction of the treasury system would mean an expansion of the process, an increase in costs, and a curtailment of the responsibilities of spending agencies. Those who favor reintroducing the treasury system suggest that treasuries would not only scrutinize payments, but would also be responsible for compiling accounts. But such a step could widen the chasm between expenditure responsibility and the power of payment. Moreover, experience shows that treasuries are no less resistant to political pressures than are the commercial banks. Circumvention and politicization cannot be cured through the reintroduction of the treasury system. Rather, observance of discipline, which is an essential part of effective government financial management must be secured through tighter controls, periodic oversight,

strengthened accountability, greater citizen participation and, above all, greater transparency".²¹

In countries that have poor governance and face arrears accumulation, centralized payment systems increase distortions in budget execution. The officials of a central office have a wider range of opportunities to bargain invoice payments than the officers of line ministries or spending units. Supplier prioritization is therefore substituted for program prioritization.

c. Partly decentralized systems

When payments are processed under the control of central agencies (Ministry of Finance, Treasury, etc.), locating the accounting offices within the line ministries is preferable to locating them in a separate central treasury office. This reduces delays in processing invoices and requests for payment, and the risk of distortions in budget execution.

A system of revolving accounts or revolving cash limits, where funds are periodically released once the spending agencies produce statements and relevant documents of the payments made in the previous period, could accommodate requirements for accounting control and even reporting. In some countries, this system is used on a nationwide scale.²² This may present inconveniences for cash management. However, in developing countries that have poor infrastructure, such revolving-account mechanisms are required in remote areas. They are also required by IFIs for the management of the projects that they finance.²³

d. Reforming the organization of accounting controls

Many accounting controls and payment systems must be improved. Current centralized payment systems must evolve toward a better involving spending agencies and acquiring more flexibility. Current decentralized systems must better accommodate needs for monitoring, accounting, and cash management. They must be subjected to regular and comprehensive audits. The supervision of banking arrangements by central

agencies must be reinforced and cash balances must be centralized (see chapter 6). However, making radical reforms, which would mean centralizing a decentralized, system or vice versa, requires caution.

If elementary control procedures do not exist and the organizational arrangements are completely fragmented, building a centralized system is the more cost-effective solution to control cash. In other situations, the opportunity to centralize accounting controls and payment processing should be reviewed in relation to the objectives sought. Centralization of cash balances, central control of the government's bank accounts, and a sound reporting system are required. However, there is no need to submit invoices and requests for payment to a central office, and thus diminish the responsibilities of the spending agencies. If the main objectives are to diminish corruption and/or eliminate arrears, it is doubtful that these could be achieved by the centralizing of payment. There are risks of perverse effects. Central control of invoices does not prevent over-commitment, but on the other hand, may be an excuse to develop "exceptional procedures," which are very frequent in developing countries with highly centralized control systems.²⁴

On the other hand, replicating the model of countries that have decentralized payment systems in developing countries that currently use a centralized system could present inconveniences. Skilled accountants can be rare. Decentralization could increase difficulties in budget monitoring and cash management because of the lack of modern technologies. Decentralizing abruptly without the corresponding modernization measures could lead to a significant change in the payment system, creating significant disorders and loosening financial constraints.

To decentralize accounting controls and payment processing effectively, the following set of actions and reforms must first be undertaken: (i) reforming accounting and reporting procedures; (ii) training accountants; (iii) enhancing the audit system; and (iv) instituting measures to maintain the centralization of cash balances. The localization of accounting offices within line ministries (the partly decentralized system reviewed earlier) should generally be the first step before further decentralization.

5. Other ex-ante external controls

In a number of countries, commitment controls (financial control) are performed by a central agency. The objectives of such controls are to facilitate cash management and to allow the MOF to supervise budget implementation, but they lead to excessive interference central agencies in the day-to-day management of the line ministries' budget and may delay budget implementation. Ex-ante commitment controls should generally be avoided except depending on the context, for projects of a significant size (see discussion below on multi-year commitments).

In other countries, commitment controls are purely internal. Generally, agencies have to keep a commitment register. In practice, either this register is not systematically kept, or the commitment information exists but is not centralized and the MOF therefore cannot monitor budget execution. The decentralization of commitments gives required responsibilities to spending agencies in budget implementation, but requires an effective budget monitoring system (see section D).

Spending agencies in most countries make verification, although a few questionable exceptions exist.²⁵ The involvement of the Ministry of Finance in this activity should not be considered, but reporting at this stage is important, notably for an accurate assessment of arrears.

The benefits of multiplying controls are often barely perceptible in developing countries. Since ex-ante controls generally hinder efficient management because of bureaucratic procedures and multiplying checkpoints opportunities for corruption could also increase. "Tolls" or levies imposed in exchange for avoiding these checks limit the external controls.

Nevertheless, the main problem of ex-ante external controls is their effectiveness. Controlling commitments for personnel and investment needs specific tools, which are discussed below. Commitments related to entitlements, transfers, and subsidies are related to policy decisions. Even for goods and services, external

budgetary controls are insufficient. Controls on the consumption of goods and services from utilities, which absorb a significant part of recurrent budgets, need to reinforce internal management systems, not necessarily the budgetary procedures. In most situations, addressing compliance issues requires a broader approach than focusing on budget execution controls.

In several Asian countries, the Ministry of Finance assigns a Financial Advisor in each line ministry to control budget execution²⁶. The Financial Adviser, whose role and reporting requirements vary according to the country, is usually expected to identify budget implementation problems quickly. However, the system presents a significant inconvenience where the Financial Adviser makes sector budgets on behalf of the Ministry of Finance²⁷ or exercises cumbersome ex-ante control on the activities of line ministries.

In some countries, the officers responsible for performing accounting or financial controls report to both the Ministry of Finance and the heads of the relevant spending agencies. This system of dual responsibility may have inconveniences, since it does not set the clear rules for accountability and submits controlling officers to contradictory requirements.²⁸ However, it has the advantage of ensuring cooperation between the Ministry of Finance and the spending agencies, as well as by proper preparation of reports on budget execution.

External controls, when they seem unavoidable should focus on the major issues. They should be limited to control of compliance with appropriations and should not be concerned with the sector budgetary policy and sector implementation choices for programs already authorized by the budget. The responsibilities of the Financial Adviser, the Financial Comptroller and the Treasury Department should be established along these lines.

In several developing countries, the Ministry of Planning performs opportunity control of new projects at the start of budget execution or before the projects are launched. In some Asian countries, this has the advantage of limiting line-item controls on development expenditures,²⁹ but in other countries, these controls may be

superposed to the controls of the Ministry of Finance. Streamlining the project planning system would require: (i) deciding on new programs or projects when preparing the budget; and (ii) unifying the external control system and exercising a financial control instead of opportunity control during budget execution, if external controls during seem necessary at that time.

Comments made in this section call for greater decentralization in budget management for a majority of developing countries, but it should be noted that measures increasing the management responsibilities of line ministries in management must come with measures reinforcing the reporting system and audit. In a number of transition economies, the issues related to controls are different. Ex-ante controls are nearly nonexistent; reinforcing management control, reporting, and audit should therefore have the higher priority.

6. Monitoring forward commitments

The monitoring and recording of multiyear commitments could be necessary especially when the investment budget is significantly large. For countries, that finance their investments mainly from domestic resources, overruns are often due to badly estimated multiyear commitments in the budget. The usual multiyear expenditure programming tools such as the five-year plan and the classic PIPs in which new prospects are included in the second and the third years in an indicative manner, do not provide an adequate framework for administering these multiyear commitments. However, a multiyear expenditure program defined more restrictively (see chapter 13) could provide this framework, provide it is detailed enough to identify the activities that will be carried out through multiyear contracts.

To monitor and control these multiyear commitments appropriately, a ceiling for forward commitments should be established could take the form of a commitment authorization included in the budget, a multiyear appropriation, or authorizations derived from a multiyear expenditure programming document (MTEF, PIP). The commitments are authorized up to these ceilings and should be reported in the same way as the uses of annual appropriations.

In non-aid-dependent countries that face overruns in the execution of the investment budget and do not prepare these authorizations or do not have adequate internal control systems, external control of multiyear commitments of a significant size cannot be dispensed with line ministries would have to submit a request to the Ministry of Finance, before committing to a contract of significant size. However, compared with controls based on formal commitment authorization, such ad hoc controls have the disadvantage of not distinguishing between financial control and policy or procurement control.

Generally, in aid-dependent countries, the problems met in executing multiyear projects are due more to insufficiencies in financial programming than to poor administration of forward commitments, since a significant share of the contracts is financed by external sources. A specific exercise in preparing commitment authorizations is less crucial in countries that finance investments from their domestic resources, but, as discussed in chapter 13, the preparation of a multiyear expenditure program is generally desirable.

D. BUDGET APPROPRIATION MANAGEMENT RULES

1. Annual nature of appropriations

Although there are exceptions, notably where some appropriations are obligation-based (e.g., in the Philippines), a classic rule of the budget is the annual nature of appropriations. At the end of the year, unused appropriations are cancelled. The adverse effects of this system are many. Revolving funds or extrabudgetary funds are set up, ad hoc private organizations are created to manage the budget under more flexible rules, etc. Concentrating the payments at the end of the fiscal year may be the result of cautious planning of commitments. However, the annual rule can also create a rush for spending at the close of the fiscal year, variously described as spree spending or squander mania³⁰. To ensure that appropriations are maintained at the same level the following year, line ministries can make unplanned spending at the end of the year.

A spending bulge at the end of the fiscal year may only reflect commendable prudence on the part of a ministry that is concerned with keeping its expenditures down as much as possible throughout the year, as protection against unexpected mid-year cuts in appropriations. In this case, a carry-over provision may be unnecessary and could possibly raise some problems in certain countries. When the year-end spending bulge is related instead to a weak budget preparation process that has accommodated inflated requests, the spending is likely to be for nonpriority or even wasteful purchases. In these circumstances, the optimal response would be to improve budget preparation; however, a carry-over provision can serve as a second-best mechanism, to remove the temptation to get rid of leftover funds before the spending authority comes to an end. The latter is likely to be the case for at least some spending agencies in most countries. In any event, rushed expenditures almost invariably requires some avoidance or bending of the procurement rules, which is not a practice to be encouraged. On balance, therefore, it appears that a small carry-over provision can provide additional flexibility at a negligible cost in terms of the integrity of budget execution.

Generally, Ministries of Finance fear that abandoning the annual rule would hamper fiscal balances and cash fiscal deficit objectives. However, expenditures carried over from the previous year could be balanced by expenditures carried over from the current year to the following year. Moreover, rules to keep carrying forward under control can be specified to take the country's context into account.

In some developed countries (e.g. Australia), the annual nature of the appropriation has been altered recently to authorize the carry-over of up to 10 percent of current expenditures. In several countries, the carry-over of capital expenditures is authorized or requires only an approval of the Ministry of Finance.

Systematically authorizing carry-over in developing or transition countries could pose problems, as regards expenditure control, especially where the budget is not prepared on realistic revenue forecasts. However, authorizing carry-over could also avoid the perverse effects of the annual rule. Alteration of the annual rule is desirable in developing countries, provided that expenditure and revenue estimates are realistic.

Some safeguards are needed. Procedures for carry-over should be implemented progressively, to ensure that they do not hamper expenditure control, and submitted to the approval of the Ministry of Finance. as a first step, they could be concerned with investment expenditures, which are difficult to manage within an annual budget framework. Appropriate procedures are also needed for paying bills and invoices that were regularly committed over the previous fiscal year, but have not yet been paid because delays in deliveries, for example.

2. Transfers between line-items (virements)

Rules for transfers between line items (or “virements”) are generally stated in the financial regulations (or in the budget organic law; see Annex IX). They distinguish before virements that may be made freely by line ministries, virements submitted to an approval of the Ministry of Finance and virements that are strictly forbidden. Often, control of virements is one the major activity of the budget offices during budget execution. This procedure is time consuming and excessively absorbs administrative resources.

Spending agencies need flexibility in implementing their budget. An investment project may be delayed for technical reasons, while another should preferably be speeded up. Determining the exact composition of the inputs of a program would be difficult. As indicated in chapter 2, several OECD countries have recently implemented block appropriations. Line ministries are free to determine the best composition of inputs to implement their programs and achieve results.

To achieve efficiency, line ministries must be give a certain degree of freedom to allocate resources within their sector. However, this freedom should not hamper fiscal discipline or the priorities defined in the budget and voted by Parliament.

78. Concerning transfers between objective of the same program, it would be difficult to adopt in developing countries or transition economies the system of block appropriations adopted in some OECD countries. Depending on the internal capacities of line ministries to control their program and the nature of problems met in budget

implementation, it may be necessary to either protect or cap some object items through a regulation of virement. Typically, virement between personnel expenditures and other economic categories needs to be regulated in many developing countries. However, the effects of these regulations need to be carefully reviewed to ensure that they are designed properly. In some countries, switching from other economic categories to personnel expenditure is forbidden; in other countries, switching items from personnel expenditures to other economic categories is forbidden. In the first case, regulations for virements aim at capping personnel expenditures. In later case the regulations aim at protecting personnel expenditures. Capping has the advantage of giving a clear signal to spending agencies. However, protecting expenditures already committed can be preferable to limit budget overruns and arrears generation.

In some countries, it may be desirable to have rules either to protect some nonwages items for which arrears are frequently generated (such as electricity consumption) or on the other hand to cap some categories of expenditures (e.g., mission of ministers abroad). However, these rules should focus on what is necessary and should not apply forever. What can be a problem of compliance one year will not necessarily be a problem the following year.

During the budget implementation of programs, certain problems can occur, particularly when it comes to investment expenditures. In this case, appropriate measures must be taken budget resources must be reallocated budget resources from problem projects to other projects to ensure that government policy objectives are effectively implemented despite the difficulties. In some countries controls of virements performed by the Ministry of Planning are made at the project level and are too detailed.

However transfers between programs or projects must not alter the policy framework adopted by the Parliament. For instance, the Ministry of Education should not be authorized to reallocate freely budget funds from primary education to higher education. Transfers between programs or between administrative units that alter the budget policy as adopted by the Parliament should be forbidden or strictly regulated.

82. Transfers between the budgets of line ministries need to be regulated by the center of government and submitted to the Cabinet, for obvious management reasons.

3. Expenditures financed by external sources

83. As indicated in chapter 2, expenditures financed will project aid should be budgeted. Obviously, appropriations for grants need to be indicative. It is necessary to setup procedures to authorize the contracting of loans and, to control indebtedness and therefore the total amount of each loan. However, annual estimates for drawings should be indicative. The impact of a project loan on debt service depends basically on the total disbursed amount of the loan. The annual distribution of disbursements over the project implementation period affects only the interests during construction.

4. Issues related to nonbudgeted expenditures and unfunded liabilities

84. Liabilities are defined as debts and obligations to pay resulting from past events. Issues covering debt management and other future liabilities are reviewed in chapters 8 and 10. In some countries, a distinction is made between funded and unfunded liabilities, the difference being whether or not resources to finance the related expenditures have been budgeted. In some countries, it is argued that the unfunded liabilities should not be paid, since the expenditure was not authorized by the legislature. However, unfunded liabilities may correspond to legal obligations that the government cannot ignore.

Therefore, sometimes these unfunded liabilities are paid, but the executive waits for the following budget to regularize them. As a result, in the budget execution reports, expenditures of the current year are underestimated, while the budget of the following year includes appropriations for expenditures already made. Measures to improve the management of unfunded liabilities depend on their causes. Unfunded liabilities not related to a lack of compliance include, notably, the following liabilities.³¹

- *Liabilities arising from legislative changes.* Legislation after the start of the fiscal year may augment existing benefits. Regulations should be established to eliminate or at least limit the generation of such liabilities.
- *Compulsory indemnities.* The legislation may include provisions for compensating losses caused by special events, for example, to compensate disaster victims. The government can be sentenced to pay judicial indemnities, or may have to indemnify contractors because of a breach of contract, etc. For miscellaneous indemnities, a reserve could be included in the budget to limit unfunded expenditures.
- *Exceptional expenditures* that are not included in the budget or that cannot be estimated accurately when preparing the budget. The country may face natural or environmental catastrophes, which cannot be forecasted when preparing the budget. Expenditures for major policy actions may be difficult to estimate, for example, expenditures related to a banking sector restructuring program. Expenditures related to these liabilities must be shown in the budget execution report, and the year-end report, and posted in the accounts. In some countries this may require revising procedures and legislation. An in-year budget revision should be made systematically to include exceptional expenditures in the budget.

Besides the cases mentioned above, some unfunded liabilities are related to lack of compliance. An appropriate and effective system of sanctions is needed. However, these liabilities may have to be recognized, if the contracts are regularly committed with respect to the commercial, and the government's legal procurement framework. Issues related to hidden liabilities such as unfunded pension liabilities are reviewed in chapter 10.

¹ This chapter is separated from the following one on managing budget implementation for the reader's convenience. However, the two chapters should be seen as part of the same overall process & budget execution.

² See, for example Aaron Wildavsky, Why Planning Fails in Nepal, *Administrative Science Quarterly* 17, 1972.

³ See Caiden and Widavsky, 1980, 1990.

⁴ See Caiden and Widavsky, op. cit. and discussion of the "core budget" in chapter 4 of the present volume.

⁵ See Caiden and Widavsky, op. cit..

⁶ U.S. terminology (Schick, *the federal budget process*).

⁷ A. Schick, op. cit.

⁸ See chart in Premchand, (1983), page 259, which lists "budgetary tasks" and "administrative tasks." The distribution of tasks suggested below is partly drawn from this chart.

⁹ In many countries this expression covers several organizations, such as the Ministry of Finance, the Treasury, the Financial Comptroller Office, or the Ministry of Planning.

¹⁰ As in Ukraine in 1976.

¹¹ These mechanisms for fund release in the various Asian countries do not always ensure that funds are released in due time for use by the spending authorities. Delays in authorization may be intentional, with the Finance Ministry withholding release orders if they are uneasy about the Ways and Means position of the government. The Finance Ministry may indeed make some informal reprioritization of expenditure of its own (ESCAP, 1993).

¹² "In the pre-computer age, which still prevails in some Asian countries [e.g., Nepal until 1997], there were frequent logistic problems over fund release when spending agencies had to make repeated visits to the Controller's office, particularly in the districts which claimed that authorization had not reached them from the Finance Ministry, the line ministry or the head office of the Controller" (ESCAP, 1993).

¹³ E.g. Turkey, New Zealand and some other Commonwealth countries.

¹⁴ Premchand, 1983.

¹⁵ A discussion of the inconveniences of sequestering may be found in Sylvie Hel,-Thierry and Yves, Meny-Alain Quinet, *Decision-Making and the Budgetary Process in France*, OECD, *Policy and Decision-Making*.

¹⁶ This paragraph is drawn from Scott, 1996.

¹⁷ See Scott, 1996.

¹⁸ Financial management policy guideline no. 8, *The Controller Function*, New Zealand Treasury, 1989. quoted in Graham C. Scott, *ibid*.

¹⁹ As in Turkey, the accounting offices which process payment report to the Ministry of Finance, while the Treasury Department, responsible for cash management and centralizing government bank accounts, is an independent body. In Sweden and several other OECD countries, cash management is centralized but accounting controls are performed by spending units.

²⁰ "Another area of strength [of the budgetary systems of transition economies] is the relative abridgement of the payment process. "The assignment of a bank to a spending agency has reduced the red tape and the numerous steps of verification associated with a number of other systems" (A. Premchand and L. Garamfalvi), *Government accounting systems in Tanzi*, 1995.

²¹ A. Premchand, 1995, page 41.

²² As in Nepal (but officers responsible for accounting controls report to both the Financial Comptroller and the Head of the spending agencies).

²³ Such as "Special accounts" for projects financed by IFIs.

²⁴ As in African countries with the French system.

²⁵ As in Cameroon

²⁶ As in India, Malaysia, etc.

²⁷ Where the Budget Office as in Turkey control both budget preparation and budget execution.

²⁸ The functions, duties, powers and responsibilities of the accounting officers working in the ministry department/office/project are nowhere clearly specified. It is difficult to assert with finality whether they are responsible to the high-ranking officers of their known faculty, or to the office chiefs or to the Comptroller General" (Report of the administrative Reform Commission, Government of Nepal. 1992).

²⁹ Premchand, 1983.

³⁰ Premchand, 1993. This practice was standard in the Soviet system and was called *shturmovschin*.

³¹ The list of these liabilities is drawn from Premchand, 1995,

Chapter 7. MANAGING AND MONITORING BUDGET IMPLEMENTATION¹

A. BUDGETARY ACCOUNTING

1. Importance of budgetary accounting

Budgetary or appropriation accounting consists of tracking and registering operations concerning appropriations and their uses. It should cover appropriations, apportionment, any increase or decrease in appropriations, commitments/obligations, expenditures at the verification/delivery stage, and payments. As indicated in chapter 10, budgetary accounting is only one element of government accounting system, but it is the most crucial for both formulating policy and supervising budget implementation. In particular, weaknesses in budgetary accounting and recording make quality analysis of the performance, outputs or outcomes impossible (see chapter 15 for an elaboration).

Most developed countries keep registers for their transactions at each stage of the expenditure cycle, or at least at the obligation stage and the payment stage. This, whatever their accounting system or budget execution procedures. Many developing countries keep similar registers, either at the spending agency level or through centralized control procedures². However, in both cases, budgetary accounting presents inadequacies. On the one hand, when registers are kept by agencies, information is not systematically available at the level of the Ministry of Finance, which would need it to supervise budget implementation. In practice, in some of these countries budgetary accounting covers only payments. On the other hand, where control procedures are centralized, sometimes information on budget execution concerns administrative steps that do not correspond to the stages in the expenditure cycle described in chapter 6.³ Such "administrative" information is useless for analyzing budget implementation. In FSU countries, spending agencies keep books on an "accrual" basis (although not in conformity with generally accepted accounting principles). Such arrangements, despite their advantages, created difficulties in the timely monitoring of payments according to the budget classification. Therefore, in these countries efforts are currently focused on the implementation of a system of monitoring payments.

The benefits of monitoring either obligations or expenditures at the verification stage or the payments stage are sometimes debated. Actually, information is needed at each stage of the expenditure cycle and can be easily compiled, thanks to developments in electronic technology.

Adequate recording of appropriations, revisions in appropriations, transfers between appropriations, apportionment, etc. is a prerequisite for good management. In several developing countries, it is difficult to know exactly which budget is being implemented, because decisions concerning allocations and reallocations of appropriations are contained in various circulars and are not gathered into a single document. The budget implementation plan should be updated regularly to take into account decisions concerning appropriations.

Accounting commitments/obligations (obligational accounting⁴) is essential in keeping budget implementation under control. They provide the basis for budget revisions. Decisions to increase or decrease appropriations and the preparation of cash plans must take into account commitments already made. For internal management, spending agencies need to follow up accurately the orders and the contracts they have awarded.

Accounting for expenditures at the verification stage (sometimes called expenditure accounting) is important to program and agency management. It gives elements for assessing costs, although these elements need to be completed with information on depreciation, inventories, etc. Expenditures at the verification stage show how far program and project implementation has progressed. In chapter 11 the preparation of reports on development expenditures at the verification stage is recommended. Recording expenditures is also required for managing payables and contracts. It is a requirement of any accounting system that recognizes liabilities.

Some countries that have non-pure cash accounting system do not report payments along the budget classifications (see chapter 7). Actually, expenditures should be recorded according to the budget classification at each stage of the expenditure cycle, to identify sector or program imbalances at that stage.

A comprehensive and timely monitoring of budget transactions could be ensured with adequate information systems recording transactions at each stage of the expenditure cycle, and appropriate electronic connections between the “Ministry of Finance” and line ministries. Basic financial controls can be automated and made when registering the transactions. To some extent, differences between budget executions systems based on external ex-ante control and system based on internal controls are dimming with modern technologies. Nevertheless, implementing an information system is not a panacea. It is costly, but overall it requires appropriate budget accounting procedures that do not exist in many developing countries. Computers do not make up for poor governance and systemic lack of compliance. In such situations, they can only increase the number of non-regular transactions and off-budget procedures aiming at overcoming computerized controls.⁵ Procedures for overcoming computerized controls are discussed in chapter 7.

Box 25
The Budget Accounting System in the People's Republic of China

"Budgeting dictates accounting" is perhaps the simplest way to describe government accounting practice in China today. The budget laws enacted are elaborated in rules and regulations issued by the Ministry of Finance. The Bureau of Budget Management of the Ministry of Finance develops accounting rules and procedures that conform to the budget rules and procedures. The advantages of this system are: (i) it ensures consistency between budgeting and accounting; and (ii) it enjoys the enforcement power of the state.

The overall budgetary accounting systems are operated by the Ministry of Finance and the finance bureaus at each subordinate level of government. They track the execution of overall budgets—that is, receipts and payments. Reports are prepared on the tenth day of each month; in addition, monthly, quarterly, and annual statements are submitted. These statements basically report the amounts of the various sources and uses of funds. The primary objective of the accounting system is to prevent spending in excess of appropriations, and to ensure the collection of revenues.

Chinese budgetary accounting is characterized by its faithfulness to the prevailing ideology and public policy, a high degree of uniformity, and broad coverage (Shi and Jiang 1993, 10-15). Moreover, budgeting practices are highly uniform as a consequence of the central government's authority to prescribe the rules and regulations, and the existence of an elaborate administrative apparatus to enforce them. The regulations determine such details as the charts of accounts for all the administrative units and institutions at all levels of government throughout China. Until recently, the Chinese accounting system encompassed not only government but state enterprise accounting as well. As a consequence of economic reform, state enterprise accounting has been separated from budget accounting, even though standards are still set by the government through a unit of the Ministry of Finance. There is an ongoing debate as to whether institutional accounting should be dissociated from budgetary accounting (Lee, 1996).

Source: James L. Chan, ed., *Research in governmental and nonprofit accounting*, vol. 9, 1996.

2. Defining and Monitoring Commitments

Registering and monitoring commitment is required for different purposes, such as contract and program management, budget implementation supervision and cash management, and fiscal analysis (to assess the deficit on a "commitment basis").

For contract and program management, it is important to register all legal commitments (contract awarded, order passed, etc.). Program managers should register all legal commitments from an order for stationery to a multi-year contract for an investment project of a significant size.

For cash planning and funds release, it is important to know the obligations to pay that will occur over the planned period. It can be expected that an order for stationery will be completed over the planned period, but contracts for investment projects (and legal commitments) may cover several fiscal years. Therefore, for cash

planning the important is the tranche of the commitment that will generate a liability over the planned period, which is generally the legal commitment for supplies but not for multi-year investment projects.

For budget preparation, it is important to know the forward costs of multi-year investment projects and the expenditures that are “compulsory” or that will occur without adjustment measures (see discussion in chapter 4). The government has legal or moral obligations to pay personnel and entitlements. It is necessary to compile all policy commitments whatever their form, legal contract, administrative decisions, promises, etc.

For fiscal analysis, arrears must imperatively assessed. They are the difference between expenditures at the verification stage (“accrued expenditures”) and payments (issues related to the “float” are discussed in section D below). The difference between commitments and payments give an approximate estimate of arrears. However, this estimate is satisfactory only if “expenditures on a commitment basis” do not include multi-year commitment and administrative reservation of appropriations.

For the day-to-day administration of the budget, it is necessary to define precisely what is a commitment, in the “budgetary sense”. For budget management, the “commitment” could be defined as: (i) the legal commitment, when it makes sense to define the commitment on this basis (for example, contracts and orders for supplies, investment, maintenance works, etc); and (ii) expenditures at the verification stage, for other items (personnel, debt servicing, utilities bills, transfers). For orders concerning petty expenditures, the commitment and the verification stage may be confused in the budget implementation reports, however programs managers should monitor all their legal commitment, whatever their amount. The financial regulations should give a clear definition of commitment

An administrative procedure for reserving appropriations can fit some organizational arrangements (the “commitment/reservation” is in some countries, a procedure for delegating authority) or some programs (e.g. “annual commitments” of multi-year program). However, in countries that confuse this procedure of reservation of appropriation with other commitments, it is necessary to define an additional stage in the

expenditure cycle for the commitment (as in the USA, where it is distinguished “commitment/reservation” from obligations).

Whatever the name of the transaction called “commitment” in the budgetary jargon, it is necessary to monitor for multi-year projects both forward commitments (legal commitments) and expenditures at the verification stage, and to estimate the annual tranche of the commitment.

As discussed in chapter 4, the deficit on a “commitment basis” is an indicator of fiscal position, which aims at comparing the actual level of expenditures, including arrears, with revenues. Expenditures to be considered when calculating this deficit should be either “annual” commitments or expenditure at the verification stage. This indicator would be meaningless if it includes multi-year commitments and commitments that are merely reservations of appropriation. Moreover, to identify orders not yet delivered and to estimate arrears more accurately, expenditures at the verification stage must also be reported, in addition to commitments.

3. Managing Payables and Arrears Issues

Sound management of payables, namely, arrears and outstanding invoices and bills, is required. Payables are often distributed among various offices, such as the program manager office, the departmental office, the financial adviser/controller’s office, and the Treasury office. The invoice cycle generally needs to be simplified, for good accounting and transparency.

Computerization could help in tracking the invoices, but only to a certain extent, since invoices can be accumulated upstream and downstream to the computerized cycle. For example, in a Treasury Information System, if checks are made by the Treasury, invoices could be accumulated at: (i) the level of the spending agency manager, who does not send in the invoices when he knows that the Treasury does not have cash; and (ii) the Treasury level.

Therefore, whatever the mode of management (manual or computerized), some principles must be adopted:

- Expenditures must be verified as soon as the goods or the services have been acquired;
- Expenditures that are verified must be entered immediately into the accounts;
- Payments must be recorded as soon as they are made.

As discussed in chapter 6, procedures for carrying over are needed to take into account expenditures incurred during a fiscal year that are not paid in the same fiscal year.

Each contract, or at least those contracts concerning civil works and projects of a significant size, needs to be monitored accurately. Payments that will be made over the fiscal year must be planned to prepare cash plan. In the day-to-day management of payables, it is necessary to take into account the date at which the payments are due. To avoid penalties for late payments, invoices should be paid on the due date, but to reduce borrowing needs they should not be paid in advance (cash management issues are discussed in chapter 8).

In some countries, expenditures monitored at a "payment voucher stage" , corresponds neither to the verification stage nor to the payment stage. The registration of expenditures at the verification stage must be made as soon as deliveries are verified.

4. Arrears Issues

A number of transition economies and developing countries face arrears problems. Arrears pose problems to suppliers and have disruptive effects on public expenditure management. When the government accumulates arrears to private suppliers, private suppliers, at first, face financial difficulties. Then, they develop an appropriate billing strategy, such as requesting to be paid before they delivering, overbilling invoices, and bribing line ministries and/or Treasury officials responsible for the management of the waiting list of arrears.

Arrears have many causes, such as insufficient commitment control or the perverse effects of a cash rationing system that do not take into account commitments already made. Improved commitment monitoring is generally required.

However, in many cases, the decision or the event that generates an obligation to pay, is upstream to the commitment in the budgetary sense. Arrears in utilities services consumption are frequent. Generally, state-owned utilities (and even private companies) do not stop providing services to government agencies even when they are not paid. Limiting arrears generation in this sector requires both realistic estimates of annual consumption and internal management measures (such as installing meters, regulating phone calls). The measures must be imperatively identified at the budget preparation stage.

Limiting arrears generation needs a combination of measures such as realistic budget estimates, internal management measures, control of personnel staff, control/monitoring of commitments and especially of forward commitments, and decisions related to entitlements.

The estimation of generation of arrears is an important issue in some countries. Arrears are sometimes distinguished from float, which corresponds to the usual processing period to outstanding invoices. A stricter definition is to say that any invoice due on one date and not paid on that date must be included in the stock of arrears. An appropriate budgetary accounting as suggested above is necessary for establishing a permanent system for monitoring arrears.

When a country faces arrears problems, it should prioritize of payments on the basis of the date on which invoices are due and on their order of precedence. In some developing countries, programs to reduce the stock of arrears led to questionable practices, such as the generation of new invoices which were given the privileged status of arrears, the payment of expenditures despite their noncompliance with to procurement regulations, choices based on patronage. Strict control of the judicial regularity of arrears payments is required. The audit offices should scrutinize such operations.

B. IMPLEMENTATION OF POLICIES

1. Reviews

Budget implementation should be reviewed periodically to ensure that programs are implemented effectively and to identify any financial or policy slip-ups.

The review of budget execution should cover financial, physical and other performance indicators (see chapter 15). Cost increases due to inflation, unexpected difficulties, insufficient initial study of projects, and budget overruns must be identified so that adequate countermeasures can be prepared. A comprehensive midterm review of the implementation of the budget is needed, while the financial implementation of the budget should be reviewed monthly.

Development budgets are often beset by implementation problems because of insufficient implementation capacities and other factors such as delays in mobilizing external financing, overoptimistic implementation schedules, climatic hazards, or difficulties in importing supplies. Mechanisms for reviewing the most significant or problematic projects are needed. These could consist of a regular monthly or quarterly review of projects within line ministries and a midyear review involving line ministries and central agencies.

2. In-year budget revision

It is difficult to make accurate forecasts for the implementation of certain programs or for developments in economic parameters such as inflation, interest rate or exchange rates. Some immediate needs that were not foreseen during budget execution may appear during budget execution. To limit the effects of these problems, rules for transfers must be flexible; appropriations for debt service cannot be a spending limit and should be revised according to developments in interest rates or the exchange rate. Contingency reserves may be included in the budget. However, their amount must account for only 1-3 percent of the total budget; otherwise, budget execution will involve bargaining the uses of reserves and the budget will become an allocation of reserves.

Therefore, for changes that alter the composition of the budget or when an overall increase in expenditures is unavoidable, the budget may have to be revised. Mechanisms for revisions depend on the countries, and should be clearly stated in the budget organic law. Some broad principles are desirable. Since the budget has been passed by the legislature, revisions should be made by law. Generally, changes in appropriation above a certain percentage of the initial appropriation or changes that affect the total amount of expenditures must be submitted for to the legislature for approval. To allow the government to address problems with dispatch, procedures authorizing exceptional expenditures before the Parliament approves them can be considered. However, the authority should be regulated and limited, and the executive must be required to present a revised budget to the Parliament at short notice.

Supplementary estimates should be approved only at a fixed time and the number of in-year revisions should be strictly limited (to preferably only one in-year budget revision). Some countries present supplementary estimates to Parliament on a case-to-case basis, each time the Cabinet approves a request from a line ministry be, as a result, an excessive number of supplementary estimates are prepared every year (e.g., up to 40 in Sri Lanka). Such procedures should be avoided. Budget execution is difficult to control when budget is continually being revised. Moreover, supplementary estimates granted to one sector may, all too soon, seem better allocated to a higher-priority sector. Preferably, only one budget revision should be made during the fiscal year and requests from line ministries should be reviewed together, not singly.

C. PERSONNEL BUDGETARY MANAGEMENT

Issues of personnel management cover different areas. On the one hand, fiscal stress and the changing role of the government are focusing attention on procedures for controlling personnel expenditures. The growing size of the public service is a major concern in most countries. This is mainly a policy issue, but it also requires appropriate tools for budgeting personnel. On the other hand, systems for personnel management should aim at fostering efficiency in delivering public services. This covers a wide set of issues such as compensation and measures for increasing mobility. Personnel budgeting methods need to take into account performance issues, but the balance

between fiscal discipline objectives and efficiency-performance concerns strictly depends on the context of each country.

1. Approaches

a. *Relevance of recent reforms in some OECD countries*

As mentioned above, in a few countries (e.g. Australia and New Zealand), personnel expenditure is grouped together with goods and services expenditures in appropriations. This is seen to contribute to increased efficiency in delivering services. The possibility of using savings on personnel costs for other expenditures gives an incentive to agencies to make these savings.

Before considering the adoption of such approaches in developing countries and even in certain industrialized countries, it should be noted that flexible methods for personnel budgeting, where they have been introduced, are only some of the elements of personnel management reforms. There is a broader set of measures to make personnel management flexible and reduce the scope of the government, and these measures cannot be defined and implemented alone. These reforms include, for instance, flexible personnel management, covering both compensation system and the recruitment policy, and increased pressure on agencies to downsize their activities, through market-testing systems or efficiency dividends. Increasing personnel performance is a global approach; beginning with budgetary issues is not necessarily the most effective approach of getting results.

Moreover, some measures to improve performance, such as the hiring of consultants for policy advice and the contracting out or transfer of activities to autonomous agencies and local governments, do not necessarily address the immediate fiscal problems met in developing countries.

Even if civil service reform is undertaken, a budgeting approach consisting of mixing personnel expenditures with other expenditures could have undesirable outcomes. In several developing countries, taking into account social pressures on the management of agencies, patronage, or simply the low level of wages and block

appropriations could generate an uncontrolled increase in personnel expenditures. In other countries, bureaucratic resistance may not be easily overcome, and every spending unit may try to demonstrate that its current composition of inputs is the optimal variant. Line-item budgeting has been resistant to the PPBS reforms in most countries.

It is doubtful that block appropriations can be a tool for reducing manpower levels in countries that face arrears on personnel (as is the case in several FSU countries). These countries are currently confronted with the choice of incurring arrears or firing personnel. Both politicians and civil servants show a preference for accumulating arrears. Block appropriations implemented in this context would transfer arrears generation from wage expenditure items to nonwage expenditure items.

Undoubtedly, in countries with a strong internal and external audit system, a long tradition of fiscal discipline, and a flexible management system for the civil service, it is better to allow spending agencies to determine the share of personnel and nonpersonnel expenditures. However, in most developing countries, special attention on personnel expenditure is required.

2. The role of ceilings

a. Personnel expenditure ceilings

Most developing countries define expenditure ceilings as budgeting personnel expenditures under a separate line item and defining rules for limiting transfers between personnel and nonpersonnel items. This definition may be insufficient. Personnel expenditure ceilings are often more of a floor than a spending limit, and rules concerning transfers are aimed at protecting personnel expenditure from overruns in spending on goods and services. In practice, the system has a certain degree of flexibility, but toward an increase in personnel expenditures. There is a need to complement it with a system that allows the government to monitor and control their legal commitments more closely, and not only cash payments and obligations.

b. Staff ceilings⁶

Several developed and developing countries make use of staff ceilings, while some industrialized countries prepare multi-year staff ceilings together with multi-year estimates⁷. These staff ceilings generally give the full time staff equivalent, and are subjected to internal or external controls or both.

When the size of the civil service must be significantly reduced, it is often necessary to prepare personnel plans to determine the specific staff sectors to be trimmed, to define an incentive policy, to estimate the amount of redundancy payments, etc. Staff ceilings would then be the annual implementation targets corresponding to these personnel plans.

In many countries, appropriations for personnel expenditures are underestimated, and ensuring compliance during budget implementation is therefore extremely difficult (for example, firing teachers during the school year could have a high indirect cost because of the disruptive effects on the education system). The inclusion of staff ceilings in the budget would allow the risks of overcommitment of personnel expenditures to be identified clearly at the budget formulation stage. Making the ceilings compulsory would avoid unnecessary commitments in the coming years such as overrecruitment.

Some countries set staff ceilings by personnel category, grade, etc., and manage budgetary posts on this basis. In the same way, a few developing countries prepare organic cadres that define the responsibilities of departments and agencies and the number of posts for each category of personnel. The preparation of these organic cadres has often been based on a needs approach that proved useless in the context of fiscal stress. Such approaches can make personnel management rigid and should be avoided. Staff ceilings should either be aggregated or broken down into a few broad categories. They serve as a tool for controlling the fiscal impact of the personnel policy of agencies and as an aid in personnel management. Line ministries should be made fully responsible for establishing staff ceilings for their subordinate agencies. Appropriations for personnel expenditures and staff ceilings should be consistent. Staff ceilings could be

announced together with expenditure ceilings at the start of budget preparation, and adequate adjustments may be made in later stages of budget preparation, if necessary.

In countries where the size of the civil service does not pose major problems and where methods for estimating personnel expenditures are satisfactory, staff ceilings are not needed. Budgeting personnel expenditures and other current expenditures under separate line-items and regulating transfers between these items could be sufficient to keep personnel expenditures under control. Information on manpower levels is required during budget preparation and should be made public (as an annex to the budget).

However, most developing countries and transition economies need to keep a tight control on their personnel expenditure and to downsize their civil service. They should prepare staff ceilings, to guide the implementation of their personnel rationalization measures.

3. Management issues

Personnel management covers a variety of issues such as those related to regulations governing the civil service or the compensation system. Some of these issues have direct budgetary consequences, notably those related to the compensation system. Personnel management must be performed by relevant line ministries or a civil service board, but any decision that affects the budget needs to be prepared in consultation with the Ministry of Finance and submitted to the same restrictions as other decisions that lead to an increase in expenditures.

4. The payroll system

A payroll system is a tool for ensuring better transparency in personnel expenditures and for monitoring staff ceilings (if any). To be cost-effective, in general, the computerization of the payroll system needs to be centralized. Arrangements can (and should be) be set to allow the line ministries to take advantage of the computerization without giving up their responsibility for personnel management. Close links must be established between the payroll management system and the personnel management system (where personnel information files are kept).

In several countries, the civil service is placed under the responsibility of a civil service board. Good coordination between this office and the Ministry of Finance must be established. If the civil service board manages personnel positions, they should be fully compatible with the staff ceilings and the appropriations for personnel expenditures.⁸ In several countries, data on the civil service are confusing and vary depending on the agency that produce it. Personnel management systems maintained independently from the payroll system are, in some countries, the source of this confusion. If a central personnel management system exists or is expected to be implemented, it must be integrated with the payroll system.

D. PROCUREMENT

The main objective of the government as a purchaser is to obtain high-quality goods and services at a competitive price. Procurement procedures should provide fair opportunity to all bidders, and be designed to get the best value for money and to minimize risks of corruption and patronage. While government procurement is certainly not the only possible source of corruption, it is one of the major ones, and vigilance is always necessary to minimize corruption risks, optimize the use of financial resources, and foster the growth of competition.

1. Procurement cycle

The procurement cycle includes the following stages:

- *Identification of user needs and project preparation.* For supplies, this identification consists of establishing what users require, specifying of the goods or services to be procured, reviewing whether the needs can be met from available stores, whether they can be aggregated with any other outstanding similar requirement, etc. For construction projects, different variants are reviewed to choose the most cost-effective and the project execution plan is prepared to include the characteristics of the project. At this stage, the possibility of a public-private partnership should also be reviewed, as well as the appropriate arrangements.

- *Determination of the procurement procedure.* A key step is to determine the procurement procedure (restricted list of vendors, local competitive bidding, or international competitive bidding). For expenditures financed by external sources, procurement procedures must conform to the guidelines established by the external lender or donor. Major multinational trade arrangements like the World Trade Organization's Government Procurement Agreement also set legal obligations for national procurement systems and practices.
- *Tendering process (generally preceded by a prequalification procedure, depending on the tendering procedure).* For competitive bids, a letter of invitation is sent to tenders. This letter should specify the characteristics of the project or the goods and services to be supplied, the selection criteria, and the award arrangements. Price is an important criterion in awarding contracts, but cannot be the sole criterion. In many cases, price is less important than technical and quality criteria. Choosing systematically the lowest-priced bids could lead to buying obsolete or poor-quality goods or services. To avoid an excessive bias toward low-priced bids, it is often desirable to review the bids in two steps, first on technical grounds, and then on the basis of cost.

2. Principles of competition and transparency

The key principles in procurement are open competition and transparent process. The procurement process should be made open to public scrutiny. The results of the bidding must be made public. Competitors' names, their bid prices, and the name of the successful bidder must be disclosed.

Contract awards and the overall procurement process must be subjected to the scrutiny of the national Parliament and external audit bodies. Written (or computerized) records must be maintained and publicly accessible. These records should show which suppliers were approached, which ones were selected, the reasons for the procurement decision, details of prices, reports on the acceptance of work done or the receipt of goods ordered, and comments on the performance of the supplier.

The legal framework or the code of ethics should include standards about procurement. There should be no conflict of interest between official duties and private interests of civil servants. Appropriate levels of financial delegation and proper separation of duties must be established. Rotation of duties is generally needed to avoid risk of collision due to the development of too close and cozy relationships between the buyer and the supplier.

In some countries, the government also aims to achieve economic policy objectives through its purchasing policy, such as giving preference to local producers or promoting new standards or innovations, in terms of safety, the environment, or other areas. These criteria should be clearly stated and published. In any case, the procurement procedures should promote competition and ensure equity and integrity.

3. Procurement administration

In some countries, the purchasing function is centralized in a central procurement unit. In principle, a central purchasing unit has the advantage of allowing the government to obtain lower prices by grouping its purchases. However, the results may be disappointing because of problems such as slow and bureaucratic response to customers, excessive inventories, losses, pilferage, and slow response to market and technological changes.

It seems preferable to make line ministries fully responsible for their purchases and establish a Central Public Procurement Office to supervise and assist in the procurement activities of agencies. Under such arrangements, the Central Public Procurement Office is responsible for developing rules and regulations, creating a government-wide information and publication system, ensuring that government purchasing entities employ trained personnel, developing a training system, and maintaining general supervision of procurement systems.

E. KEY POINTS AND DIRECTIONS IN REFORMS

1. Key Points

It is possible to execute badly a well-formulated budget; it is not possible to execute well a badly formulated budget. However, budget execution is more than simply assuming compliance with the initial budget. It must also adapt to intervening changes, and promote operational efficiency. A procedure for controls is needed, but should not hamper efficiency nor lead to altering the composition of the budget. The controls must focus on what is essential while giving flexibility to spending agencies in implementing their programs.

a. Expenditure control

The budget system should assure effective expenditure control. The first step is to prepare a realistic budget and to identify measures to contain permanent commitments (such as entitlements, wages). Besides this, the budget implementation system should have the following features:

- A complete budgetary/appropriation accounting system. It is needed to track transactions at each stage of the expenditure cycle (commitment, verification, payment) and movements between appropriations or budget items (apportionment, virements, supplementary estimates).
- Effective controls at each stage of the expenditure cycle, whatever their organization.
- A system for managing multi-year contracts and forward commitments.
- Personnel management system including staff ceilings, which should be controlled and budgeted in countries that need to undertake civil service reform.

- Adequate and transparent procedures for competitive procurement and systems for managing procurement and contracting out.

b. Enforcing priorities stated in the budget

- Cash rationing should be avoided (except in an extreme emergency). Budget implementation and cash plans must be prepared, but they should be based on budget estimates and take into account existing commitments.
- Supplementary estimates must be strictly regulated and their number limited.
- Virements between programs should not alter priorities stated in the budget.

c. Efficient budget implementation

- Budget funds should be released on time.
- Internal controls (within line ministries) should be generally preferred to ex-ante controls performed by central agencies, but the internal controls require a strong monitoring and auditing system. Commitments and verification controls should be internal, to avoid excessive interference by central agencies in budget management. When payment processing and accounting controls are decentralized, central control on cash is required (see chapter 6). When payment processing and accounting controls are centralized, it should be verified that payments are made on time and according to the budget and the cash plan, without additional prioritization. The use of modern technology should make it possible to reconcile the need to decentralize controls for efficiency and the need to centralize data on budget execution for expenditure control.
- Rules for virement should allow both flexibility and control over the major items.

- Carry-over appropriations should be authorized, at least for capital expenditures, but the procedure needs to be regulated.
- The contracting out of government activities should be considered, but caution is needed in contract preparation and management. Procurement for activities that are contracted out should be competitive.

2. Directions for improving budget execution

Budget execution generally needs to be improved in two respects: enhancing expenditure control and creating the conditions for increased efficiency in public spending. An adequate balance between these two different requirements must be found.

a. First step: Ensuring that the basic requirements are met

In a number of countries, the first step should be to reinforce expenditure control as well as to ensure conformity in budget execution with the policies stated in the budget. In this respect, attention needs to be paid on the following points:

- Timely release of funds;
- Cash planning in conformity with budget authorization and taking into account ongoing commitment (for a sound budget preparation is a prerequisite);
- Effective control of expenditures at each stage of the expenditure cycle (whatever their organization internal or ex-ante/external);
- Adequate budgetary monitoring, at each stage of the expenditure cycle (commitment, verification, and payment);
- Clearly defined procedures for recording transaction (notably for commitments);

- Adequate cash management (see chapter 8);
- Transparent procedures for procurement.

b. Second step: Improving the efficiency of the system

To improve efficiency in public spending, the following actions are generally needed;

- Flexible rules for virement and regulated carry-over for capital expenditures;
- Decentralized controls (in parallel with strengthened procedures for auditing and reporting).
- Market testing and contracting out.

¹ Note that management control, which is an important part of budget implementation is discussed in chapter 9 together with audit and evaluation.

² See comparison between the British System and the French System in Jack Diamond and Christian Schiller "Government arrears in fiscal adjustment programs" in "How to measure the deficit" IMF. op.cit.

³ Notably in countries that make a budgetary accounting on the basis of vouchers for payment sent to accounting offices. When these countries face arrears problems these vouchers correspond neither to accrued expenditures nor to cash payments, since arrears are accumulated upstream and downstream the stage of the expenditure cycle at which these vouchers are issued.

³ As shown by the experience of several African countries that have implemented integrated expenditure management systems in the early 80s.

⁴ Sometimes obligational accounting is confused with accrual accounting. There are two major differences. First, obligation basis is usually restricted to outlays, while accrual basis includes both receipts and outlays. Second, accrual basis recognizes liabilities at the verification stage, not at the commitment stage and (for "full accrual") covers uses of goods and services acquired (e.g., recognizes inventories, depreciation). See chapter 7.

⁵ As shown by the experience of several African countries that have implemented integrated expenditure management systems in the early 1980s.

⁶ See SIGMA-OECD, 1997.

⁷ As in the U.S., Denmark, Canada, and the Netherlands.

⁸ In Turkey, the system of cadres managed by the Personnel Presidency led besides the regular cadres, "authorized cadres" and "released cadres".

Chapter 8. CASH MANAGEMENT AND THE TREASURY FUNCTION¹

A. THE TREASURY FUNCTION

Governments need to ensure both efficient implementation of their budgets and good management of their financial resources. Spending agencies must be provided with the funds needed to implement the budget in a timely manner, and the cost of government borrowing must be minimized. Sound management of financial assets and liabilities is also required.

Financial management within the government includes various activities: formulation of fiscal policy; budget preparation; budget execution; management of financial operations; accounting; and auditing and evaluation. Within this broad financial management function, the Treasury function is to achieve the set of specific objectives mentioned above. It covers the following activities:²

- Cash management;
- Management of government bank accounts;
- Financial planning and forecasting of cash flows;
- Public debt management;
- Administration of foreign grants and counterpart funds from international aid;
- Financial assets management.

¹ The government's strategy to manage its moneys to maximize financial returns is a critical part of overall cash management. The accent of this chapter, however, is on control of cash flows and on the efficiency of payments' arrangements, in keeping with the expenditure focus of this entire book.

² Cf, Teresa Ter-Minassian, Pedro P. Parente, and Pedro Martinez-Mendez, "Setting up a Treasury in economies in transition," IMF, 1995.

To carry out these activities, organizational arrangements and distribution of responsibilities vary considerably according to countries. In some countries, the Treasury Department focuses only on cash and debt management functions (which are reviewed in this section). In a few countries, debt management is performed by an autonomous agency. In other countries, the Treasury Department performs budget execution controls (which are reviewed in chapter 6) and/or accounting and budget execution reporting activities (which are reviewed in chapters 10 and 11).

B. CASH MANAGEMENT³

Cash management has the following purposes: controlling spending in the aggregate, implementing the budget efficiently, minimizing of the cost of government borrowing, and maximizing the opportunity cost of resources (the last two purposes yielding interest). Control of cash is a key element in macroeconomic and budget management. However, as emphasized in chapter 5, it must be complemented by an adequate system for managing commitment. For efficient budget implementation, it is necessary to ensure that claims will be paid according to the contract terms and that revenues are collected on time. It is necessary to minimize transaction costs; and to borrow at the lowest interest rate or to generate additional cash by investing in revenue-yielding paper. It is also necessary to avoid paying in advance and to track accurately the dates on which payments are due.⁴

In developing countries, governments often do not pay attention to issues related to cash management. Budget execution procedures and the management of cash flows focus on compliance issues, while daily cash needs in are met at low cost by the Central Bank. Spending units are not concerned with borrowing costs since their interests are already taken account in the budget prepared by the Ministry of Finance.

However, the costs of borrowing, the fact that the credit granted to the government by the banking system is a key macroeconomic target and a performance

³ The relationship between the Treasury and the Central Bank in this and other respects is briefly discussed in section.

criterion in IMF-supported financial programs, and the increasing separation between the activities of the Central Bank and the government budget make cash management more important. Performance concerns have also had an impact on cash management and some countries have implemented reforms to make spending agencies more responsible for cash, while maintaining instruments to ensure fiscal discipline.

Box 26

Cash Management in the Philippines

Until 1985, cash authorizations were issued to government agencies each quarter through the release of cash disbursement ceilings (CDCs) which specify the maximum amounts that the agencies can withdraw from the Bureau of the Treasury (BTr) to pay for their obligations. Even with the creation of a New Disbursement System in 1986 the CDC system, the tendency for agencies to issue checks and Treasury warrants in excess of the amounts provided persisted.

In May 1990, the Synchronized Planning-Programming-Budgeting System (SPPBS) was introduced to improve coordination among the budget, planning and revenue agencies and ensure the consistency of budget plans with development goals and available funds. In the following year, the Department of Budget and Management (DBM) and the Department of Finance (DOF) initiated the creation of an Inter-Agency Committee on Cash Programming composed of representatives from the DBM, DOF, BTr, and the Central Bank. Regular meetings were held to assess the fiscal performance of the national government for the previous month and to discuss prospects for the succeeding months. The Committee determined the disbursement ceiling on which the issuance of Notices of Cash Allocation (NCAs) was based.

The SPPBS did nothing to resolve the situation, and problems with cash float and timeliness of cash releases continued. Accordingly, in 1992, the Modified Disbursement System was established to provide for closer coordination between DBM and DOF in releasing funds, based on shorter-term calculations of cash availability. Agencies, to optimize their use of cash in their priority programs, implemented cash conservation measures.

Under the Modified Disbursement System, the DBM continued to allocate funds appropriated under the General Appropriations Act. The DOF made the corresponding arrangements with the servicing banks, deposited the minimum funding requirements for each government entity, and replenished these deposits regularly. The deposits were maintained by the Treasurer of the Philippines and interest earned accrued to the General Fund.

In the event that the estimated cash balance of the government reached a level where budget cuts could be avoided, the DBM implemented proportionate across-the-

⁴ The 1997 annual report of the Western Australia Audit Office, for instance, shows the savings made through the reform of payment techniques and accounting procedures in the main roads agency of the government of Western Australia.

board reductions in the budget. Government agencies, however, continued to determine disbursement priorities, subject only to the prior payment of personal services and mandatory expenditure.

To expedite and standardize the release of funds across agencies in line with specific policy initiatives of the government, the Simplified Fund Release System (SFRS) was implemented in 1995. It standardizes releases across government agencies that are similarly situated. It allows flexibility in the use of funds within limits prescribed by law and simplifies the process, thereby reducing paperwork and facilitating the monitoring of allotment releases.

Source: Darlene Casiano, Department of Budget of Management, January 1999.

1. Control of cash flows⁵

a. Inflows

It is necessary to minimize the interval between the time when cash is received and the time it is available for carrying out expenditure programs. Collected revenues need to be processed promptly and made available for use. When tax collection is done by the tax administration offices (or by Treasury offices) the administrative organization of these offices may have to be reviewed and their equipment modernized.

Commercial banks by virtue of the banking sector infrastructure are often able to collect revenues more efficiently than tax offices, which should therefore focus instead on tracking taxpayers. When revenues are collected by commercial banks, arrangements must be defined to foster competition and ensure prompt transfer of collected revenues to government accounts. Systems of bank remuneration through float, which consists of authorizing the banks to keep the revenues collected for a few days, present inconveniences. Stringent rules to ensure prompt transfers must be established. Moreover, bank remuneration through fees is more transparent and promotes competitive bidding. An appropriate system of penalties for taxpayers is also an important element in avoiding delays in revenue collection.

⁵ See Herma R. de Zoysa, Cash Management, in Premchand (1990).

b. Outflows

For cash management, the control of cash outflows, which is directly related to organizational arrangements for budget execution, can pose more difficulties than the control of cash inflows. However, issues related to cash management should not be confused with issues related to the distribution of responsibilities for accounting control and administration of the payment system. The major purpose of controlling cash outflows is to ensure that there will be enough cash until the date payments are due and to minimize the costs of transactions, while keeping cash outflows compatible with cash inflows and fiscal constraints.

The first condition for ensuring that cash outflows fit fiscal constraints is good budget preparation and budget implementation covering both cash and obligations. However, during budget implementation, cash outflows must also be regulated through cash plans to smooth cash outflows.

c. Payment techniques

Payment methods affect the transaction costs of cash outflows. Depending on the banking infrastructure and the nature of expenditures, various payment methods may be considered (check, cash, electronic transfer, debit card, etc.).⁶ Modern methods of payment, for example, payment through electronic transfers instead of through checks or cash, allow the government to plan its cash flow more accurately, expedite payments, and simplify administrative and accounting procedures. However, whether one mode of payment is preferable to another depends on many factors, such as the degree of economic development of the country, the banking network, the status of computerization. For payments within government (when an agency provides services to another agency), a number of countries use nonpayable checks, while others make book adjustments. Using nonpayable checks has the advantage of avoiding delays in

⁶ Instruments for payment are presented in Premchand, *Effective government accounting*, IMF, 1995, page 25 (table 1) and page 27 (table 3).

the preparation of accounts. In some aid-dependent countries nonpayable checks are used to pay taxes related to imports financed with external aid, to avoid loopholes in the tax system created by duty-free imports.

2. Centralization of cash balances and Treasury single accounts

a. Centralizing cash balances

To minimize borrowing costs or maximize interest-bearing deposits, operating cash balances should be kept to a minimum. In countries where funds are released through an imprest system, spending agencies often accumulate idle balances their bank accounts. These idle balances increase the borrowing needs of the government, which must borrow to finance the payments of some agencies, even if other agencies have excess cash.

Where imprest accounts are held at a commercial bank, the idle balances can help loosen constraints on credit, by giving the banking sector additional resources for credit.

Daily clearing of accounts with various banks could be more difficult in some countries than daily settlement within a set of accounts at one bank (generally Central Bank). However, in many countries, the Treasury does not perform daily clearing of the balances of the line ministries accounts with the Central Bank. Therefore, despite a positive balance with the Central Bank, the government has to borrow from the financial markets. Daily consolidation of cash balances is also needed when line ministries accounts are held with the Central Bank.

Cash balances are efficiently centralized through a Treasury Single Account. This is an account or set of linked accounts through which the government transacts all payments.

A standard Treasury Single Account is organized along the following lines: (i) line ministries hold accounts at the Central Bank, which are subsidiary accounts of the Treasury's account; (ii) spending agencies under the line ministries hold accounts either at the Central Bank or, for banking convenience, with commercial banks; in both cases, the accounts must be authorized by the Treasury; (iii) spending agencies' accounts are zero-balance accounts, with money being transferred to these accounts as specific approved payments are made; (iv) spending agencies' accounts are automatically swept at the end of each day (where the banking infrastructure allows daily clearing); (v) the central bank consolidates the government position at the end of each day including balances in all the government accounts.

In practice under the notion of a Treasury Single Account, there are a variety of methods of centralizing transactions and cash flows. These can be grouped very broadly into two categories:

- *Treasury Single Account and centralized accounting controls.*⁷ Requests for payment are sent to the Treasury which controls them and plans their payment. The Treasury manages the float of outstanding invoices. This solution seem more efficient both for cash management and expenditure control. However, as discussed in chapter 7, the centralization of accounting controls and the central management of float lead to inefficiencies, and even corruption, in countries where the Treasury Department selects the suppliers to be paid.
- *Passive Treasury Single Account.* Payments are made directly by spending agencies, but through a Treasury Single Account. The Treasury, or the budget implementation plan, sets cash limits for the total amount of transactions, but the Treasury does not control individual transactions. In practice, the Treasury Single Account consists of several bank accounts. These accounts may be held only at the Central Bank or also in several other banks (e.g., Agriculture Bank, giro postal service). These accounts are cleared every day and their balance is transferred to the central account of

⁷ As in the French system.

the Treasury. This variant has the advantage of making the spending agency responsible for internal management, while keeping central control of cash.

This system allows but does not require diversified banking arrangements. Payments can be made through banks selected on a competitive basis. The banks accept the payment orders sent by spending units up to a certain limit defined by the Treasury or the budget implementation plan. Settlement is made with the Central Bank that holds the Treasury central account at the end of each business day.

Whatever the institutional arrangements, the centralization of cash balances should cover all the government accounts used for payment transactions, including accounts managed by funds.

From a cash management point of view, these modes of centralizing cash balances give identical results. The feasibility of their implementation depends on the level of technological development of the banking sector and the government. Modern technology allows electronic links between spending agencies, the Central Bank (or the commercial banks), and the offices of the Treasury. Actually the concept of a General Ledger System, which is a system into which all transactions are recorded (see chapter 7, for further discussion of the General Ledger System), can fit either decentralized or centralized accounting controls and payment processing systems. Countries with centralized controls (e.g., Brazil) as well as countries without central control (e.g. the U.S.) have set up a General Ledger System into which not only payment transactions but also commitments are posted. The GLS can also be linked with the accounting and management information systems maintained at the agency level.

Poor banking and technological infrastructure in some developing countries is an obstacle to combining centralization of cash balances with decentralization of payment processing. But most countries use the greater portion of their cash either for transactions at the central level (e.g., debt payment and expenditures managed by the central departments of line ministries) or for payments that are due on a fixed date (e.g,

wage payments). Therefore, a first step in streamlining cash management could consist of: (i) daily centralization of transactions made at the central level; and (ii) for decentralized agencies, procedures for cash transfer that conform to the in-month distribution of expenditures.

In countries with an underdeveloped banking infrastructure, daily clearing of accounts with various banks could be more difficult than daily settlement within a set of accounts at the Central Bank. Maintaining a large number of accounts could therefore also hinder the implementation of appropriate clearing and consolidation procedures.

For policy analysis and management, it is important to record each transaction and to classify it along functional and economic categories. Thereby centralizing cash balances is not sufficient for this purpose. Information on transactions must also be centralized. Processing payment transactions within the Treasury could facilitate monitoring. However, experience shows that this does not automatically guarantee that monitoring will be satisfactory. Generally in developing countries, the Treasury centralizes its internal cash balances and global information on cash outflows and inflows, but the centralization of payment transactions is not systematic or the data are too much aggregated to allow a sound analysis of budget execution. Moreover, as indicated in chapter 5, cash flow monitoring is insufficient to control budget execution. Issues related to monitoring and reporting are reviewed in more detail in chapter 7.

Arrangements for cash management in several countries aim implicitly at supporting ailing banks. Restructuring the banking system in these countries is generally required. However, banking reform is a policy issue that should be addressed as such. Before considering any reform of cash management, its effect on the banking system should be assessed. On the other hand, entrusting the management of the governments accounts to commercial banks could burden the banks with the governments cash problems, particularly if the Treasury is not able to meet its obligations.

Reform of the cash management system must take into account its possible impact on budget management within spending agencies and must also be cost-

effective. For example, it is generally advisable for the central departments of line ministries to replace an imprest system with a system that centralizes cash. But for regional departments, the organization of the payment system must take into account the country's context and infrastructure. Often, developing countries have different arrangements within their payment system according to the location of spending agencies. This can be seen as a fragmentation of the system, but it may be required.

The centralization of cash balances within a single account is meant to optimize cash management. It avoids borrowing and paying additional interest charges to finance the expenditures of some agencies while other agencies keep idle balances their bank accounts.

b. Giving incentives

If value for money is to become a working principle in government, a significant start should be made by establishing businesslike arrangements between the government and the banking system. The principle that the government should earn interest on all its deposits and that it should, in turn, pay for all the banking services it receives should be seriously explored.⁸

Reforms made in New Zealand and being implemented in some other countries,⁹ are headed in this direction. In New Zealand, departments negotiate their annual cash requirements with the Treasury, and pay an interest-rate penalty if they run out of cash, or earn interest on their surplus funds. In parallel, the NZDMO, which is the branch of the Treasury that is responsible for cash and debt management, sweeps department bank accounts each evening and invests the surplus in the overnight money market. The departments do not keep idle balances. Incentives given to spending agencies to manage their cash coexist with clearing of government bank accounts and daily centralization of cash balances. Compared with the previous system where departments kept idle balances in their bank accounts, the new system generates yearly savings of about \$US 20 million.¹⁰

⁸ Herma R. de Zoysa, *op. cit.*, page ____

⁹ Asia, Sweden, and Australia.

¹⁰ This description is drawn from Graham S. Scott, *Government reform in New Zealand*, IMF, 1996.

Countries where the spending agencies are responsible for making the payments could consider implementing incentives for cash management at the spending agency level. However, in many developing countries, centralizing cash balances should generally be the first measure to consider, since it would give the most tangible benefits.

Box 27
Incentives for Good Cash Management in Sweden

With efficient financial management as a key feature of the Swedish system, appropriations are now deposited into each agency's interest-bearing account, normally at the rate of one-twelfth each month. If an agency spends its appropriations at a slower rate, it is paid interest on the balance in the account. Similarly, if an agency spends its appropriations at a faster rate, then it must pay interest to reflect the government's cost of borrowing. Agencies, of course, vary greatly in their ability to time individual transactions precisely but this system has served to increase cash-consciousness in agencies.

Another measure to improve cash management was allowing agencies to carry forward their unused appropriations. This was designed to avoid end-of-year spending binges which are an inherent problem of the annual budget process; increase discipline among managers as any overspending in the year gets carried over as well; and foster efficiency gains in agencies beyond those assumed in the budget, as any gains would be retained by the agency. Without the carry-forward option, managers were deemed to have insufficient incentives for seeking efficiency gains.

Source: OECD, "Budgeting in Sweden," 1998.

C. MANAGEMENT OF GOVERNMENT BANK ACCOUNTS

Whatever the organization of tax collection or expenditure payment, the Treasury must be responsible for supervising all central government bank accounts, including any extrabudgetary funds. When commercial banks are involved in revenue collection or expenditure payments, the banking arrangements must be negotiated and contracted by the Treasury. This will enable the government to negotiate better arrangements and to ensure that requirements for cash and budget management are appropriately taken into account.

Besides using bank accounts for budget management, the Treasury may have deposit accounts with commercial banks, which should be selected on a competitive basis to get higher-yielding terms.

D. FINANCIAL PLANNING AND FORECASTS

Financial planning and cash flow forecasts are needed both to ensure that cash outflows are compatible with cash inflows and to prepare borrowing plans. As indicated in chapter 5, cash planning must be done in advance and communicated to spending agencies to allow them to implement their budgets efficiently. Moreover, reducing uncertainty about the borrower debt program is generally rewarded with lower borrowing charges. Therefore, it is also important to prepare and announce borrowing plans in advance .¹¹

Financial planning includes the preparation of an annual cash plan and a budget implementation plan, monthly cash plans, and in-month forecasts.

1. Budget implementation plan and cash plans

Annual cash plans must be prepared in advance, and should set out projected monthly cash inflows, cash outflows and borrowing requirements. It is necessary to have: (i) quarterly updates of the projections for the entire fiscal year; and (ii) monthly updates of the projections for the succeeding month.

The preparation of the cash plan and its updating require close coordination between the Treasury Department, the Budget Department, and the Tax Administration Department.

Often, the Treasury Department prepares both the budget implementation plan and the overall cash plan on a pure-cash basis. However, in some countries, the Budget Department prepares a budget implementation plan, which can include gross

¹¹ Montserrat Ferre Carradeco and Peter Dattels, Survey of public debt management frameworks, in V. Sundararajan, Peter Dattels and Hans J. Blommstein, Coordinating public debt and monetary management, IMF, 1997.

flows (e.g., wages, including income taxes), then the Treasury Department prepares a cash plan showing cash flows. In a number of countries, this budget implementation plan is a requirement for commitments or requests for payment, rather than a form of cash control.¹² In other cases, the budget implementation plan merely divides appropriations by four (for quarterly disbursements) or by twelve (for monthly disbursements), but in practice the budget is implemented through cash rationing. Close coordination between the Budget Department and the Treasury Department is required when planning budget implementation. The budget implementation plan and the cash plan must be fully compatible.

a. Budget implementation plan

As discussed in chapter 7, the budget implementation plan must be consistent with the budget, prepared in advance, and communicated to spending agencies. Except when the budget has been badly prepared or the country is in fiscal difficulties, the preparation of the budget implementation plan should be driven by the budget, not by cash management concerns.

The budget implementation plan should take into account the timing of payments and payment obligations arising from commitments over the fiscal year. In particular, it consider the schedule of disbursements for investment projects, which are not equally distributed by month. The plan must be rolled over quarterly, to allow for changes in the macroeconomic environment and progress in budget implementation. However, it should not be used to make nontransparent revisions in the budget.

b. Revenue forecasts

Forecasts of the monthly distribution of revenues should be prepared. These forecasts should be updated regularly, preferably every month, since changes in the

¹² In Turkey, for example, the Budget Department prepares the budget implementation plan and regulates the *tahakkuk*, which is an administrative stage before payment, while the Treasury prepares cash plans. Similar approaches may be found in other countries that have a budget system derived from the French system.

macroeconomic environment or in the tax administration system may affect revenue collection.

The preparation of monthly revenue forecasts requires economic as well as management expertise, to factor in changes in the tax administration system. This exercise should be carried out by the Tax and Customs Administration Departments, in close co-operation with the Treasury and the departments responsible for macroeconomic analysis. In several developing countries, monthly forecasts prepared by the tax administration departments are more administrative than economic. They show the distribution of budgeted revenues over the fiscal year but do not take into account fiscal and economic developments after the budget preparation. The Treasury may therefore have to strengthen the forecasting capacities of tax administration departments.

A good monitoring system is a prerequisite for forecasting. Thus, revenue collections need to be monitored along the major tax categories and adjusted to reflect changes in the assumptions underlying the forecasts. In-year revenue forecasts must be based on revenue assessment and tax collection reports the results of economic surveys, etc. Short-term forecasting tools, such as short-term macroeconomic models and tax forecasting models, are also helpful.

The revenue forecasts must also include forecasts of nontax revenues to be prepared by the Treasury in close coordination with the agencies responsible for their management.

c. Cash plans

The cash plan shows forecasts of financial flows before new borrowing, including reimbursements of loans or bills due from the government, repayment of arrears, and drawings on loans already contracted. The plan should be rolled over every three months, and the projections systematically updated every month.

Monthly forecasts of cash outflows should be derived from the budget implementation plans. Although the budget implementation plan, even in a cashbudget system, is not necessarily on a pure-cash basis, monthly cash plans should be on a pure-cash basis. These monthly cash plans should be updated every month. This updating should be made on technical grounds, to take into account developments in exchange rates and interest rates, changes in the payment schedule of investment projects of a significant size, and outstanding obligations, among other things.

The preparation of monthly cash outflow plans requires good monitoring of both payments and obligations. These monthly cash plans are used to define monthly cash transfers within an imprest system or cash limits for payments within a Treasury Single Account. Except in particular circumstances, these limits should conform to the budget implementation plan. As indicated in chapter 5, planning obligations on a monthly basis is not recommended. Regulating cash by generating arrears must be avoided.

Preparing monthly cash outflow plans is more of a Treasury task than a budgeting task. However, the Treasury should coordinate with the Budget Department, in case a departure from the budget implementation plan appears necessary. Borrowing plans are derived from the monthly forecasts of cash inflows and outflows.

2. In-month forecasts

The in-month distribution of cash flows must be estimated to determine the date of auctions, the date of transfers of funds to agencies within an imprest system, etc.

In-month forecasts of debt servicing and wage payments do not pose major problems. For other expenditures, there is a need for an appropriate recording of obligations and expenditures at the verification stage, including the date on which payments are due. In practice, only spending agencies can do this. Within a centralized payment system and without appropriate tracking of obligations and verified expenditures, the Treasury must focus on forecasts of payments of a very significant amount (e.g., for a few investment projects), based on information from spending agencies, and limit its other payment forecasts to rough estimates.

The preparation of in-month revenue forecasts is better undertaken by the Tax Administration office than by the Treasury, since factors related to tax administration or taxpayers behavior affect strongly the in-month distribution of revenues.

In-month forecasts should be reviewed and updated every week. For this purpose a number of countries have a Treasury Committee that meets weekly. Such arrangements improve cash management, provided they do not slip into day-to-day budget management or the setting of priorities on political grounds.

E. DEBT MANAGEMENT

1. General issues

a. Legal and budgetary arrangements

To avoid uncontrolled indebtedness, only one government authority should be authorized to borrow. It must be the authority responsible for fiscal management (i.e., the Minister of Finance). The Legislation should provide for this point.

Regulations can also provide for the amount of borrowing, which must conform to the annual budget.¹³ The annual budget should outline the annual borrowing plan.

A public debt act can also provide guidance on the types of instruments and selling techniques that the government can use. However, this act should be flexible enough to adapt to developments in the financial market and to the level of technological sophistication.

b. Transparency and predictability

¹³ In Canada a borrowing bill that sets an annual ceiling on borrowing is prepared at the same time as the budget and submitted to Parliament. In Thailand, foreign borrowing under the law cannot exceed 10 percent of the annual budget (Robin Miller, Canada: Debt management policy and operating practices, in

The objectives of the debt management policy should be clearly stated and made public. The basic objectives are to finance the budget deficit, or specific projects (for project loans), and to minimize the costs of borrowing. Governments also pursue other objectives in debt management, such as the development of financial markets, support for the monetary policy, encouragement of saving. The development of a large and liquid market for government debt facilitates monetary management and the development of financial markets.

As indicated above, reduced uncertainty about the borrower debt program is generally rewarded with lower borrowing charges. Many countries announce their borrowing plans in advance.¹⁴ Taking into account uncertainty in revenue collection, the amount of future auctions can be presented in public borrowing plans within a range of +/- 10—20 percent, and for example, the precise characteristics of a particular auction can be announced the week before it takes place. Issuance and pricing results should be published shortly after auctions.

The government should provide Parliament with regular and detailed reports on its indebtedness and its debt policy, and publish statistics on the government debt, including guarantees.

Debt management has two main aspects: (i) Central Bank borrowing operations as part of monetary policy (in Pakistan, for example, the State Bank of Pakistan manages the issuance of Treasury bills to control liquidity in the banking system and meet monetary targets¹⁵); and (ii) government borrowing to finance the fiscal deficit. The use of government securities as instruments of monetary policy is seen a stimulus to the development of the financial markets. However, it requires adequate support arrangements, such as coordination between monetary and fiscal authorities regarding the amounts to be issued; protection against overfunding of the government budget for the purpose of monetary management; and sharing the cost of this funding (in the

V. Sundararajan, Peter Dattels and Hans J. Blommstein, *Coordinating public debt and monetary management*, IMF, 1997. Premchand, *Public expenditure management*, IMF, 1993).

¹⁴ In the United Kingdom, the Treasury announces each financial year in its annual debt management report the details of financing requirements, auction plans, and the maturity structure of gilt issuance. In Turkey the borrowing plans are announced every quarter.

Philippines, for instance, the remuneration for the cost of deposits related to overfunding is determined at regular meetings between the Ministry of finance and the Central Bank¹⁶).

c. *Debt policy and responsibilities*

The initial step in formulating debt policy for financing the budget deficit is to set borrowing objectives in conformity with fiscal targets. The second step is to determining strategic choices.

Concerning borrowing in the financial markets (issues related to project loans are reviewed below in paragraph 2), the formulation of debt policy includes strategic and tactical policy choices that concern the choice of instruments, currency, targeted markets, etc.¹⁷ The choice of instruments and the establishment of an adequate mix of these instruments must be based on the needs of investors, risk factors, and the objective of promoting the liquidity and the overall development of the market. The choice of maturity is important in balancing the debt profile, adjusting the volatility of debt, and exploiting investor preferences. Targeting the wholesale domestic market reduces interest costs, but the development of the retail market may promote household savings.

In developing countries and transition economies, extreme caution is required before considering certain instruments that increase volatility in debt service (such as index-linked rate instruments and currency-linked instruments). Although portfolio theory suggests that borrowing in a variety of currencies diversifies risks and reduces the cost of borrowing, borrowing in foreign currency presents higher risks and costs in most developing countries. The use of derivatives requires high degree of expertise and should generally not be considered in developing countries.

¹⁵ Montserrat in V. Sundararajan, Peter Dattels and Hans J. Blommstein, *Coordinating public debt and monetary management*, IMF, 1997.

¹⁶ See Marc Quintyn, *Government securities versus Central Bank securities*, IMF, 1994.

¹⁷ Montserrat op. cit., page ____

The formulation of debt policy, for financing the budget deficit, should rest with the Ministry of Finance, but close coordination with the Central Bank is required, and the effects on monetary policy should be considered. In developing countries, Central Banks are more knowledgeable about the functioning of the financial markets than Ministries of Finance. The distribution of responsibility for implementing the debt policy should be established according to technical capacities within the Ministry of Finance, the degree of development of the financial markets, and the objectives pursued. In several developing countries, the Central Bank is responsible for implementing the debt policy and securities management. In developed countries, there is currently a move toward placing debt management fully under the responsibility of the Ministry of Finance, with a view to avoiding any policy conflict between debt and monetary management.¹⁸

d. Accounting

Even in a cash-based budget system, double entry accounting should be: (i) a double-entry system that permits the debit and credit sides of transactions to be recorded; (ii) on an accrual basis. The accounting system must distinguish repayments from interest. Risks related to contingent liabilities must be assessed and recognized.

2. Medium- and long-term external debt management

In middle-income countries, increased openness of financial markets tends to diminish differences between external debt and domestic debt. Market rating covers both external and domestic bills or bonds which may be issued in foreign currency and held by foreign lenders. However, the management of project and program loans needs specific procedures. In low-income countries, project loans and program loans make up the major part of external debt.

Systems and procedures for managing medium-term external debt must cover the following features and functions:

¹⁸ See, for instance, U.K. Treasury, *The future of UK government debt and cash management*, 1998.

Contracting loans. Only one government authority should be authorized to contract external loans and grant guarantees.

Program loans (support for the balance of payments and/or the budget) should be included in the financial plan annexed to the budget. In some countries the signing of these loans is subject to the approval of Parliament. This increases transparency, but may cause delays. Global authorization of the financing plans might be preferable, but this depends on circumstances and the legal and constitutional framework of the country.

Project loans should finance only projects included in the MYEs or the PIP (if a sound PIP is prepared). The total amount of project loans should be presented in these documents. However, the amount of a loan under negotiation cannot be determined precisely. If MYEs or a sound PIP is not prepared or not made public, a list of project loans should be annexed to the annual budget. This list should show their total amount and their terms.

Recording transactions. Every loan transaction should be recorded, including loans contracted and guaranteed, disbursements, payments due, payments, rescheduling, debt remission, cancellation of the nondisbursed part of a loan, and change in the terms of a loan.

To facilitate comparison and accounting, it is better to register individual transactions than aggregated data. For example, it is easier to compare individual drawings expressed in foreign currency with actual expenditures expressed in domestic currency than to compare monthly aggregated data. The average exchange rate for a month is rarely equal to the exchange rate weighted by drawings made within the month.

A crucial problem is the collection of information. In many developing countries, information on drawings is not readily available. The Debt Management Office often records disbursements only on the basis of information communicated by lenders, but not every lender transmits this information in a timely manner. Consequently, as

stressed by different National Auditing Offices (NAOs) (e.g., in Turkey and Nepal), National Auditors cannot perform audits satisfactorily since data on debt cannot be compared with budget execution reports. Information dissemination between line ministries, project managers, and the Debt Management Office is often inadequate. Drawings on guaranteed loans are not systematically communicated to the Debt Management Office. Procedures for disseminating information need generally to be strengthened, by establishing, for example, a monthly system of reporting by project managers and beneficiaries of guarantees to the Debt Management Office. Data from lenders and users must be systematically compared. This needs appropriate bookkeeping for special accounts of projects financed by IFIs and adequate treatment of exchange rate variations in the accounting system.

Managing debt. Future payment schedules and drawings, and the impact of rescheduling operations, should be kept and regularly updated, to provide a basis for macroeconomic forecasts and debt policy.

Payment forecasts are based on the terms of the agreements. But determining exactly the amount of payments due requires additional information. Many countries rely solely on the claims from lenders. Often the Debt Management Office does not know exactly how lenders calculate payments (for example, when the amount of payments depends on the value of a currency pool). Debt accountants must be trained, and basic information on methods of calculating payments must be obtained from lenders.

In the same way, some Debt Management Offices in developing countries do not take full control of the payment schedules for rescheduling agreements. To forecast rescheduling, a simple spreadsheet model is sufficient. To manage rescheduling, the schedule of payments related to the rescheduling agreements must be calculated accurately. This problem is currently being addressed through the implementation of debt management systems that incorporate the management of rescheduling.¹⁹ Often, public enterprise debts and even private debts are passed on to the government through a rescheduling. The government should account for this operation and be

¹⁹ As in the British Commonwealth, UNCTAD systems, and systems developed in a number of countries.

reimbursed by the entity that benefited from this rescheduling. Normally, rescheduling agreements should benefit only the government, and enterprises should pay back the government on the basis of the initial payment schedule.

Reporting. The reporting system for debt transactions should fit the needs of macro analysis, negotiations with lenders or with countries, the preparation of financial programs, budget monitoring, etc. For this purpose, lenders, countries, etc., must appropriately classify loans. The system of notification to the World Bank gives a basic framework for debt reporting, but must be supplemented to take into account other needs related to financial monitoring and forecasting, notably for the preparation of financial programs or debt negotiations.

Accounting. Developing countries with a cash accounting system generally also monitor debt service obligations, but this is not sufficient. A double-entry accrual accounting system is required. Payments are made not only in cash from government bank accounts, but also through debt operations (rescheduling, remissions, etc.). An increase in liabilities (e.g., drawings from external loans) may correspond to an increase in assets (e.g. through a non-lending operation). The risks related to guarantees and on-lending should be assessed and account for. Accounting should be based on accounting standards, not on debt policy. For example, an expected rescheduling may be taken into account in a financial program, but should be accrued into the accounts only when it takes effect. Noncompliance with accounting standards, confusion between forecasted data or policy objectives and actual data, and confusion between new operations (such as debt remission) and revisions in actual data create difficulties in the interpretation of many debt reports. Accounting methods used for specific operations, such as debt remissions, should be indicated in the debt reports.

In several countries, organizational arrangements for the management of external debt are fragmented. The Ministry of Finance, the Ministry of Planning, the Financial Comptroller, the Ministry of Foreign Affairs, etc., may all be involved in debt management.²⁰

²⁰ See Ishrat Husain, Organizing for efficient debt management, in World Bank, *Managing external debt in developing countries*, 1990.

The Ministry of Finance, which is responsible for fiscal management, should be responsible for debt management and should determine the debt policy, review draft agreements, verify whether the loan terms fit debt policy and whether its purpose fits the budgetary policy, assess the future impact on the debt service, conduct financial negotiations, and keep books and the debt recording system.

In several countries, statistics on debt are kept by the Central Bank. Although the government is responsible and accountable for debt management, this organizational arrangement is acceptable. It could ensure more comprehensive coverage of transactions, since every payment is made through the Central Bank. However, where such distribution of responsibilities is made, the statistics unit of the Central Bank must also be made to report to the Ministry of Finance, which is responsible for managing and implementing the medium-term external debt policy. The existence of two statistics units, one at the Central Bank and one within the Ministry of Finance, is generally a source of confusion.

A distinction must be made between functions related to debt management, budgeting and investment programming, and aid management. Budgeting and investment programming consist of prioritizing expenditure programs, and the Debt Management Office should not interfere in this aspect of public expenditure management. On the one hand, project loans should finance only projects included in the MYEs or the PIP. On the other hand, every loan must be submitted to the scrutiny of the Debt Management Office. If budgeting and financial responsibilities are divided between the Ministry of Finance and the Ministry of Planning, neither one should be allowed to borrow for a project not included in the development budget, the MYEs, or the PIP.

Aid management covers the relationships between the country and the lenders/donors. To avoid conflict of competencies, this function should be located within the Ministry of Finance, or within either the Ministry of Finance or the Ministry of Planning in a dual budgeting system. Some countries have adopted other types of institutional arrangement, for instance, by installing an aid management unit within the

Ministry of Foreign Affairs. Where such arrangements are made, the aid management unit must not be allowed to interfere in financial programming and expenditure programming. The unit responsible for aid management should not make decisions on contracting loans or launching a development project and should not be responsible for preparing a PIP.

3. Monitoring borrowings by subnational governments²¹

In a few developed countries, the central government does not control the borrowings of local governments. Control of local-government borrowings relies both on market discipline and public information. Many other developed countries have more stringent controls. In developing countries or transition economies, the stage of development of financial markets and weaknesses in the system of information do not allow the central government to rely on market discipline to control the borrowing policy of local governments.

Control of subnational government borrowing by the central government is needed in developing or transition countries. As discussed in chapter 4, fiscal targets, such as the deficit and the net borrowing requirements should be set for the general government. The central government can control its deficit directly through expenditure control. Since subnational governments have their own budgets, the central government needs to control their deficit through borrowing control. The nature and the coverage of this control must take into account the country's experience and context.

Developing as well as developed countries have, in several instances, either adopted a golden rule, which stipulates that the amount borrowed cannot exceed the current deficit of the local government budget,²² or prohibited local governments from incurring a deficit. However, these stringent rules can have perverse effects, since they may be bypassed through misclassification of expenditures or the setting up of ad hoc funds for borrowing.²³

²¹ See Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997.

²² As in Germany.

²³ In China, local governments are not permitted by law to run deficits or to borrow from the local branches of the Peoples Bank of China. However local governments undertake indirect borrowing mainly by creating

In a number of countries, the central government has direct control over borrowing. These controls may take different forms such as annual borrowing ceilings; ex-ante authorization of individual borrowing operations; or centralization of all government borrowing associated with on-lending mechanisms to finance local projects.²⁴

Two elements need to be considered when designing or revising procedures for controlling local government borrowing. First, the objective of increasing devolution and diminishing bureaucratic procedures suggests developing a system based on rules rather than on ex-ante control of individual operations, at least for domestic borrowing. Second, rules should be appropriately designed to avoid the creation of mechanisms to bypass them. They could, for example, be based on the ratio of the current and projected levels of debt to revenues. Korea sets detailed eligibility criteria that determine which local governments are allowed to borrow.²⁵ These criteria are based on the soundness of the local government policy, and the nature of projects that can be financed from borrowing.

Concerning external borrowing, central coordination of the external debt policy is required. Its impact on the balance of payments must be taken into account. Approach to foreign markets and negotiations with international financial institutions need to be coordinated well. Moreover, foreign lenders, when lending to local governments, generally count on an explicit or implicit guarantee from the central government. Therefore, lending operations made abroad by local governments should comply with conditions set by the central authorities.

financial companies that borrow to finance local government expenditures. See Ehtisham Ahmad, China in Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997.

²⁴ In India according to the Constitution only the central government is entitled to borrow abroad. The states are, in principle, entitled to borrow domestically, but they have to get permission from the central government if they have any outstanding liabilities to the center. All state governments have such liabilities and therefore need authorization to borrow. However, the central government sometimes provides special assistance to the states to clear their short-term outstanding debts. The total indebtedness of the states in 1992/93 accounted for more than 20 percent of GDP, of which nearly two-thirds was outstanding liabilities to the central government, (Hemming, Mates, and Potter, in Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997, op. cit., page ____.

²⁵ Ke-young Chu and John Norregaard, in Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997.

F. TREASURY ASPECTS OF AID MANAGEMENT²⁶

Foreign grants must be budgeted, whether they are given as grants or in kind. The use of counterpart funds from sales of granted goods needs to be budgeted, recorded and accounted for. A central system of recording foreign grants and related transactions is needed.

Institutional arrangements generally vary according to the country or the donor, but the minimum requirements for good management of grants should be the following: (i) expenditures financed with grants must be submitted to the same scrutiny and prioritization as other expenditures, whatever the organization for aid coordination; (ii) transactions relating to grants must be accounted for and data collected and recorded at the central level; and (iii) accounts for counterpart funds should be controlled and audited along the same lines as other government accounts.

Generally, this suggests placing the management of counterpart funds within the Treasury. The central registration of grants should be performed either by the Treasury or by the Ministry of Planning, which has an existing network for collecting information in countries with a dual budgeting system. As for debt management, there should not be any overlap between the activities of an eventual aid management unit, coordinating the relationships between the government and donors, and the programming of expenditures and their management.

G. MANAGEMENT OF GOVERNMENT FINANCIAL ASSETS

Government financial assets consist of shares in enterprises, loans granted by the government, payments of guarantees not honored by debtors, etc. The Treasury has to record and account for these assets. It should manage the loans granted by the government, notably by authorizing disbursements and tracking payments. It has to get financial information on enterprises in which the government has shares, monitor the dividend payments, and deal with the financial aspects of privatization.

²⁶ This section covers different aspects from those of "aid management" discussed in Chapter 17.

H. RELATIONSHIP WITH THE CENTRAL BANK IN PUBLIC EXPENDITURE MANAGEMENT

The Central Bank is, in most countries, the main cashier of the government. Even where spending agencies hold their bank accounts at commercial banks, funds are released from a Treasury account at the Central Bank. More generally, central banks are the fiscal agents of governments and perform activities in such areas as government issuing, public debt management, intervention on the secondary market for government securities, etc.²⁷

In many countries, the central banks provide the governments with overdraft facilities. However, to avoid assigning responsibilities to the Central Bank that could conflict with its price stability mandate, more and more countries set stringent limits for government borrowing from the Central Bank or forbid it. From the cash management point of view, prohibiting borrowing from the Central Bank requires an active policy of issuing government securities in the capital market and also intervening in the secondary market. The prohibition may be unrealistic in the short run for countries with underdeveloped markets,²⁸ but it needs to be strictly regulated in conformity with monetary and fiscal policy.

In principle, profits or losses of the Central Bank are, in most countries, transferred to the government, although actual practices vary. Often, losses of the Central Bank are not included in the government accounts (see discussion on quasi-fiscal expenditures in chapter 2). To encourage the government to optimize its cash management and to limit nontransparent quasi-fiscal expenditures, commercial terms should be applied to overdraft facilities granted by the Central Bank to the government. For transparency, profits or losses of the Central Bank should be treated as revenues or expenditures in the budget. On the other hand, adopting these rules requires the Central Bank to reimburse the Treasuries deposits on commercial terms.

²⁷ See Hans J. Blommestein and Eva C.Thunhoml, Institutional and operational arrangements for coordinating monetary, fiscal and public debt management in OECD countries, in V. Sundararajan, Peter Dattels and Hans J. Blommstein, *Coordinating Public Debt and Monetary Management*, IMF, 1997. Teresa Ter-Minassian, Pedro P.Parente, and Pedro Martinez-Mendez, op. cit., page _____

²⁸ Teresa Ter-Minassian, Pedro P.Parente, and Pedro Martinez-Mendez op. cit.. See also C.Cottarelli *Limiting Central Bank Credit to the Government*, IMF, 1993.

I. KEY POINTS AND DIRECTIONS IN REFORMS

1. Key points

Cash management has the following purposes: aggregate control of spending, efficient implementation of the budget, minimization of the cost of government borrowing, and maximization of the opportunity cost of resources (the last two purposes yielding interest).

- Centralization of cash balances is required. This centralization should be made through a Treasury Single Account. This is an account or a set of linked accounts through which all government payment transactions are made. It should have at least the following features: (i) daily centralization of the cash balance (when possible); (ii) accounts open under the responsibility of the Treasury; and (iii) transactions recorded into these accounts along the same set of classifications. This model could fit both centralized and decentralized arrangements in public expenditure management, provided that modern technology is available.
- Cash planning is essential. It includes: (i) the preparation of an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, the preparation of a monthly cash and borrowing plan; and (iii) weekly review of the implementation of the monthly cash plan. To prepare the monthly cash plan it is necessary to monitor commitments, in order to avoid arrears generation or delays in payment.
- The borrowing policy needs to be prepared in advance, and the borrowing plan made public. Borrowing from subnational governments must be controlled, and fit overall fiscal targets.

- Guarantees, insurance schemes and other contingent government liabilities should be evaluated for risk and political cost, and reserves appropriately set to prevent cash management from being disrupted by unanticipated claims on government.

The medium-term external debt, should be contracted in accordance with the budget or multiyear expenditure programs, and drawings and loans accurately monitored.

2. Directions in reforms

In most countries priority actions should concern the following areas:

- Centralization of cash balances should be ensured (together with a centralization of the monitoring of transactions). In countries, where the payments system has broken down, a centralized Treasury system may have to be implemented from scratch. In other countries, banking arrangements and procedures for transferring funds will have to be reviewed to ensure better control of cash and avoidance of idle balances. The following should be taken into account: (i) constraints due to the localization of local agencies and the infrastructure of the country; and (ii) modern technologies.
- Sound cash planning should be abolished, together with other measures such as improving revenue forecast and instituting commitment accounting.
- Debt management should be reinforced.

Once cash flows are centralized, incentives for managing and forecasting cash flows more efficiently could be considered, but in practice this concerns only a limited number of developing countries.

Box 28**Building a Treasury System**

In Kyrgyz, after the collapse of the FSU, the payment system broke down. The following approach has therefore been adopted:

The development of the Treasury, with IMF technical assistance, has significantly enhanced government control over public expenditure and cash management. The Treasury, now fully in operation, has achieved comprehensive coverage of government finance including the budgetary as well as extrabudgetary activities of both republican and local governments. In addition, a new government payment system has been introduced, and a Treasury Single Account established at the Central Bank replacing over 5,000 separate bank accounts. Monthly and annual reports on all fiscal operations passing through the Treasury are now generated.

Source: T. Abed, "Fiscal reforms in low-income countries. IMF, 1998.

Chapter 9. MANAGEMENT CONTROLS, AUDIT, AND EVALUATION

By Harry Havens*

Management controls, auditing, and evaluation are processes and mechanisms that are designed to assure that budgeting is linked to the real world of program operations. Without these links, there would be considerable risk that decisions would be based on flawed information, that resources are mismanaged, and that the decisions would be ignored by the operating organization. Thus, this chapter focuses on the ways in which governments, with the help of these processes and mechanisms:

- assure implementation of budgetary and other policy decisions;
- avoid improper use of funds and detect and correct instances of such improper use;
- assess the efficiency of operations and seek ways of improving that efficiency;
- obtain reliable reporting of financial and other data concerning the execution of budgetary decisions; and
- gather information about program operations and results that can be used to adjust future policy decisions and budgets.

The three concepts—management control, and internal audit, external audit, and evaluation, are not self-evident, and other words are sometimes used to describe them. Let us therefore start by pointing out some important characteristics. Management control is used here to describe all the policies and procedures put in place by a government or by the managers in the various entities of the government, to ensure the proper and effective functioning of the overall government or the individual entity. A synonym often used for management control is internal control. Internal audit, in turn, has the key function of reporting to the senior management (the minister, board, or head of an agency, etc.) on the functioning of the management control systems, and recommending ways for improvement.

External audit is, in most countries entrusted to a separate organization connected to or at the same level as the legislature (the Parliament). These organizations, the Supreme Audit Institutions (SAIs), are independent from the government and have the mandate to audit or

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investigate most aspects of the government's activities and to report their findings to the legislature and, often, to the general public.

A. MANAGEMENT CONTROL

The term "evaluation" means a systematic effort to identify and measure the effects of government policies and programs. It implies the use of scientific methods to increase the reliability of findings by systematically isolating the policy or program effects from other factors and influences that might have caused or contributed to those effects.

1. Objectives of management control

Management controls are the heart of budget and policy implementation. The European Court of Auditors in its 1998 publication *European Implementing Guidelines for the INTOSAI Auditing Standards (draft)*, defines management controls as all the policies and procedures conceived and put in place by an entity's management to ensure:

- the economical, efficient, and effective achievement of the entity's objectives;
- adherence to external rules (laws, regulations,...) and to management policies;
- the safeguarding of assets and information;
- the prevention and detection of fraud and error; and
- the quality of accounting records and the timely production of reliable financial and management information.

Management controls can include a wide variety of mechanisms designed to assure that budgetary and other policy decisions are executed properly; that resources are used appropriately; that waste, fraud, and mismanagement are minimized if not entirely avoided; and that reliable and timely information is obtained, maintained, and used for decision making. While certain elements are common to most management control systems, no single set of control devices is appropriate for all entities in all circumstances.

Management controls are essential in managing any organization, whether it is part of government or it is a privately owned business. In a government ministry or agency, for example, it does little good to enact laws or regulations, to develop budgets, or to establish

administrative policies, if there can be no assurance that they will be properly implemented. For example, the Kingdom of Tonga undertook a systematic assessment of government management controls. It found frequent problems involving incomplete or non-existent documents and records, lack of separation of duties, and inadequate training and supervision of staff.

However, management must also assure that the systems of controls do not conflict with the overall management philosophy of the entity. For example, in many countries, emphasis is now given to allowing discretion to managers and holding them accountable for results, rather than for strict adherence to detailed rules and procedures. This approach can be easily vitiated by systems of management control that put undue reliance on detailed procedural safeguards or on multiple levels of supervisory review of decisions. Conversely, where public integrity and/or fiscal discipline is the major concern of management philosophy, management control systems that allow discretion without sufficient accountability can be problematic. In general, therefore, management controls should be carefully balanced, taking into consideration the related risks and the costs and benefits of the safeguards to be introduced.

Management must also recognize that circumstances change. Controls that were needed and effective at one time may be rendered unnecessary or ineffective by changes in the nature of operations or in the external environment. It is essential that management periodically examine its systems of management control, modify those systems as necessary to assure that they remain effective, and eliminate or alter controls that are no longer needed or have become unnecessarily burdensome. In countries that are seeking to establish or strengthen their management controls, a high priority in most transition and developing countries, it may be useful to have a formal requirement that government organizations perform a periodic assessment of their systems of control and report any material deficiencies that are found. The organization's internal and external auditors can be of great assistance in making such an assessment and in suggesting ways of overcoming weaknesses that are disclosed.

For an organization's internal audit unit, a continuing assessment of management controls should be one of its highest priorities. The external auditor can also play an important

role in helping management build and maintain effective control systems. Any audit that is intended to render an opinion on the reliability of an entity's financial statements or other reports must include an assessment of the control systems. Such an audit will pay special attention to the controls that govern the recording and processing of data that are included in the statements. In many cases, however, the assessment will include the controls that are meant to assure compliance with applicable laws and regulations. In such an assessment, the auditor will not only examine the controls themselves, but will also conduct such tests as the auditor deems necessary to assure that the controls are operating properly.

Other audits can also be useful in strengthening management controls. Any irregularity, whether or not found during the course of an audit, should be seen as evidence of a possible failure of the relevant control system. Such irregularities should be examined carefully by both the auditor and management to determine whether or not a strengthening of controls is warranted. For example, New Zealand has a firm commitment to effective management controls. For example, each year the Chief Executives and Chief Financial Officers of operating units sign a Statement of Responsibility covering the management controls of their entities. Nevertheless, problems still come to light, including weak documentation of purchases, irregularities in the use of credit cards, irregularities in the employment of consultants, and the failure to fully test changes in accounting systems before implementation.

The International Organization of Supreme Audit Institutions (INTOSAI) has developed standards for management controls as a framework for countries to use in designing and developing their systems of management control and as a guide for auditors in assessing those controls. Following the practices of the accounting profession, the original wording of these standards uses the term "internal controls". In this chapter, however, the term "management control" which is deemed to be more descriptive and less likely to be misunderstood by the readers, is used. The wording of the standards has been modified accordingly.

The general standards are as follows:

- Management control structures exist to provide reasonable assurance that the general objectives of the organization will be accomplished. (This obviously assumes that the objectives are clear—which is not always the case.)
- Managers and employees are to maintain and demonstrate a positive and supportive attitude toward management controls at all times. (Of course, this is only possible if there is a consensus that controls are efficient and effective to begin with.)
- Specific control objectives are to be identified or developed for each ministry/department/agency activity and are to be appropriate, comprehensive, reasonable, and integrated into the overall organizational objectives.
- Managers are to monitor their operations continuously and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, or ineffective operations.

The detailed standards are as follows:

- The management control structure and all transactions and significant events are to be clearly documented, and the documentation is to be readily available for examination.
- Transactions and significant events are to be recorded promptly and classified properly.
- Transactions and significant events are to be authorized and executed only by persons acting within the scope of their authority.
- The same person should not hold key duties and responsibilities in more than one of these areas: authorizing, processing, recording, and reviewing transactions and events.
- Competent supervision is to be provided to ensure that management control objectives are achieved.
- Access to resources and records is to be limited to authorized individuals who are accountable for their custody or use. To ensure accountability, the resources are to be periodically compared with the recorded amounts to determine whether the two agree. The vulnerability of the asset should determine the frequency of the comparison.

2. Prerequisites for effective management controls

Management controls are the responsibility of the leadership of an organization. Therefore, establishing and maintain effective management controls, the top leadership of the organization must, first of all, be committed to the effective management of the entity and to the creation and effective use of mechanisms that will assure its ability to exercise its management responsibilities. The leadership must also demonstrate personal integrity and professionalism. Only if that commitment and example are in place will it be possible to establish and maintain an effective system of controls.

Because of the importance of management controls in assuring the effective control of public funds and the proper execution of the budget, the central budget office (typically, the Ministry of Finance) in many governments plays an active role in strengthening the management controls of the operating units.

If the leadership of an organization is committed to effective management, the next requirement is a careful and thorough assessment of the risks facing the organization and an identification of useful controls to manage those risks. In a complex organization, this can be a difficult task and one for which the leadership of the entity may wish to seek expert assistance. Internal and external auditors are frequently the source of this assistance. They may be able to identify risks of which the management was unaware and to suggest control procedures that can minimize those risks. Whatever assistance is obtained, however, it is essential that the leadership of the entity remain involved throughout the process and especially in the decisions about the control arrangements to be put in place. The controls that are implemented must be ones that the management will use, even when they create some inconvenience in day-to-day operations, and must be used throughout the entity.

The controls must therefore be cost-effective. They must not be so detailed and onerous as to paralyze the organization. And the cost of the control systems must not be out of proportion to the risks they are intended to avoid. This point is stated briefly, but is extremely important: "red tape" is an ever-present risk, and the temptation is usually present to introduce new controls even when there is no need for them.

3. Types of management controls

Because management controls must be designed for the particular circumstances of a particular entity; there is no universally applicable list of controls. However, it is possible to describe categories of controls and the circumstances in which they might be appropriate.

- *Financial reporting.* All organizations must operate within their budgets. Those budgets may be relatively fixed, as with an appropriation from the legislature, or they may be flexible, as in a commercial activity that generates income. In either case, it is essential that management receive a timely, reliable flow of information about its financial status and that management initiate prompt corrective action when the accounting data indicate a significant deviation from the budget. Thus the financial accounting system is a vital part of any structure of management controls. To assure that the accounting system produces timely and reliable data, management should require that the system be audited at regular intervals.
- *Performance monitoring.* Organizations exist to accomplish certain activities. Management's first responsibility is to assure that those activities are achieved. To this end, it is essential that management track the performance of the organization against its stated goals. This requires that management describe the goals in measurable terms (clients served, units of output delivered, etc.) and establish a reliable and timely reporting system to keep itself informed of progress against the stated goals. To assure the reliability of the data, it is desirable that the performance reporting system be linked to the financial accounting system and that it be audited (including appropriate tests of the reporting procedures) at regular intervals. Management should also establish its performance expectations with respect to the outputs being measured and should initiate corrective action if the reported results deviate materially from the expectations.
- *Effective communications.* In modern organizations, managers recognize that subordinates and front-line workers perform better if they have a clear understanding of the mission and goals of the organization and the purpose being

served by the activities they are asked to perform. In such an organization, the channels of communication are part of the management control system. For example, managers should communicate their performance expectations to subordinates, who should then define the expectations for their components of the organization that are needed to accomplish the overall goals of the organization. It is important that communications flow upward as well as downward. When management sets clear goals and expectations, workers can often suggest ways of achieving greater efficiency in the attainment of those goals. Management should pay careful attention to such suggestions, as front-line workers are often aware of procedural inefficiencies that escape the notice of senior managers.

In addition to assuring that the output goals of the organization are achieved, however, managers are also responsible for assuring that the resources available to the organization are protected against improper use. A variety of management controls might be used for this purpose:

- *Physical controls.* These would include the security procedures that are intended to control access. For example, it may be desirable to control who will have access to inventories of items that have high value or might be easily pilfered and sold. It may also be necessary to control the access to particular rooms or buildings where accounting and other records are stored. This may be accomplished by locked doors, the keys to which are held only by authorized persons, or may warrant full-time protection by a security force, which permits entry only to those on an approved list.
- *Accounting controls.* These would include the procedures by which transactions are required to be recorded in the accounting system. For example, there might be a requirement that all cash receipts be deposited daily. The person who collects the cash might be required to provide a written receipt to the payer and to file a copy with the accounting clerk. The person who deposits the cash in the bank would be required to file a copy of the bank receipt with the accounting clerk. Accounting controls also include the internal procedures within the accounting systems that are intended to detect and report any anomalies. In this example, the accounting clerk

might be required to reconcile the two reports of cash collections and to report any discrepancies. Another typical accounting control would apply to expenditures, which would be compared with the budget or other authorization. Expenditures that depart from the expected pattern would be reported while expenditures that exceed the maximum authorized amount would be blocked.

- *Process controls.* These are the procedures that are designed to assure that actions are taken only with proper authorization. For example, the issuance of a purchase order or the approval of a contract, especially one above some minimum threshold, might require documentation from the requesting official, review by a purchasing clerk, and approval by a supervisor. Unusually large purchases might require approval from a higher official. Payments to contractors might require documentation in the form of the original purchase order, a voucher from the contractor describing the goods and services provided, and a certification from the receiving official that the goods and services were received. Elsewhere payments above a certain amount might require review and approval by a higher authority. In the People's Republic of China, personnel standards are an important part of the management control system. Applicants for a post undergo rigorous examination and must receive a "Certificate for the Post" before assuming the position.
- *Procurement controls.* These have been discussed in some detail (see Chapter 5).
- *Separation of duties.* This is both a control measure and an indispensable element of many control systems. The central feature is that, with to "risky" events or transactions, at least two people should be involved to minimize respect the risk of improper actions. In the previous example concerning the handling of cash receipts, one person collects the cash, another makes the bank deposits, and a third reconciles the cash receipt documents and enters the data in the accounting records. Separation of duties in this way is properly an essential element of almost every financial control system, but its use can be overdone. If carried to extremes, it can severely degrade the efficiency of an organization and impair its ability to accomplish its mission.

- *Internal audit.* Internal auditing can be defined as an independent appraisal activity established within an organization as a service to the organization. It is a managerial control, which functions by measuring and assessing the effectiveness of other controls. Any government organization should include an internal audit unit. The role of the internal audit organization is very different from that of the external auditor, although the two should cooperate wherever possible. The external auditor is independent of the organization and reports to an external overseer of the organization. The internal auditor, on the other hand, is part of the organization and is typically responsible to the top management of the organization, although there are some circumstances, such as evidence of high-level corruption, that warrant reporting the facts to an outside authority. Managers should use their internal audit units primarily to perform a continuing assessment of the control systems and as a source of recommendations for improving the effectiveness of those systems. In addition, however, the internal audit unit can be used to examine apparent irregularities. Its findings can serve both as evidence of the need to strengthen the control systems and as a basis for determining what action may be appropriate against those who caused the irregularity.

There are many other types of management controls discussed in the literature. Those who are interested in a more exhaustive discussion of the topic might start with the previously mentioned *European Guidelines* document.

4. Limitations of management control systems

No system of controls can be an absolute guarantee against the risk of wrongdoing or honest error. Any system that attempted to reach that goal, especially in a complex organization, would impose costs far out of proportion to the risks and create rigidities for the organization. Thus the proper goal of the control system should be to provide “reasonable assurance” that improprieties will not occur or that if they occur, they will be revealed and will be reported to the appropriate authorities. With this in mind, managers should be aware of certain risks involved in building and maintaining management control systems.

- *Design flaws.* It has been stressed that management control systems must be designed for the specific organization, operations, and environment in which they will function, after careful consideration of the risks involved in that particular situation. Managers are sometimes tempted to shortcut the design process, such as by adopting the control systems designed for another organization. This can be dangerous. A flawed design may leave the impression of safety but may overlook important risks in one part of an operation while creating unnecessary inefficiencies in another.
- *Poor implementation.* The best-designed system will achieve its goal only if it is implemented properly. Managers and supervisors at all levels must be vigilant to assure that everyone complies with applicable control procedures. Even more importantly, the required procedures must be ones that workers will be comfortable using at all times, and which they will not be tempted to ignore when the procedures become inconvenient or in times of pressure and stress. Meeting this criterion is one of the key considerations in the design of effective control systems. Managers should also plan ahead for alternative arrangements that might need to be put in place in the event an emergency requires bypassing the regular procedures.
- *Poor response to reported anomalies.* Control systems are designed to call attention to events that depart from normal expectations. For the systems to remain effective, it is essential that supervisors and managers respond properly to such alerts. The triggering event should be investigated promptly to determine if an irregularity was involved. If so, corrective action should be initiated. Failure to respond effectively to reports of anomalies will quickly undermine the effectiveness of the control system. This should also be a factor in the design of control systems. Care should be taken to avoid making the systems so sensitive that they yield frequent “false alarms”. If this happens too frequently, valid alarms might be ignored.
- *Collusion.* Any system of controls can be defeated if a sufficient number of dishonest key individuals conspire to subvert them and are able to falsify the relevant documents. A sufficiently complex set of controls can make it difficult to

assemble the needed number of conspirators, but at a potentially great cost in organizational inefficiency. Conspiracies of this sort usually come to light when they are observed (and reported) by someone who is not a party to the conspiracy, or when there is a falling out among the conspirators. They may also be detected during a routine audit if substantial amounts of funds are involved or if the conspirators are not sufficiently careful in falsifying the documents.

- *Wrongdoing by top managers.* Management controls are designed to help control the organization on behalf of its management, not to control the top managers themselves. The managers can easily circumvent the control systems, bypassing the controls directly or instructing or authorizing others to do so. There are many examples of dishonest top managers evading the control systems to commit various forms of fraud and abuse. In a large organization, however, such activities are usually noticed by subordinates. Thus, the best protection against wrongdoing by top managers may be an environment of openness, in which workers are encouraged to report evidence of irregularities, confident that they will not be punished for being disloyal to their superiors. Such openness in an organization becomes part of the control environment.

Management controls are an essential part of the structure and operations of any organization. The larger and more complex the organization and its activities, the more care must be given to the design of the control systems. But control systems are effective only if they are installed, maintained, and used by competent, dedicated managers. Systems can support such managers, but they cannot substitute for them.

B. EXTERNAL AUDIT

The Lima Declaration of Guidelines on Auditing Precepts, published by INTOSAI, opens with the following statement:

"The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim

is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent—or at least render more difficult—such breaches."

Effective auditing can contribute in several important ways to the management of a government's finances. It can:

- Detect irregularities involving the misuse of public funds and identify related weaknesses in management controls that may imperil the integrity of the organization and the effective implementation of budgetary and other policy decisions;
- Determine the reliability of reports on budget execution and other financial data;
- Identify instances and patterns of waste and inefficiency that, if corrected, will permit more economical use of available budget resources;
- Provide reliable data about program results as a basis for future adjustments in budget allocations.

This discussion focuses primarily on the role of the organizations that are responsible for auditing the government as a whole. They have many different names but, collectively, these organizations refer to themselves as Supreme Audit Institutions or simply SAIs. In most English-speaking countries, Commonwealth member states, and Scandinavian countries, the SAIs are National Audit Offices headed by an independent, sole head, the Auditor General. The General Accounting Office in the U.S., the National Audit Office in the U.K., the Office of the Comptroller and Auditor General in India, and the Rigsrevisionen in Denmark are examples of this type of SAI. In most Latin countries the SAIs are Courts of Audit (or Courts of Accounts), headed by a collegiate of court members, who normally enjoy the same status as conventional judges. The Cour des Comptes in France, the Corte dei Conti in Italy, the Tribunal de Cuentas in Spain, and the majority of SAIs in South America are examples of this type of SAI. There are however several variations of these two SAI models. The German, the Austrian, the Dutch, and several central and eastern European Courts of Audit combine characteristics of both

models. The SAI of the European Union, the European Court of Auditors, is also shaped along these lines.

While this section focuses on the SAI, much of the discussion is also applicable to other audit organizations, such as the audit units of government ministries and commercial auditors who may be hired under contract to perform audits of government entities. Throughout, the reader should keep in mind that even the most rigorous audit provisions are not always safe. In Japan, for example, constitution provides the foundation for that country's government management control systems by requiring annual audited statements of State revenues and expenditures. This is reinforced by statutory requirements governing the accounting activities of ministries and agencies and, for example, by the mandatory separation of contracting and disbursement functions. Even so, failures can occur. For example, Japan's Board of Audit found significant overpayments of health subsidies that arose, in part, because municipal officials did not understand the requirements of the health subsidy system.

1. Prerequisites for effective auditing

The International Organization of Supreme Audit Institutions (INTOSAI) has promulgated standards for the audit of government organizations and operations. These standards, or national standards that are equally or more rigorous, have been adopted by government audit organizations around the world, including virtually all SAIs. Anyone who is interested in the auditing function in government is encouraged to obtain a copy of the standards from the INTOSAI Secretariat in Vienna. Among the most important of these standards are those dealing with the following matters:

a. Independence

The independence of the auditing organization is essential to assure that its work will not be biased by any relationship it might have to the entity being audited. This is also necessary for internal audit, whereby the entity responsible must not be part of the finance or treasury function of the ministry concerned, but report directly to the senior manager overseeing financial transactions. In the Lima Declaration, INTOSAI made the following statements about the independence of the SAI:

Section 5. Independence of Supreme Audit Institutions

- 1. Supreme Audit Institutions can fulfill their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.*

- 2. Although state institutions cannot be absolutely independent because they are part of the state as a whole, the Supreme Audit Institutions shall have the functional and organizational independence required to fulfill their tasks.*

Independence is typically accomplished by creating the SAI as an organization apart from the government. Often, the SAI is responsible only to the national legislature. This is the arrangement in the United Kingdom, most of the countries that are members of the Commonwealth, several other countries of the European Union and the United States, in all of which the SAI reports to the legislature. Another way of securing independence from the auditee, the government, is to make the appointment of the Auditor General or the members of Courts of Audit dependent on approval by the legislature. Auditor Generals are normally appointed either by the legislature or by the legislature together with the government. As an exception, the appointments of the Auditor General in Sweden and Finland rest with the executive. Members of Courts of Audit and/or the President of Courts of Audit are in some countries appointed by the legislature or the legislature together with the government. This is the case in Spain, Germany, and the Netherlands. In other countries, such as Italy, France and Portugal, appointments rest with the executive. Here the independence is safeguarded through the independent and indissoluble status of the Court members.

It is essential that the institutional independence of the SAI be genuine. The constitutional or statutory basis for the organization should be clear. The SAI should have its own budget. It should have statutory authority to determine the scope of audits, to obtain any documents and records relevant to the audit, and to exercise its judgment as to the audit results to be reported.

Not only must the organization be independent, the individual auditors must also be with respect to the audits on which they are working. This matter is usually handled through internal regulations promulgated by the SAI, but may also be covered in various laws, including those that are generally applicable to the civil service. For example, it may be appropriate to have laws and regulations requiring that an individual auditor not be an investor in an entity that might be affected by the results of the audit. Such potential conflicts of interest arise more often than one might suspect. If the SAI is auditing the operations of a government computer system, the auditors on that assignment should not own shares of stock in any computer firm that might benefit from the results of the audit, such as a firm that might compete to supply replacement computer equipment.

Other requirements may be imposed to avoid any likelihood that the audit work will be (or might appear to be) subject to improper influence. Auditors may be prohibited from active participation in political parties. They may be prohibited from auditing an entity in which a close relative by blood or marriage holds a position of responsibility. Rules to avoid such conflicts of interest are often inconvenient, but the independence of the auditor is central to an SAI's credibility and the inconveniences must be tolerated.

b. Professional skills

Auditing is a profession that encompasses a wide range of technical skills, mirroring the types of audits and auditees that the SAI may be required to face. Few, if any, auditors possess the entire range of skills that may be needed by an SAI. For each individual audit, however, it is essential that the audit team, as a whole, possesses the knowledge and skills required for that particular audit. If the SAI is auditing the financial statements of an entity, the audit team must include (and preferably be led by) a fully qualified financial auditor. In most countries, this ability is evidenced by some type of certification, usually one that is issued following completion of a course of study and successful completion of a related examination. There may also be a required period of practical experience. If the SAI is auditing a government computer system (or an activity that is highly dependent on computer support) the audit team should include individuals who are knowledgeable about computers and experienced in auditing such systems. This, too, may be evidenced by a special certification of competence.

From time to time, an SAI will encounter a situation in which it must carry out an audit for which no one on the permanent staff has the requisite knowledge and skills. When such situations arise, the SAI must be able to obtain the needed skills elsewhere. The most common solution is to hire consultants who can help plan and guide the audit and interpret the data resulting from the audit work. In other circumstances, the SAI may contract a private firm to carry out all or some part of an audit for which it lacks the necessary resources or specialized skills.

Such consultants and contractors can be an important supplement to the SAI's own staff, but great care must be taken in using them. The outside expert or firm may perform the work, but the SAI remains responsible for the results. Thus the SAI should require the experts and contractors to adhere to the same standards of objectivity and independence, including avoidance of conflicts of interest, which the SAI's own staff is subject. In addition, the SAI should maintain sufficient oversight of the work performed by others, to confirm that it was done competently before approving any findings based on that work. In some circumstances, the SAI may need to seek advice from other experts in assessing the quality and reliability of a contractor's work.

Using the work of others as a basis for reaching audit conclusions is the subject of much discussion among auditors. The previously mentioned *European Guidelines* document addresses this issue at some length. It is also the topic of a study published in 1994 by the International Federation of Accountants entitled "Using the work of other auditors: A public sector perspective".

2. Types of audits

Many different kinds of work are subsumed under the term "auditing". Most SAIs are authorized to perform any of these activities, but they may be required to perform certain audits. The SAI must develop a strategic plan that will allow it to carry out any mandatory audits while also using its available resources in a cost-effective way on other types of audits.

a. Ex-ante audit

In this type of auditing, also called “pre-audit” or “a priori auditing”, individual transactions are examined for propriety before they are completed. That is, a payment may not be made until the auditor has approved the related voucher after examining the supporting documents. Centralized ex-ante auditing by the SAI is still practiced in many places. In other countries, however, such audits are viewed as being an element of the management control structure, and therefore are a responsibility of management, not of the SAI. In these countries, ex-ante auditing by the SAI has been largely abolished, with the SAI focusing instead on the reliability of the measures taken by each ministry to avoid improper payments and other transactions.

b. Regularity audits

This form of government auditing involves checking individual transactions after the fact, to assure that the appropriate authorizations and documentation are present. The focus is on determining the legal propriety of the individual transaction.

An SAI that does a substantial amount of regularity auditing needs to decide its strategy for such work. It might decide, as others have, to delegate that responsibility to the ministries. However, this may not be a practical solution in a country where management controls in government entities are weak and unreliable. In that situation, the SAI may, for the time being, be the only institution capable of detecting and halting irregularities. If that is the case, the SAI should carefully consider how its regularity auditing resources can be used with greatest cost-effectiveness.

Few, if any, SAIs have enough staff resources to examine every transaction in every unit of government. It would be wise for an SAI, preferably in cooperation with the Ministry of Finance and the internal audit units of the operating organizations, to use its available auditing resources as part of a coordinated strategy for strengthening the management controls that can prevent irregularities and other sources of waste of budget resources, rather than in an ultimately futile effort to detect and correct every regularity that may occur. By the strategic use of regularity audits, the SAI can identify the control weaknesses that permitted the irregularities to occur and demonstrate the consequences of failing to correct those

weaknesses. The Ministry of Finance or other central management agency can then use this information within the Government to emphasize the necessity of improving controls and, in particular, of strengthening the internal audit units that are an essential element in building and maintaining effective control structures.

There are several ways of implementing such a strategy. One approach would be to concentrate on areas where frequent irregularities are known to occur. In some countries, this might include such matters as wage- and salary-setting procedures or cash disbursements for routine supply purchases. The individual irregularities in such areas may be small but their total amount may be large. Furthermore, they may create a climate of tolerance which, over time, can weaken the integrity of the entire organization.

Another approach would be to focus on specific areas of government activity, where there is judged to be high risk of major irregularities. In many countries, for example, SAIs have come to recognize the risks associated with large procurements and have concentrated substantial resources on audits of such procurements in an effort to strengthen the procurement system. Thus, process audits (or management audits) are needed, as discussed later, in “value-for-money” audits.

The real purpose of a strategic approach to regularity auditing should be to strengthen the systems to prevent irregularities, not just to detect past errors, although that will also occur. Most SAIs have found the practice of routinely auditing individual transactions to be a very inefficient way of seeking better management of state resources. Identifying individual errors and transgressions may (or may not) result in correcting that particular error, but experience shows that, unless regularity auditing is part of a broader strategy to overcome the sources of irregularities, detecting an irregularity is unlikely to prevent the same error from arising the next day or the next year.

c. Financial audit

As used here, the term “financial audit” implies more than is described in the foregoing section on regularity audits. Many SAIs are required to perform annual audits of the State budget or other government financial reports. The objective of such an audit should be to

determine the reliability of the data in the report. For example, the audit report may be required to be completed before the legislature can accept the financial report.

The nominal objective of such an audit is to render an opinion as to whether the reader of the statement or report can be reasonably sure that the information contained in the report is correct. To render such an opinion, however, the auditor must go far beyond an examination of the statements and reports and of summary documents that supposedly support those statements. The auditor must also examine the accounting and other systems that are used to compile the data and the accounting and other controls that are intended to assure the proper reporting of transactions. A relatively small sample of various types of individual transactions is often examined as a way of testing the effectiveness of the accounting systems and controls. Thus, the true focus of such an audit is the reliability of the systems and management controls underlying the statements and reports.

SAs have taken various approaches to satisfying such requirements, some more successful than others. One technique is to examine a few of the transactions that are included in the report, relying on the auditor's judgment in selecting those transactions. If no errors or irregularities are found in the selected transactions, the report is considered accurate and that conclusion is reflected in the audit report. This approach can also be valid for assessing the efficiency and policy compliance of nonfinancial transactions.

Users of financial data in the finance ministry, the legislature, and elsewhere should view an audit conducted in this manner with considerable skepticism. There is no valid statistical basis for assuming that a judgment sample of this sort is representative of the entire body of transactions included in the financial report, even if the sample was drawn by an experienced auditor. Thus, one can have little confidence in conclusions reached about the overall report on the basis of having audited a judgment sample of transactions.

An alternative is to examine a sample of transactions that is statistically representative of the entire body of transactions. Such an audit demands the assistance of skilled statisticians, who should also be involved in interpreting the results. If a sample audit is performed properly, the user can have relatively high confidence in the results.

In some countries, the auditing of government financial reports employs a basically different approach, modeled on the techniques used in auditing the financial statements of commercial enterprises. This type of audit has been found to be particularly useful in strengthening the management of state resources.

Some SAIs may need to outsource some of their financial statement audit work because of their limited audit resources. However, each SAI must determine how best to meet its responsibilities in this area. It needs to make a strategic judgment as to the extent of outsourcing required and how it will assure itself that applicable standards will be followed, if the work is to be done by others. In any event, the SAI must equip itself with staff who are sufficiently skilled in this type of auditing to assess the quality of the work, even if that work is to be outsourced.

d. Value-for-money audits

This type of audit has become increasingly common among SAIs. A value-for-money (VFM) audit examines an entire entity, activity or program to suggest ways of improving the efficiency of those operations. The VFM auditor searches for areas of waste and mismanagement which, if eliminated, would permit the same purposes to be achieved at less expense, and for areas where the same resources, used differently, would produce greater value for the same cost. This type of auditing can make a major contribution to increasing the efficiency of government. Audit reports with useful recommendations in this area are typically quite popular with those who are trying to deal with difficult budgetary problems, such as ministries of finance and committees of Parliament with budget responsibilities. However, value-for-money auditing is quite different from regularity auditing and financial statement auditing. It requires the ability to analyze operations in a way that is more often associated with the profession of management consulting than with traditional auditing. SAIs wishing to begin this sort of auditing must make a strategic decision about how much they are prepared to invest in training to build a staff with competence in this work.

e. Other work

Some SAIs have gone beyond the traditional VFM focus on economy and efficiency to the performance of program evaluations. The boundary between VFM auditing and program evaluation is fuzzy. In general, however, VFM audits focus on efficiency (cost per unit of output) while program evaluations focus on outputs (amounts accomplished) or outcomes (program effects on society). As discussed in the next part of this chapter, program evaluations involve a careful effort, based on scientific methods, to measure the actual direct accomplishments or effects of a program in terms of its stated objectives. For a variety of reasons, SAIs rarely perform the most advanced types of program evaluations, such as social experiments. However, they may be called upon to examine the validity of such experiments and, if they have the required skills, they may be asked to perform time-series evaluations and case studies. This area, too, requires skills that are quite different from traditional auditing. For example, effective program evaluations often require staff with the capability to perform sophisticated statistical analyses. Building a staff with these capabilities will require a considerable investment in training.

As the SAI's stature and credibility grows, it may be asked to perform other tasks, outside the traditional realm of auditing. For example, an SAI with a strong field organization may be asked to assemble information that is relevant to the debate on major policy questions without performing any analysis of that data. Or, because of its expertise in assessing the management and operations of organizations, the SAI may be asked to advise the government in restructuring its ministries and agencies. Or, because of demonstrated expertise in a particular area of policy, the SAI may be asked for its advice on policy questions that go well beyond its audit and evaluation work. Requests of this sort are most likely to arise if the SAI has developed an especially close working relationship with the Government or Parliament.

A relationship of this sort is usually highly desirable, as it is a valuable way of focusing attention on important findings and recommendations, and thus of gaining corrective action on problems that the SAI has uncovered. However, such a relationship must also be handled with great care.

If the SAI becomes too close to the Parliament, the members of Parliament may be tempted to treat the SAI as a "staff agency", without adequate regard for the SAI's

independence, and may seek to impose tasks that unduly burden the SAI with nonaudit duties and that may undermine the SAI's credibility with regard to its primary responsibilities. The same risks are involved in the relationship with government, especially the Ministry of Finance (MOF). The SAI and the MOF should cooperate wherever possible, as the MOF can play a key role in implementing SAI recommendations. However, the SAI should carefully preserve its independence from the MOF and must avoid being seen as its agent or surrogate. Finally, despite the great temptation to speak out on matters on which the SAI may, in fact, have considerable expertise, the SAI must avoid offering opinions and advice that are not the direct outgrowth of work it has performed, lest it be seen as only one among a chorus of voices on controversial policy questions.

Because of the potential diversity of the tasks that an SAI may undertake, it is essential that careful thought be given to relative priorities. The highest priority should usually be assigned to building and maintaining the integrity of the public financial systems, especially in places where the risk of corruption is high. In countries where management controls are of limited reliability, as is typically the case in transition and developing countries, this suggests an emphasis on regularity and financial statement audits as part of a strategic effort to strengthen controls. VFM audits and, especially, program evaluations should normally have somewhat lower priority until basic problems in management controls and financial reporting have been overcome.

3. Reporting audit results

Requirements for the distribution of audit reports are often specified in the laws establishing an SAI and specifying its authority and responsibilities. In many countries, all audit results are required to be reported to the Parliament. The reports may be forwarded individually, or may be provided in a summary report at specified intervals, perhaps annually, or both. Often, reports to the Parliament are automatically delivered to a single committee with responsibility for overseeing the work of the SAI, such as a Public Accounts Committee. Typically, however, requirements such as these describe only the minimum permissible distribution of audit reports. Most SAIs have considerable discretion to distribute additional copies of their reports as they deem appropriate.

The general rule for distributing audit reports should be to provide copies to those with an interest in the topic and especially to those who should act on the findings and recommendations contained in the report. For example, the entity that was audited should always be informed of the results and the Ministry of Finance (or other central budget office) should be routinely informed of reports that have implications for budget allocations or the management of budget resources. If the audit shows the need for new or revised legislation, the SAI should bring this to the attention of the parliamentary committees that would consider such legislation and the ministry that would be responsible for proposing or implementing it.

The SAI and other auditors should also recognize that, in a democracy, the general public has a legitimate interest in the results of audits of public entities and of the use of public funds. In many countries, all SAI audit reports are made available to the public unless they must be restricted for national security reasons. Auditors should also recognize the role played by the media in informing the public about government operations and should take steps to assure that media representatives are aware of significant audit reports. A competent and proactive media is critical for the effective administration of audit results, as the public at large is most unlikely to be interested or directly competent to interpret the audits.

4. Gaining action on audit results

1. Some SAIs are empowered to order corrective actions of certain kinds when irregularities are found during an audit. When an overpayment is discovered, for example, these SAIs may issue an enforceable order to recover the excess payment. However, this authority is usually available only with respect to matters of regularity and many SAIs lack such authority even in these matters.

For the most part, auditors are authorized only to report what they have found. They must rely on others to correct the reported problems. This is especially true with respect to matters on which modern auditing tends to concentrate, the adequacy of management controls and the economy, efficiency, and effectiveness of programs and operations. Some SAIs are empowered to issue binding directives, but this is typically limited to recovering funds that have been misspent. If the problem is more complicated than this, solving it may require action by the Parliament, the government, a line ministry, or an operating agency. Typically, the auditor

cannot force any of these to act. However, the auditor bears considerable responsibility for encouraging an appropriate response to audit findings and for facilitating needed corrective action. There are several things an auditor should do to meet this responsibility:

- *Clear findings.* General observations that “money was wasted in program X” are not helpful. Auditors must state as clearly and specifically as possible the nature of the problems they find and the consequences of those problems. Which management controls were absent or failed and how much money was wasted or misappropriated because of that failure? Which specific policies or procedures caused the observed inefficiencies and what was the effect of the inefficiency? It is the auditor's responsibility to assure that the reader of the audit report can easily grasp the nature of the problem and the importance of correcting it.
- *Convincing evidence.* The evidence supporting the findings must be relevant and credible and must be presented in a clear and persuasive fashion in the report.
- *Cost-effective recommendations.* If an auditor identifies a problem, it is incumbent upon him to suggest a reasonable solution for that problem. As with findings, general remarks about solutions are not helpful. If there was a failure of controls, the audit report should specify the actions needed to prevent a recurrence. If changes are needed in laws, regulations, or administrative procedures to achieve greater efficiency or effectiveness, these should be described with as much precision as possible. It is also essential that the recommended corrective actions be legally and administratively feasible and that the costs of implementing them not be disproportionate to the problem. The goal should be to convince the reader of the wisdom of correcting the problem.
- *Effective communications strategy.* The best-written audit report serves no purpose unless its contents are made known to those who can act on its findings and recommendations. The auditor should think carefully about who needs to read the report and how best to assure that they give it the attention it deserves. Merely sending the report to someone may not be sufficient. Parliamentarians and government officials are busy people and typically receive far more written material

than they can find time to read. A brief, well-written executive summary accompanying the report can help, as can follow-up conversations with the official or with key members of his staff. It is often useful to work with others, such as officials of the Ministry of Finance, who may be in a position to encourage appropriate action. In addition, if the media gives attention to a report, this can be a helpful stimulus to corrective action.

In many cases, audit units issue “audit observations”. These are based on evidence and advise the auditee that corrective action is needed (specifying the nature of the corrections). The auditee has the opportunity to make changes before the final audit report is written the audit report would then contain information on the audit observations and on actions taken or not taken on them. As stressed in the discussion on accountability in chapter 1 dialogue is often more effective than faultfinding, and is far more constructive for institutional capacity building. Box 30 illustrates the variety of useful audit findings.

Box 30
Some Examples of Concrete Audit Findings

Audit can uncover not only financial irregularities, but deviation from moving or performance issues:

- Japanese auditors found improprieties in the House Purchasing Loan Program, which was designed to facilitate home ownership. Several borrowers rented out the houses they had purchased, violating program requirements. Most of the improperly borrowed funds were recouped.
- New Zealand auditors examined the procedures used to prevent and detect improper payments for medical and pharmaceutical services. They found that existing procedures detected some irregularities and probably deterred others. However, some types of transactions, representing considerable risk to the funds because of high estimates of probable irregularities, were not adequately covered by existing procedures. The auditors recommended procedural improvements to reduce this risk.
- Indian auditors found that machinery for a state enterprise was purchased at an unnecessarily high price, that installation of the machinery was delayed beyond the warranty period, that defects subsequently developed and that the machinery was lying unused.
- Hong Kong, China auditors examined the status of General Post Office facilities occupying a very valuable waterfront site. They concluded that considerable savings could be realized by relocating the facility. Such relocation, however, was severely delayed by lack of proper planning and coordination and by unnecessarily restrictive specifications for the new site.
- In an assessment of the new drug evaluation and approval process. Australian auditors found that there had been great improvement in the speed with which drug applications were approved. At the same time, improvements were needed in the reporting of adverse reactions to drugs.
- In auditing the execution of the State budget, auditors of the People’s Republic of China found that some departments violated standards and laws in managing their finances, that some financial reports were untruthful, and that some entities failed to collect or surrender

5. Limitations of audit

Reasonable assurance. The audit profession has strengths, but there are limitations as well. No reasonable auditing procedure can be sure of finding every error or irregularity. The prevention and detection of errors and irregularities is, first and foremost, the responsibility of management, not the auditor. If problems are discovered later, the auditor should be held responsible only for conducting a proper audit in accordance with auditing standards. It is in the nature of auditing that some mistakes, only minor ones, it is hoped, will escape the auditor's attention.

For example, in auditing the financial statements of an entity, the auditor can provide only "reasonable assurance" that the statements are reliable. Neither the auditor nor the reader of the audit report should believe that such an opinion is an absolute guarantee that there are no material errors in the statements. The limitations discussed in the management controls section of this paper apply to audits, as well. If there is collusion among key individuals in the entity, or if there is an intentional effort on the part of the top managers deliberately conceal facts, there can be no absolute assurance that the auditor will detect the resulting distortion of the truth. Thus, the phrase "reasonable assurance" in an audit opinion must be taken seriously by the reader, and it is the SAs responsibility to stress this point.

Access to data and records. Auditors can audit only that which they can observe. If the management of an entity maintains secret records involving matters that are material to the audit, to which the auditor is not permitted access, the audit will have no credibility and should not proceed. In government auditing, these cases arise most frequently with regard to agencies involved in national security activities. However, auditors may also encounter situations in which access is restricted or denied in an apparent attempt to avoid disclosure of illegal, corrupt, or politically embarrassing activities. In these circumstances, the auditors should report the facts to others, such as the Parliament, who may be able to facilitate the required access or take other appropriate action.

C. EVALUATION

Evaluation is the key function that connects the past to the future—that feeds lessons from actual experiences back into the programming and decisions for future actions. It is the element that “closes the circuit” and permits progress to be made.¹ Of course, it is only one such element. To quote from Petrei (1998, p. 393):

“Evaluation should not be understood as an alternative or substitute for other techniques that promote spending efficiency. Rather, it is one of several complementary practices that should be mutually reinforcing. The evaluation of a program or project requires the comparison of results with what was anticipated in the program design. If project or program goals are stated clearly, their evaluation is significantly easier. For that reason, performance indicators are especially useful for evaluation tasks. A program with well-defined mileposts that establish the scope of certain goals, is much better able to have a complete evaluation, using those mileposts as anchors for a more detailed examination of the achievements. As noted, the conceptualization of goals themselves will indicate how far an evaluation can go.”

1. Objectives of evaluation

The goal of program evaluation is to improve decision-making and resource allocation by providing reliable data about the effects of policies and programs. For this reason, program evaluations of high quality should be encouraged, valued, and used by those responsible for managing the budget and other policymaking processes.

There are a number of circumstances in which those making budget decisions will want to know the effects of a government program. In an environment of limited budget resources, it is important to consider the likely effects of a potentially expensive policy change before deciding to implement it. For example, will early childhood education, or smaller class sizes, or longer school terms have the greatest likelihood of improving the educational attainment of children from families living in poverty?

Once a program has been operating for some period of time, policymakers may want to know whether or not its affects are commensurate with its cost. For example, does participation in a job-training program actually increase the number of previously unemployed individuals who find employment? Does a profit-motivated clinic or hospital deliver services more efficiently than a free, government-operated institution?

The objective of program evaluation is to provide reasonably reliable answers to questions such as these.

2. Prerequisites for an effective evaluation

Evaluations are useful only in an environment in which decisions will be based on analysis rather than ideology, and in which cost-effectiveness is an important goal. This may seem obvious, but in every country there are certain topics which, at a particular time, are not susceptible to analytically based decision processes. These topics are matters of faith or ideology and it would be pointless to raise questions about them, no matter how well-founded in logic and analysis.

Thus, evaluations must be part of a wider performance management framework in which there is a systematic search for ways to make government programs as effective and efficient as possible.

For evaluations to be effective, there must be cooperation among the key participants in the evaluation process. Those who request the evaluation must work with those who perform the evaluation and those who will be affected by the results.

The *requester* must define clearly the question to which he wants an answer and the time frame within which the answer is needed. The requester may be the Parliament or one of its committees, a ministry, a budget office, or the managers of a program. However, in reality, many evaluations are done not in response to a request but to fulfill a management commitment and the evaluators must rely on their own judgement in determining what to evaluate.

The *evaluator* must define clearly the process and resources that will be needed to obtain the answer and must set forth the limitations on his ability to assure the reliability of the answer, in the light of any time and resource constraints imposed by the requester. The evaluator may be part of the analytical staff of a ministry or, an audit organization, or an outside contractor. Whoever fulfills this role must have the technical and managerial skills necessary to plan and implement the evaluation successfully. An evaluation involving staff examining data at multiple sites, for example, can be a huge managerial task. Moreover, evaluation of complex programs often relies heavily on sophisticated techniques of statistical analysis, without which reliable findings cannot be developed.

The intended *user* of the evaluation (who may or may not also be the requester or a stakeholder, or both) must be involved in planning the evaluation to assure that the results will be relevant to the user's decision process.

The views of *stakeholders* (those with an interest in the outcome of the evaluation, such as those operating a program under examination) must be considered in defining the question and planning the evaluation, as they are typically expected to supply data to the evaluator and often play a major role in interpreting the results and in implementing any recommendations that emerge from the evaluation. Stakeholders often are the people with the best understanding of the "real" world of the program. If they are actively involved in the evaluation, they can provide important assistance in planning and implementation. However, stakeholders sometimes feel that their interests are threatened by an evaluation. If they become actively opposed, they can sometimes sabotage the project.

If these participants in the evaluation do not come to an agreement, it is sometimes very difficult to carry out an effective evaluation plan.

3. Types of evaluation

Evaluators have developed a variety of techniques for assessing the effects of programs. Each method has both strengths and limitations. None is perfect and none is appropriate for all situations. For discussion purposes, they are grouped here into three broad categories, although each category contains numerous variations.

a. *Experimental design*

A true experimental design is modeled on the work of laboratory scientists. In such an experiment, the scientist attempts to hold everything constant except for the one variable that is the subject of the experiment. If the experiment is successfully constructed, the observed effects can be determined with high confidence to have been the result of changing the single variable. In program evaluation, this method is usually found in the assessment of social welfare programs. The strongest designs involve randomly assigning people to two groups. This randomization is intended to make the two groups as similar as possible in all respects. One of the groups, called the "experimental group" or the "treatment group" participates in the program of policy under examination. The other, called the "control group" does not participate. In a properly constructed experiment, the differences in outcomes between the two groups can be attributed to the effects of the program or policy.

An evaluation based on a strong experimental design has the advantage of producing results in which there should be a high degree of confidence. Unfortunately, it is often very difficult to obtain such reliable results. Full comparability of control and treatment groups can be hard to achieve and differences may later come to light that contaminate the results. For example, one group may later be found to have a higher proportion of people with certain cultural characteristics, such that they respond differently to the treatment. Another problem is how to decide who is in the treatment group and who is not.

In addition, a true experimental design can be quite expensive in terms of both resources and time. The experimental approach works best when both groups are relatively large, so that potentially small statistical differences in outcomes can be confidently attributed to the program rather than to random chance, and when the two groups can be observed over an extended period, so that delayed effects have time to emerge. The cost of the evaluation thus tends to increase, because of the increase in the cost of the benefits being provided to

the treatment group as well as the costs of collecting data and managing the evaluation project.

Developing countries, by contrast, these evaluations need to be built into a project. Project officers would have to decide that they want to test the form of an experimental evaluation. This does not happen often for a variety of reasons: no time, no interests, no control. Experimental evaluation can not be done ex-post. Even evaluating a project while it is ongoing is difficult, because treatment groups would have been chosen in a way that may not allow easy construction of a control group.

b. Time-series analysis

This technique involves the analysis of time-series data in a search for changes in the trend lines that may be attributed to a policy or program under examination.

For example, in response to budgetary constraints, those financing a public health clinic may plan an increase in the fees charged to people visiting the clinic. Because of the obvious political sensitivity of such a change in policy health, ministry officials (or officials of the Ministry of Finance) may want to determine the effect of that increase. The evaluator may start by examining administrative data on clinic visits before and after the increase in fees. He might well observe that, after the fees are increased, the number of patients visiting the clinic on an average day drops by a significant percentage. It would be reasonable to conclude initially that the increased fees were at least partially responsible for the decline in visits, on the premise that some potential patients were discouraged from using the clinic because of the higher costs.

In addition, however, other important questions would need to be considered before the evaluation could be considered complete. Did other factors affect clinic usage at the same time as the increase in fees? This careful search for other possible explanations is a vital part of any evaluation. Without it, time-series data alone is quite unreliable as a basis for reaching conclusions about effects. Just because two events occur one after the other, does not necessarily mean that the earlier event caused the later event. To reach this conclusion, the evaluator must have both a logical basis for thinking that the two events would be related (in

this case, the long-standing economic principle that higher prices reduce consumption) as well as the ability to rule out other competing explanations. More effectively, and certainly more logically, the evaluator should solicit feedback from the people who were affected by the change—which is normal practice in a good evaluation, as noted earlier.

A second important question that most evaluators would want to answer relates to the people who did not seek service at the clinic. Were they individuals who would probably not have gained materially from that service? Or were they people who later became even more seriously ill because of the lack of treatment? This apparently difficult question can be answered in small communities by feedback from the local health centers, and in larger communities by appropriate random surveying of the entire population.

High-quality time-series analysis depends heavily on the availability of reliable baseline data. That is, to assess the results of a change in a policy or program, the evaluator needs sufficient and relevant data about the situation that existed before the change (see the extensive discussion in chapter 15). This makes it almost essential that the evaluation be planned, and implementation begin, before the change in policy is implemented. It is very difficult, and sometimes impossible, to reconstruct important elements of the baseline later.

c. Case studies

This evaluation technique involves the systematic examination of a particular operation in an attempt to identify what causes the results that have been attributed to that operation. For example, a country may have a large number of offices providing social welfare services. Ostensibly, those offices are identical in terms of staffing, services provided, etc. However, a few of those offices may have reported consistently superior operating efficiency or greater output than the others. The responsible ministry (or the central budget office) might wish to know why those offices are superior, in the hope of saving budget resources by replicating this performance in other offices.

In this situation, the most effective approach would often be a detailed case study comparison of one of the "superior" offices with one or more of the others. As with any evaluation, the most difficult task is to determine the cause of the reported superior results,

and to do so with a high level of confidence. This means searching for possible explanations and either ruling them out or describing logically how they may have caused the observed effect. This is a particular challenge for case studies because there are typically many differences between the "superior" offices and the control group. That makes it very difficult to rule out any of the differences to settle on the particular set of differences that account for the differing results. Thus, while case studies often yield highly useful information, particularly about ways of improving operating efficiency, they typically provide relatively low confidence levels in the attribution of results to particular causes.

4. Conclusions

The goal of evaluation is to provide decision makers with information that they need to decide whether to continue or change a policy or program, by measuring the effects of government policies and programs and to ascribe those effects with confidence to the policy or program under examination. There is a variety of ways of answering evaluative questions. Each has its strengths and limitations and the choice among them should not be considered a purely technical question. Successful evaluations require agreement among the affected parties, especially between the evaluator and the requester, as to the question being examined, the resources (both money and time) available to answer the question, the evaluation method that will be used in the light of the resources that are available, and the level of confidence that one can expect to have in the answer.

D. KEY POINTS AND DIRECTIONS FOR REFORM

1. Key points

Management controls, (also called "internal controls") are the policies and procedures put in place by the managers of an entity to ensure the proper and effective operation of the entity. There are many kinds of management controls. Developing an effective system of controls requires, first, a careful assessment of the risks facing the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable costs.

Management controls are a basic responsibility of any manager. To be effective, the management control system must have the strong support of the entity's leadership. Policies and procedures must be observed consistently throughout the organization. Irregularities revealed by the control system must bring prompt and effective corrective action. To assure continued effectiveness, both the risks facing the organization and the control system, itself, must be reassessed frequently.

No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities will be detected. At the same time, even well-designed controls can be defeated by collusion, especially if that collusion involves senior executives who have the power to disarm or bypass the control system. As stressed earlier, effective accountability requires appropriate external feedback and "voice".

Internal audit is part of an organization's management control structure. It performs audits of lower level units on behalf of the top management of the entity. Some of its most important functions are to test the management controls themselves and to assist management in assessing risks and in developing more cost-effective controls.

External audit of the government is typically performed by a separate organization, the SAI, which usually reports its findings to the legislature and/or the public, as well as to the audited entity itself. SAIs may perform several types of audits, including ex ante audits, compliance/regularity audits, financial (assurance) audits and value-for-money (efficiency) audits. The appropriate audit emphasis depends on the particular circumstances of each country. Weak or non-existent management controls in government organizations may require the SAI to conduct extensive auditing of individual transactions in an ex ante or compliance/regularity mode. However, this is an inefficient use of audit resources. An SAI in these circumstances should work with the legislature and the Ministry of Finance to implement a coherent strategy for building effective systems of management control.

The credibility of external audit requires that the SAI and its staff be independent of the governmental units being audited and have unrestricted access to required information. This independence is typically set forth in the legal provisions establishing the SAI. The SAI must

guard this independence zealously but, at the same time, its effectiveness depends on maintaining a professional, cooperative relationship with the legislature, the government and the entities being audited.

There are several organizational models of SAI designed to reinforce independence while also providing effective management of the SAI as an organization. Most are variations of the “office” model, headed by an Auditor General reporting to the legislature (typical of Commonwealth countries) or of the “court” model, in which the auditors have the status of law court judges (as for example in France and Italy). Combinations of these two basic models are also seen in some countries.

To be effective, the SAI’s audit staff must possess the professional skills required by the audits being performed. For an SAI to move from ex ante and regularity audits to financial assurance and value-for-money audits will require extensive training or the hiring of new professional cadres to perform these more complex audits.

The SAI, especially one pursuing strategic objectives such as improved management controls or undertaking more advanced types of audits, needs an effective means of communicating audit results and a sound approach for encouraging appropriate corrective action.

No audit, however thorough, can provide absolute assurance of detecting every irregularity or error. An audit can give only reasonable assurance that any material errors will be found and reported. Even this level of assurance that any material errors will be found and reported. Even this level of assurance can be given only if the auditors have access to all needed records and the audit was performed in accordance with generally accepted auditing standards.

Program evaluation is a systematic effort to identify and measure the effects of government policies and programs. The more sophisticated forms of evaluation, experimental design and time series analysis, involve the collection and statistical analysis of large volumes of data to isolate reliably the effects of the program from other factors that might have caused

these effects (“impact evaluations”). Case studies provide less reliable information about causation but have proven useful in identifying ways of improving efficiency.

For an evaluation to succeed, there must be clear agreement on the question being examined and the data required to provide a reliable answer. Those performing the evaluation must have the professional skills and resources needed to collect and analyze the data. The evaluator often must depend heavily on the cooperation of operating units to gain needed access and to collect needed data. Program evaluation itself, like value-for-money audit, must show that it is cost-effective relative to the improvements to be identified or the progress expected.

2. Directions for reform

The several elements that can contribute to the integrity, efficiency, and effectiveness of government organizations and programs, must be instituted by the government; they do not come into existence because one wishes them to. Some of the key considerations involved in the development effective management controls, auditing, and program evaluation are as follows.

A government that is convinced of the need to build or strengthen its control and analysis capabilities needs to define a strategy for accomplishing these goals and to establish responsibility for doing so. In most countries, there are two institutions that should play critical roles in this process, the Ministry of Finance and the Supreme Audit Institution. Typically, the MOF, because of its central position in managing the government's finances and its authority over the state budget, has unusual influence over the line ministries with regard to their control structures, especially their accounting systems and procedures. The SAI, because of its special expertise in auditing, is usually a reliable source of advice and technical assistance in defining the steps that need to be taken. Ideally, the strategy should be the outgrowth of consultation and cooperation between these two institutions. Implementation of the strategy, involving the actions that must be taken by the line ministries, should be the responsibility of the ministers and senior civil servants in those ministries, under the leadership of the MOF and external oversight by the SAI.

It is not possible to develop all the needed institutions and procedures at one time. Thus, it is necessary to set priorities. In almost all countries, and especially in developing and transition economies, the highest priority should be placed on assuring the reliability of the financial systems and the integrity and security of the controls over transactions. This translates into placing first emphasis on building reliable management control structures and effective internal audit units in the ministries and on assuring the effectiveness of the SAI as the external auditor. Only when these structures are in reasonably satisfactory condition is it worthwhile to focus on the efficiency and effectiveness of operations.

Countries need not be dependent exclusively on their own knowledge and experience in the development of effective management controls, auditing and program evaluation. Technical assistance is available in all these areas from multilateral institutions, donor nations and professional organizations. The assistance can take the form of providing relevant documents, formal training and temporary secondment of experts, as well as financial support. Donors, whether bilateral or multilateral, are typically committed to helping developing and transition countries build their management controls and auditing capacity as a way of helping assure the effective use of donated funds. SAIs and MOFs in developed countries are often prepared to provide technical advice and assistance to their counterparts in developing and transition countries because of their professional commitment to the importance of sound financial management in all countries.

¹ The experience of Australia, among developed countries, and Costa Rica, among developing countries, has been particularly positive.

Chapter 10. ACCOUNTING

1. Accounting and reporting systems are crucial for budget management, financial accountability, and policy decision making. Traditionally, government accounting was aimed at assuring compliance and proper use of public monies. For this purpose, the cash budget, and cash and commitment accounting provide an adequate framework.

2. Experiences of performance budgeting during the 1960s to 1970s, the needs for managing business activities of the government or for preparing the national accounts, lead a few countries to develop accounting systems that encompass liabilities and assets¹. The UN System of National Accounts (SNA) standards for the government sector were established on an accrual basis. However, in the 1980s, concerns about macroeconomic stabilization led most countries to focus back on cash and commitment reporting.

3. Currently, accrual accounting is gaining importance in several OECD countries. To assure not only financial compliance but also operational efficiency and results, these accounting and financial reporting systems require spending entities to report their full financial position (including their stock of assets and liabilities), and to assess the full costs of their operation, including the uses of assets. In parallel, concerns about the future impact of current policy decisions (such as those related to pensions) give governments an incentive to improve their accounting for liabilities. Some countries have switched recently from a cash accounting system to a full accrual accounting system.

A. ACCOUNTING SYSTEMS

1. Types of accounting systems

4. The bases of accounting systems are generally classified into four broad categories: cash, modified cash, modified accrual, and full accrual. This classification refers to the accounting principles that determine when the transactions or events should be recognized for financial reporting purposes.

5. However, this classification is somewhat schematic. For example, in countries with a cash-based system, government accounting has traditionally had a twofold approach:² (i) budgetary or *appropriation* accounting which keeps track of appropriations and uses of appropriations at different stages of the expenditure cycle; and (ii) cash-basis accounting which recognizes a transaction only when cash is received or disbursed. Therefore cash-basis accounting should not be to the exclusion of commitment accounting for monitoring budget management or compliance control. In fact, cash-based systems are sometimes called “cash and commitment” systems.³ Besides commitments, cash-based systems can also recognize other noncash transactions, such as receipts of foreign aid and some outstanding liabilities.

6. Complete budgetary accounting (or appropriation accounting) must be the common denominator of every accounting system. It should track appropriations, supplementary estimates, virements, and the uses of appropriations (release of funds, commitments, expenditures at the verification stage, and payments).

7. Accounting requirements depend on programs and agencies. A full accrual accounting system may be needed for an agency that delivers services or has commercial activities, while for other agencies a cash-based system and budgetary accounting could be satisfactory.

8. Therefore, the normative classification of bases of accounting presented below must not lead to oversimplifying the analysis of accounting systems and recommendations to improve them.

a. *Cash accounting*

9. “The cash basis of accounting measures the flow of cash resources. It recognizes transactions and events only when cash is received or paid”⁴.

10. Financial statements produced under the cash basis of accounting cover cash receipts, cash disbursements, and opening and closing cash balances. A cash accounting system has the advantage to be simple.⁵

11. As mentioned above, a cash-based accounting system is supplemented, in a number of countries: (i) a few suspense or “below-the-line accounts” for some liabilities; (ii) commitment accounting; and (iii) debt accounting on an accrual basis.

b. *Modified cash accounting*

12. The modified cash basis of accounting “recognizes transactions and events which have occurred by year-end and are normally expected to result in a cash receipt and/or disbursement within a specific period after year end.”

13. Therefore, the accounting period includes a “complementary period” for payments (e.g., 30 or 60 days) after the close of the fiscal year. Payments over the complementary period that are related to transactions of the previous fiscal year incurred during the fiscal year are reported as expenditure of this previous fiscal year. Usually, this is achieved by holding the books “open” during the complementary period. This aims at ensuring a greater conformity between the “annual” commitments made during a fiscal year and the payments that are reported as “budgetary expenditures”.⁶

14. In some countries, the complementary period also concerns revenues. This should not be imperatively the case. Revenues must be reported on a pure-cash basis.

15. Modified cash accounting is frequently adopted by governments (particularly in the French and Spanish systems). However, as discussed below in section c, this system presents inconveniences in developing countries.

16. Financial statements produced under the cash basis of accounting cover cash receipts plus receivables within a specified period from the end of the period (complementary period); cash disbursements plus payables within a specified period from the end of the period (complementary period). Some countries that use the cash basis of accounting for their budget operations also produce financial statements under a modified accrual basis (e.g., France, Spain).

c. Modified accrual accounting

17. The modified accrual basis of accounting (sometimes called “expenditure basis”) recognizes transactions and events when they occur, irrespective of when cash is paid or received. However, there is no deferral of costs that will be consumed in future periods. Physical assets that will provide services in the future are “written off” (or “expensed”) in the period acquired.

18. Full accrual and modified accrual accounting therefore have the same accounting framework. The major difference lies in the time between the acquisition of goods and assets and their utilization. Under modified accrual accounting, supplies are considered consumed and assets are written off as soon as they are acquired. Under full accrual accounting, changes in inventories are recognized and assets are progressively depreciated according to their useful life. An overriding principle of full accrual accounting is the matching principle whereby expenses are recorded in the same period as the related revenues are recognized.

19. Compared with cash accounting, modified accrual accounting systems present the advantage of recognizing expenditures at the verification stage, and therefore give an adequate framework for assessing liabilities and arrears. There is a variety of modified accrual accounting systems, depending on the treatment of superannuation liabilities, inventories, depreciation (which may be recognized for some assets, as in Spain), etc.

20. Financial statements produced under a modified accrual accounting system cover revenues, expenditures, financial assets, liabilities, and net financial resources.

*d. Full accrual accounting*⁷

21. Like modified accrual, “the full accrual basis recognizes transactions and events when they occur irrespective of when cash is paid or received. Revenues reflect the amounts that came due during the year, whether collected or not. Expenses reflect the amount of goods and services consumed during the year, whether or not they are paid for in that period. The costs of assets are deferred and recognized when the assets are used to provide service”⁸. Full accrual accounting is similar to the accounting systems for private enterprises (commercial accounting).

22. “Expenses” recognized by the full accrual basis of accounting, should not be confused with actual expenditures. They are the costs of goods and services consumed as well as any increase of liabilities or decrease of assets, over the accounting period (e.g. they include depreciation and losses, which can occur in the absence of transactions). The notion of expense in commercial accounting is similar to the notion of “use” in the SNA.

23. Financial statements produced under a full accrual accounting system cover revenues; expenses (including depreciation); assets (financial and physical); liabilities; net assets. Accrual accounting systems are reviewed in detail later in this chapter.

e. An evolving consensus?

24. Views differ concerning the usefulness of the “intermediate” bases of modified cash and modified accrual. The accounting subcommittee of the IFAC/PSC at its meeting of January 1999 decided to recommend a single standard covering cash accounting with all other accounting standards issued on an accrual basis. However, for governments that wish to convert from cash to accrual, a transition period would permit selective introduction of accrual elements. Much more discussion lies ahead before a firm consensus and agreement is reached on these issues. It must also be

stressed that public finance and economic policy considerations are relevant to the issues as well.

2. What is the difference among accounting systems?

25. The example below shows the broad differences between the different types of accounting.

Table 3				
Comparison Among Accounting Systems				
I. Current Expenditure				
Accounting period January-December				
Commitment, October 1996. Order of supplies				1100
Delivery/verification, November 1996				1000
Partial payment, December 1997:				800
Supplies used in 1997:				700
Inventory, December 31, 1997:				300
Depreciation of assets of the department, 1997:				137
	Account	Debit	Credit	date
Cash				
<i>Payment</i>	Budget operations	800		1996
	Cash-Bank		800	1996
Modified Accrual				
<i>Verification</i>	Budget operations	1000		1996
	Liability		1000	1996
<i>Payment</i>	Liability	800		1996
	Cash-Bank		800	1996
Full Accrual				
<i>Verification</i>	Budget operations	1000		1996
	Liability		1000	1996

<i>Payment</i>	Liability	800		1996
	Cash-Bank		800	1996
<i>Use of supplies</i>	Budget operations		1000	1997
	Expenses	700		1997
	Inventories		300	1997
<i>Depreciation</i>	Assets		137	1997
	Expenses	137		1997

Commitment: 1100 (1997) (should be registered whatever the basis of accounting)

II. Comparison between modified accrual and full accrual for investment

Bridge delivered in 1998
Amount is 2,000,000
Useful life: 50 years

Modified accrual:

1998 **Expenditure** **1,000,000**

Full accrual:

1998 **Expenses**

0

Assets

1,000,000

1999 Expenses

20,000 (depreciation)

Assets

980,000

2000 Expenses

20,000 (depreciation)

Assets

960,000, etc.

3. Relationships between accounting systems and budget systems

26. In chapter 3, budget systems are classified according to the nature of the appropriations. Except for a few obligation-based budgets, two broad categories exist:

- *cash-based budget*, when most of the appropriations are authorizations to make annual commitments and to pay;
- *accrual-based budget*, when appropriations for running costs and some other items cover full costs, including depreciation, and other increases in liabilities.

27. There is no one-to-one mapping between accounting systems and budget systems. Cash-based accounting systems are always associated with cash-based

budgets, but a cash-based budget does not necessarily require cash accounting. On the other hand, accrual budgeting requires full accrual accounting, but full accrual accounting does not require accrual budgeting.

28. Every budgetary and accounting system has its own characteristics that make difficult to classify the system unambiguously. However, the following relationships of budget systems with accounting systems are found in various countries:

(i) *Cash-based budgets*. Countries with a cash-based budget may have the following accounting systems:

- cash accounting (e.g. traditional British Commonwealth system);
- modified cash accounting (e.g., some developing countries that follow the French or Spanish budgeting system);
- modified accrual accounting (e.g., Canada, France, Spain);
- accrual accounting, in the sense that depreciation is posted into the accounts, although accounting principles are not strictly defined along the Generally Accepted Accounting Principles (GAAP)⁹ (e.g., transition economies);
- full accrual accounting. (e.g., the U.S., where it has been recently implemented for all federal government transactions¹⁰).

(ii) *Accrual-based budget*

- full accrual accounting: (e.g., New Zealand).

These differences concern mainly noninterest expenditures. As far as debt is concerned, most countries use accrual accounting.

4. Chart of accounts and general ledger

a. *What is a chart of accounts?*

29. A chart of accounts is a classification of transactions and events (payments, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature. It defines the organization of the ledgers kept by the accountants. A chart of accounts is organized in the way transaction or event is defined (e.g., commitment, liability, payment, depreciation) and by the administrative category (for accounts covering internal operations). The budget classification system reviewed in chapter 3 defines the structure of the accounts or subaccounts of the chart of account that are related to budgetary operations.

30. Under a cash accounting system, the chart of accounts is often limited to budgetary accounts for payments, a few accounts for posting internal financial transactions and financing operations, and eventually a commitment account (or ancillary books for commitments). Under modified or full accrual accounting, expenditures at the verification stage are recognized as liabilities. Hence, they must be recorded in a ledger, which includes accounts for assets, liabilities, expenditures/expenses, revenues, etc.

31. Financial statements are prepared along the categories set in the chart of accounts. Financial statements prepared under an accrual accounting system are shown in section E.3 below. They are not a substitute for budget monitoring reports.

32. Figure 9 illustrates a chart of accounts and its relationship with the budget classification system and the reporting system.

[Insert Figure 9 here]

b. *Financial Ledger*

33. The set of books or the data base where all the transactions are recorded along the chart of accounts (including the budget classification system) is called the General ledger.

34. With a computer-based integrated financial management system, each transaction and its attributes can be recorded in a Financial Ledger System. These attributes cover both the budget classification categories (function, organization, etc.) and the other chart of account categories (liabilities, increase of assets, etc.). In a manual system, commitments are generally recorded in ancillary books, often badly linked with the main ledger. In a computerized ledger system, there is one single data base, or a set of interrelated databases, which covers both the ledger for accounting and the ancillary books for tracking the uses of appropriations.

35. A computerized Financial ledger system will allow reporting according to the needs of the different users. It can perform budgetary execution controls, such as control of payments and commitments against appropriations. It fits a budget system with centralized ex-ante controls (e.g. in Brazil or in France), as well as budget systems where execution controls are carried within spending agencies (e.g., in the U.S.). Controls depend on the procedures for recording transactions not on the fact that transactions are recorded.

36. In a manual system, decentralizing accounting presents inconveniences for information dissemination. Modern technologies allow a more decentralized approach, since accounts can be easily consolidated provided that they fit the same classification system.

37. In theory, each elementary transaction is recorded into a GLS. However, depending on organizational arrangements, centralizing consolidated transactions can be sufficient, provided that this consolidation is made along the categories of the chart of accounts.¹¹ For example, if payroll administration is decentralized, it is sufficient to record in the GLS only the total personnel expenditures by program/project and object category. As discussed in chapter 8, this consolidation approach should not mean that cash balances are not centralized daily.

B. Accrual Accounting

38. Developing countries should avoid overambitious accounting reforms, which would be ineffective. Nevertheless, a review of the accrual accounting framework and methods gives directions for improving accounting.

39. A complete assessment of liabilities is desirable in every country. Recognizing expenditures as liabilities at the verification stage, and therefore assessing arrears accurately, should be systematically done. Issues related to some expenses, such as supernannuation liabilities, the treatment of interest subsidies, recognition of financial losses, concern all countries. Modified and full accrual accounting give methods for assessing and recognizing liabilities. These methods can however, be implemented gradually.

40. Concerning the assets side and the assessment of "full costs," implementing full accrual accounting for all government agencies can be considered in only a very limited number of countries. However, agencies that deliver commercial services or consume a large quantity of capital goods should assess their full costs and consider adopting a full accrual accounting framework, at least for internal management. The transition countries that have some form of accrual accounting system could consider making the GAAP standards better, but for the time being, strengthening cash and expenditure reporting should have higher priority.

1. Revenues

41. The accrual basis of accounting recognizes the effects of transactions and other events in the period during which they occur, regardless of the timing of the associated cash receipts.

42. Practices vary in industrialized countries that have an accrual accounting system (e.g., the U.S., recognizes revenues on a cash basis; New Zealand's approach is more accrual-based). Several developing countries include in their accounts taxes

owed on the basis of tax assessments. This is sometimes considered orthodox accrual accounting methodology. As an unfortunate result, accounts often show taxes that will never be collected. In fact, according to the accrual accounting principle, taxes assessed should be recognized only if they are expected to be collected. In developing and transition countries, this would call for estimating the probability of collecting assessed taxes. Posting revenues on the basis of such estimations is tricky¹². In the Russian Federation, for example, tax collection is a central and variable problem.

43. In developing countries and transition economies, revenues must be recognized on a cash basis. (Obviously, data bases for tracking taxpayers and tax arrears are needed, but they should not be mixed with the government accounts.)

44. Accrual accounting recognizes grants-in-kind. Developing countries, whatever their accounting system, require the recording of grants-in-kind. While cash accounting and modified accrual accounting recognize the sale of assets as revenue, full accrual accounting recognizes only the loss/gain compared with the net book value.

2. Expenses in full accrual accounting

45. Full accrual accounting systems recognize “expenses” instead of “expenditures.” Although in common parlance the two terms are almost synonyms, in accounting they carry very different meanings. “Expenses” are the uses of resources over the accounting period (as opposed to expenditures, which are the value of goods of services acquired over the same period). They include the following items:

- Personnel costs, including pension liabilities;
- Full costs of all operating activities (including depreciation);
- Interest and other financial costs;
- Capital asset use (depreciation and loss of service potential), changes in the book value of physical assets, and losses;
- Accrued interest changes in the market value of financial assets and losses, and foreign exchange losses;
- Government transfers.

a. *Pension liabilities*

46. Each year, current employees earn entitlement to future benefits. If the government pays the pensions under a “pay-as-you go” system, the change in total cost of future pension entitlements is considered as an expense, based on the actuarial value of future pension payments (under certain economic and demographic assumptions). If instead pension contributions are paid into a pension fund and payouts are equal to the annual increase in the fund, the scheme is referred to as fully-funded. If the payments into the scheme are lower than the expenses, an unfunded liability must be recognized.

47. Assessing pension liabilities is important for policy formulation. It would reveal, for example, whether a fiscal deficit problem is merely shifted onto the future instead of being resolved. There is a temptation for hard-pressed governments to meet short-term cash deficit objectives through increased long-term liabilities. For example, in developed countries, governments sometimes promise pension increases in lieu of salary raises,¹³ or obtain revenues from public enterprises in exchange for the transfer of pension liabilities of these enterprises to the budget. Therefore, the recognition of pension (and other) liabilities is a key advantage of accrual accounting.

b. *Full costs and uses of physical assets*

48. “Full costs” of programs include costs of goods and services acquired and used over the period, and the uses of inventories and assets (depreciation). For an assessment of full costs the following elements are needed: (i) sound management of physical assets and inventories; (ii) estimates of depreciation; and (ii) sound cost measurement systems, since overhead and shared use of equipment by various programs or activities must be imputed to each program/activity (cost measurement is reviewed below in section D2). Box 29 compares cash payments with full costs.

49. A capital expenditure is not an expense. Moreover, since payment schedules for construction works do not correspond systematically to the progress of the work, the

accounting increase in the physical assets may differ significantly from the expenditures made over the period.

Box 29

Comparison Between Full Costs and Cash Payments for a Program

For running costs over a given period

Payments for capital expenditures excluded

Cash payments

- + depreciation of physical assets over the period
- + Variations in liabilities over the period
 - + New arrears over the period
 - Arrears at start of period paid over the period
 - Advance payments made over the period
 - + Supplies/works financed with previous advance payment.
- + Variations in inventories over the period
 - + Inventories consumed and losses
 - Increase in inventories
- + Costs of services provided by other programs/cost centers
- Costs of services provided to other programs/cost centers

Full costs

d. Transfers Subsidies

50. To recognize a transfer, it is necessary to assess whether there is in fact an obligation; whether the transfer is authorized; whether the beneficiary group can be identified, etc. All these decisions are partly a matter of judgement.

51. Loans granted by the government often include an interest subsidy and might not be repaid. Under accrual accounting, the interest subsidy must be posted and the risk of failure of the debtors will fail to repay is assessed. This method complements the suggestion made in chapter 2, including these loans in the budget, but is not a substitute for it. The loans should always be authorized by the legislature.

3. Liabilities

52. A liability is “a probable future outflow or other sacrifice of resources as a result of past transactions or events.”¹⁴ Liabilities include, notably, the following categories: (i) accounts payable; (ii) other accrued liabilities, e.g. pensions; and (iii) debt outstanding.

53. As reviewed in chapter 7, adequate management systems and procedures are needed to manage payables and take better account of unfunded liabilities in the budget. Issues related to debt management are reviewed in chapter 8. Other liabilities covered by an accrual accounting system concern, notably, liabilities related to government pensions, including hidden liabilities related to an independent pension schemes that the government will support if they cannot fulfill their obligations.

54. A contingent liability is a potential liability that depends on a future event arising out of a past transaction. Under accrual accounting, contingent liabilities are recognized as real liabilities when: (i) it is probable that future events will confirm that, after taking into account any related probability of recovery, an asset has been impaired or a liability incurred at the balance-sheet date; and (ii) a reasonable estimate of the amount of the resulting loss can be made.

55. This assessment can be difficult. The first step should be to publish the list of loans guaranteed, as recommended in chapter 2. Then, the preparation of a more complete statement of contingent liabilities should be considered. These statements would include a schedule of payments related to contingent liabilities and give some indication of the probable or most likely loss.

4. Assets

56. In principle, full accrual accounting could recognize the following categories of assets:

- Financial assets, such as, cash, revenues receivable, loans, etc.;
- Physical assets, such as, property, plant and equipment, infrastructural assets, investments, heritage assets, defense or military assets, and natural resources;
- Intangible assets, such as mineral or fishing rights (in theory at least).

57. Accounting for physical and intangible assets, when possible, would increase fiscal transparency. Sales of assets made through a privatization program, sales of facilities, and sales of gold reduce the cash deficit artificially.¹⁵ Sales of mineral rights are in some developing countries an easy way to “balance” the budget, to the detriment of future generations. Identifying losses or gains related to the sale of intangible assets is not an easy matter, however.

58. Information on assets and inventories is needed for preparing decisions on maintenance, or the acquisition of new equipment and facilities and supplies. A full accrual accounting system gives a framework for setting up assets and inventory registers, but by itself does not improve asset management. To be effective, asset registers should be integrated into the accounting system, be up to date, regularly reconciled with the control records, and subject to periodic physical comparisons. As

shown by the poor quality of asset registers in developing countries, posting assets into the accounts risks being only a formal and bureaucratic exercise.

59. Issues related to physical assets are important for performance and cost measurements. There are also disputed features of full accrual accounting systems, notably those related to the valuation of military equipment, national parks, museums, and other heritage assets. Critics argue that there is no market for these assets and that, by definition, they are not to be sold in any case. On such issues, standards vary, depending on the nature of the asset and on the country.¹⁶

60. Assessing the value of all assets and posting them into the accounts would pose major difficulties in a majority of countries. However, whatever the basis of accounting, most countries need to improve their asset management. Asset registers should be maintained, beginning with sectors and/or types of assets for which asset management is crucial. (e.g., road maintenance agencies, computers, cars) To promote transparency, operations related to the sale of assets must be disclosed. One-shot operations must be separated from other transactions, in the accounts and financial statements.

5. Operating deficit

61. Under full accrual accounting the operating deficit¹⁷ is the difference between expenses and revenues, as defined above. Therefore, increases in unfunded liabilities and uses of assets are “above the line” and included in the operating deficit, while investment expenditures are not taken into account in calculating the operating deficit. As indicated in chapter 3, the deficit on a cash basis is crucial in assessing the monetary impact of the budget policy and the deficit on a commitment basis to assess arrears, and their impact on the liquidity of the economy and the credibility of the government. The operating deficit can supplement these indicators, but is not a substitute for them.

62. From a macroeconomic point of view, proponents of accrual accounting note that the cash-basis fiscal deficit indicator introduces a bias against investment, since

investments and recurrent expenditures are accounted for in the same manner, despite the fact that the capital invested will be consumed over a longer period. Cash accounting systems are also seen to favor “number cooking” and “creative accounting,” when policy decisions diminish assets or increase the liabilities of the government.¹⁸ However, accrual accounting also leaves plenty of room for “creative accounting”, through manipulating estimates of depreciation, provisions, method to recognize losses, etc.¹⁹

63. The deficit under a modified accrual accounting system is equal to the deficit on a cash basis plus net increases of liabilities. It is close to the “deficit on a commitment basis.” Depending on the accounting methods, two differences are, however, possible. On the one hand, the deficit on “a commitment basis” can include orders not yet delivered besides arrears. On the other hand, liabilities recognized by a modified accrual accounting system can include liabilities other than arrears (e.g., superannuation liabilities).

6. Accrual accounting and budget management

64. Figure 10 illustrates the relationships between the expenditure cycle and the accounting systems.

[Insert Figure 10 here]

65. Modified accrual accounting and full accrual accounting require an analysis of the invoices in order to post: (i) the related increase in physical assets (which is immediately written off under a modified accounting system); and (ii) the other contractual payments (e.g., variations in the advance payments account). Whatever the accounting system, this exercise is required particularly for civil works, since the contractual payment schedule is generally different from the work schedule.

66. As discussed earlier, full accrual accounting requires a detailed analysis of full costs. This needs an appropriate management system. Accrual accounting cannot rely

only on traditional budget management. It needs adequate management systems at the program or spending agency level.

7. Accrual budgeting

67. An accrual budget is presented according to the standards of full accrual accounting. However, as shown by the comparisons made in section A3, full accrual accounting should not be confused with accrual budgeting.

68. Figure 11 compares the budget execution cycle under an accrual budgeting system and under a cash budgeting system, both variants using a full accrual accounting system. Depreciation is only an accounting information item in a cash-based budget system. It is included into the appropriations in an accrual-based budget. Compared with accrual accounting with a cash-based budget, accrual budgeting systems have the advantage to give more importance in the budgetary process to full-cost estimates. However, this alters the traditional rules for compliance, since appropriations include depreciation forecasts no longer set a cash limit.

[Insert Figure 11 here]

69. Under an accrual budget, cash controls are based on separate cash plans that are not directly derived from appropriations. This requires sound cost estimates, and good fiscal discipline to avoid depreciation becoming an excuse for cash overruns. Accrual budgeting has proven to be neutral or even good for fiscal discipline in New Zealand but it could have the opposite effect in other countries if the appropriate cash controls are not in place.²⁰

70. In most developing and transition countries, changing the nature of appropriation, and the rules for compliance would reduce fiscal discipline. In countries with poor accountability, it would open a new door to misappropriation and corruption, and be an excuse for diminishing accountability to Parliament. Developing and transition countries should not consider implementing an accrual budgeting system for the central government, even if they intend to develop an accrual accounting system. In

these countries, there are greater returns, and lesser risks, from ensuring control and discipline than from attempts at estimating the value of assets and their depreciation schedules.

71. These problems are related to the degree of “disconnect” between appropriations and the day-to-day management of payables. There are no such problems when the cash limits are presented to the legislature in the same degree of detail as accrual-based appropriations (as in Iceland). But this variant of “accrual budgeting” is really no different from a cash budget to which accrual accounting information is annexed.

72. Local governments in several countries (e.g., Malaysia, France, Italy, and the United Kingdom), present accrual information in their budget. The administrative organization and budget management procedures for local governments are much simpler than for central governments. The presence of an allowance for depreciation in the budget of a local government does not alter any rule for budget management. In developed countries, the presentation of local government budgets in a balance sheet format is often stipulated by regulatory texts issued by the central government, since it is seen as a means of controlling the running costs of the local governments.²¹ An accrual-budget for local government can be favorably considered in developing countries where accountants have adequate skills.

C. *Reforming an accounting system*

73. Reforming an accounting system requires first analyzing its major weaknesses. For example, are arrears accurately monitored, payments reported in a transparent manner, accounting procedures clearly defined and enforced, etc.? Priority improvements in accounting should aim at consolidating the foundations for sound accounting. More complete budgetary accounting and disclosure of liabilities is needed in a majority of countries. The progressive development of a modified accrual accounting system should be considered favorably. In countries where conditions are conducive, a latter stage in improving accounting could be the progressive or partial

implementation of a full accrual accounting system, beginning with agencies where it is more useful for assessing performance.

1. Major weaknesses in accounting systems

a. Insufficient budgetary accounting

74. For traditional and administrative reasons, there is, in many countries, a separation between commitment accounting and the other elements of the accounting system. In a number of British Commonwealth countries, commitment registers are kept by spending agencies, but are badly linked with accounts kept by the Treasury Department. Therefore, the Ministry of Finance does not have sufficient information to supervise budget implementation.

75. A similar separation can also be found in countries with a more centralized system. For example, in developing countries under the French system, it is often difficult to compare data from the Financial Controller or the Budget Department, which control and record commitments and requests for payment prepared by spending agencies, with data from the Treasury, which makes the payments.

76. Coordination between the different actors involved in recording budget operations and accounting must be sought through improved procedures for information dissemination, and the setting up a comprehensive accounting framework covering all aspects of government accounting. Computerization of the expenditure cycle may help, provided that it does not also adopt a fragmented approach.

77. As discussed in chapter 7, expenditure should be monitored at each stage of the expenditure cycle. Commitment accounting is essential for control of budget implementation and for program management. For supplies and investment expenditures, the commitment and the verification stage are distinct stages in the expenditure cycle, and expenditures should be recorded at both stages. Expenditure accounting (at the verification stage) is essential for program and contract management, management of payables, and assessment of arrears. In countries that

face arrears, there may be significant gaps not only between expenditures and payments, but also between expenditures and commitments. Before delivering new committed orders, a cautious supplier usually waits for its previous deliveries to be paid.

78. Transactions that are to be recorded must be clearly defined and must be stipulated in the financial regulations. As discussed in chapter 6, the definition of “commitment” in the budgetary sense is based more on management grounds than on legal grounds. This is understandable. However, as discussed earlier, what a budgetary commitment is should be made clear. Moreover, commitments in the legal sense (contracts and orders) should be monitored by agencies, even when the commitment in the budgetary sense corresponds to the deliveries or to a reservation of funds.

79. In some countries, expenditures are monitored at a payment voucher stage, which corresponds neither to the verification stage nor to the payment stage. Expenditures at the verification stage must be recorded as soon as deliveries are verified (see chapter 5).

80. Supplementary estimates, virements/transfers, releases, allotments, etc. are often followed up in a fragmented manner. In several countries, it is difficult to determine which budget is being implemented, since supplementary estimates and virements are not assembled into a single document.

81. Often, spending units track uses of appropriations in single entry books while cash inflows and cash outflows are matched in double-entry books kept by the Treasury Department. When spending units record only one kind of operation (payment from a bank account or requests sent to the Treasury), single-entry bookkeeping does not pose a major problem. However, better linkages between the different components of the accounting system, comprehensive budgetary accounting and the recording of movements between budgetary accounts require generalized double-entry bookkeeping.

b. Arrears and liabilities

82. Issues related to arrears are reviewed in chapter 7. Many countries using the cash accounting system also have suspense or “below-the-line” accounts where they record some outstanding liabilities. The “below-the-line” accounts may cover financial assets such as advances, imprests and liquid investments, and financial liabilities such as deposits by contractors and some arrears. These “below-the-line accounts” make up partly for a lack of satisfactory monitoring of expenditures (at the verification stage) and liabilities. However, these accounts are far from covering all liabilities (in Nepal, for example, the suspense accounts are used only for liabilities due to personnel). All outstanding invoices and liabilities should be entered into the accounts. This implies the setting up of an appropriate budgetary accounting system, along the lines suggested below. Assessing arrears from separate registers kept in parallel to the accounts is only a palliative measure.

c. Nontransparent reporting of payments

83. Uses of “below-the-line accounts” are not systematically transparent and they may include off budget spending. This problem is not dependent on the basis of accounting; however, it is particularly crucial in developing countries with poor governance whose accounting systems are not on a pure-cash basis.

84. Budget execution is reported on the basis of requests for payment transmitted to the Treasury. In theory, these requests correspond to expenditures at the verification stage. In practice, since private suppliers require payment before delivering services to a government that has the habit of accumulating arrears, payment orders are usually based on pro-forma invoices. They are nevertheless entered into a liability account, where they sometimes stay for several months or even years. This account mixes true invoices, proforma invoices, old vouchers for transfers to government entities, and subsidies that were budgeted but never paid.

85. Budget execution reports show the requests for payments along the budget classification. Since accrued vouchers fit budget appropriations very well, formal compliance is ensured. *But the real budget execution is elsewhere.* It consists of the selection of the vouchers to be paid among the vouchers in the liability account. Payments made from the liability account do not follow the budgetary classification, since they have been classified as "expenditure" months (or years) before. As a result, "true" budget execution along the budget classification is completely unknown.

86. In a pure-cash accounting system and a pure-cash-based budget, the budget and the accounts are closed on the same day. Under a modified cash accounting system, there is a "complementary period", as indicated earlier. This has the advantage of taking into account the time between obligation and payment. However, keeping open the books of the previous year leads to questionable practices, such as executing two budgets at the same time. Budget data must therefore be adjusted to a chronological time to allow the comparison of fiscal and monetary statistics. In developing countries, modified cash accounting systems present risks as regards transparency and accountability.

87. In countries that accumulate arrears, full or modified accrual accounting could pose similar problems if payments are not monitored in accordance with the expenditure classification system. Payments are reported in the cash flow statements under accrual accounting systems. However, two sets of payments can be made in parallel: one from the budget itself, and the other from the liability account that contains accrued expenditures of the previous year not yet paid. Generally, this liability account does not have the same classification as the budget. In countries where payments are made on time, this technical difference is not a problem. But in countries that have weak accountability and/or that face an arrears problem, it is a different matter.

88. Whatever the basis of accounting, transparency requires reporting all payments over the accounting period and the fiscal year in accordance with the expenditure classification system, including payments related to expenditures made in a previous period.

d. *Other weaknesses*

89. Sometimes, "internal payments" (i.e., transfers of funds between government agencies) and "true" payments get mixed up. Line by line consolidation of expenditures, autonomous agencies, special accounts and expenditures of the consolidated or budgetary fund is required. Funds and autonomous agencies may have specific management procedures, but must report according to a common set of expenditure classifications (see chapter 3).

90. In several developing countries, lack of training of accountants and lack of clear accounting procedures create difficulties even for accounting for cash payments. Comparisons with bank statements are barely made, forms are coded only approximately, different accounts are confused. These problems, which concern especially small countries, where human resources with the appropriate skills are rare, and must be taken into account when reforming an accounting system. Training and the establishment of a clear accounting procedures are priority actions in such countries.

91. Management of assets is weak in a majority of developing countries. Asset register should be set up and updated, starting with agencies where the need is more urgent.

2. Minimum requirements

92. Whatever the basis of accounting, an accounting system should have the following features:

- Adequate procedures for bookkeeping, systematic recording of transactions, adequate security, and systematic comparison with banking statements. In a number of countries, this requires switching from a single-entry bookkeeping system for tracking transactions at the agency level, to a double-entry bookkeeping system. In several developing countries, comparisons with bank statements are barely made. Improving the situation does not need to

changing the basis of accounting, but requires training accountants and reviewing procedures. Computerizing the accounts may help in improving accounting procedures, but the related security issues must be reviewed. Some countries have implemented or are implementing “light” computerized system to quickly produce monitoring reports. Such systems can improve information dissemination, but often, data are not properly secured (backup procedures, control of accesses, etc.). In such situations, manual systems should not be abandoned completely.

- All expenditure and revenue transactions are recorded in the accounts, according to the same methodology. This covers funds with earmarked revenues and foreign and domestic loans, etc. (see chapter 2 for a discussion of the coverage of the budget).
- A common set of classifications for expenditure along functional and economic categories (see chapter 3).
- Clear and well-documented accounting procedures and clearly defined concepts (as discussed in chapter 6, the notion of commitment, for example, is diversely interpreted).
- Statements regularly produced (see section on reporting below).
- An adequate system for tracking the use of appropriations (“budgetary accounting”), at each stage of the expenditure cycle (commitment, verification, payment).
- Transparent reporting on transactions made through “below-the-line” accounts or liability accounts.

3. Budgetary accounting

93. Sound budgetary accounting requires a double-entry bookkeeping system to record movements between budgetary accounts, namely, budgetary resource accounts (e.g. appropriation, apportionment, allotment); commitments; expenditures at the verification stage; and payment accounts.

94. A double-entry bookkeeping system ensures that outflows match inflows. This system can be simple. Procedures for accounting transactions along the expenditure cycle are as follows:

- *When an order is placed*, it is recorded: a commitment is recorded as: (i) an increase in obligations/undelivered orders; and (ii) a decrease in budgetary resources;
- *At the delivery/verification stage*, a bill is recorded as: (i) accrued expenditure/liability; and (ii) a decrease in the obligations/undelivered orders;
- *At the payment stage*, payment is recorded as: (i) a reduction in accrued expenditure/liability; and (ii) a reduction in cash.

95. In countries that monitor only payments, an immediate action could be to implement an obligation register and an ancillary book for outstanding payments. However, the objective should be to implement a comprehensive budgetary accounting system eventually.

4. Disclosing liabilities

96. Improvements in accounting and reporting on liabilities and contingent liabilities are required in most countries. The following elements should be covered:

- The budget monitoring/accounting system, which should show the arrears that arise from budget execution (which is the difference between expenditures at the verification stage and payments);

- Follow-up of transactions made from the stock of arrears from the previous year;
- Debt accounting on an accrual basis. This is necessary, whatever the basis of accounting;
- Accounting and reporting on other liabilities, such as unfunded liabilities, and on contingent liabilities.

97. Modified accrual accounting gives an appropriate framework for accounting liabilities (in addition, contingent liabilities must be disclosed in supplementary notes). An implementation approach can be to improve an existing cash accounting system gradually, through a more comprehensive coverage and a more transparent disclosure of transactions made through suspense accounts.

5. Caution in implementing full accrual accounting

98. Accrual accounting is standard for nongovernment activities and its importance within governments is increasing. However, caution is required before considering the implementation of a full accrual accounting system.

99. Full accrual accounting requires a comprehensive registration of assets and a sound cost measurement system. Implementing such system governmentwide needs time. Full accrual accounting would not contribute to the development of a performance-oriented approach at the agency level if depreciation is roughly estimated at the end of the year by a Treasury Department that keeps a central account. Some countries are currently implementing a chart of accounts according to full accrual accounting principles, but without having previously implemented an adequate instrument for assessing full costs and recording assets at the agency level. To a certain extent, this gives an appropriate framework for further improvements. However, it is doubtful that such an approach is more beneficial than a modified accrual accounting system that focuses on liabilities and financial assets.

100. Making accrual accounting effectively useful requires switching from an administrative accounting approach that fits budgetary accounting to a true and fair recognition of expenses. Applying only formal accounting rules would not increase transparency. Accrual accounting therefore requires the availability of many high skilled accountants both inside and outside the government.

101. Accrual accounting can improve transparency only if the public is well-informed and knowledgeable about the foregoing issues. It is far from evident that this is true of developed countries (some assign a lot of the blame to the press, including the financial press²²) it is certainly not true of developing countries.

102. Taking these requirements into account, a gradual approach to implementing accrual accounting should be considered. It would start with the areas with a greater need for an assessment of physical assets, their uses and full costs (e.g., estimates of full costs are needed to assess user charges). In many countries, government departments use cash accounting while some autonomous agencies and agencies that perform commercial activities use accrual accounting. The government is thus better able to control the management of these agencies. Donors often request an accrual accounting system for their projects.

6. Administrative organization of an accounting system

103. Two models can be considered for the organization of accounting within the government:

- *Traditional model.* The accounts are prepared at the central level either by the Treasury or a separate Central Accounting Office. This organizational model poses a problem under full accrual accounting, since depreciation, asset value, and analysis of invoices are better assessed at the spending agency level. Even for commitment and expenditure reporting, it poses problems, since agencies often reports commitments and liabilities only when they request payment. Accounting then becomes purely procedural and formal, whereas it should be a tool for program management.

- *Consolidation model.* Spending agencies prepare their accounts for consolidation at the central level. In a computerized environment, consolidation would be facilitated by the implementation of management systems similar to those used by corporate enterprises.

104. Issues related to the organization of accounting, budget execution controls, budgetary accounting, and cash management are linked and need to be reviewed together when implementing an information system.

D. Special issues

1. Generational accounting

105. *Net worth* is the balance of assets and liabilities of the government. Some macroeconomists, following an orthodox monetarist approach, also argue that the permanent income of the country, which depends on the net worth of the government, must be taken into account for macroeconomic stabilization. However, further economic research on this subject is needed.²³

106. Several tools have been developed to evaluate the long-term impact of current policies on the net worth of the government (e.g., the measurement of contingent liabilities²⁴, environmental accounting). Basically, this impact is estimated by the actuarial balance of flows of revenues, payments, depreciation of assets, etc. under different assumptions and for a particular discount rate.

107. *Generational accounting* calculates, over a long period, the present value of public consumption, taxes, debt and intergenerational transfers (i.e., pensions) for a set of growth and demographic assumptions and for a specific discount rate.²⁵ It takes into account government revenues and expenses on the basis of the generation to which these transactions are linked by adding up the present value of receipts less payments that a government expects to collect over the life span of the generation.²⁶ It is considered an important tool to describe the way the government budget affects

intergenerational distribution and an essential measure of the burden imposed by current and future budgetary policies on current and future generations. Likewise, it is an important indication of how the budget affects national savings and, thus, investment, interest rates, and growth.

108. Developers of generational accounting initially thought of it as an alternative to the traditional manner of accounting for the government's revenues and expenses. They argued that traditional approach focuses only on the very short-term, thereby creating a bias for fiscal policy, and fails to consider the future implication of government policies. They also believed that the conceptual framework underlying the traditional manner of accounting for government revenues and expenses no longer exists and that classifications are "arbitrary" and oftentimes manipulated for political reasons.²⁷

109. Intergenerational equity requires that these flows be balanced to avoid creating a burden on future generations. Such calculations are made in several countries. The United States was the first OECD country to use generational accounting by presenting such accounts in its Fiscal Year 1996 Budget. Several OECD countries followed, including Germany, Italy, New Zealand, Norway, Sweden, and lately, The Netherlands.

110. Studies by the IMF and the OECD concluded that given the potential pitfalls and weaknesses of generational accounts as a measure of how the government budget affects intergenerational distribution and savings, strong caution should be exercised in their use and interpretation. In the absence of an explicit consideration of the intergenerational implications of the government consumption program, convincing evidence that the life-cycle model adequately characterizes private consumption behavior, and a fully articulated model of the general equilibrium repercussions of budgetary policy, what generational accounts are expected to indicate could be totally misleading. Generational accounting is used only as an analytical tool to illustrate the trends of government policy.²⁸ As Premchand notes, Generational accounts can serve at best only as analytical inputs, primarily because of the aggregate nature of the analysis and the imputations involved.²⁹ Moreover, to assume a significant impact of generational accounting on actual policy, politicians (and the public) around the world

would need a far longer time perspective than is typically the case. As John Maynard Keynes remarked long ago: "In the long run, we are all dead."

111. It must be emphasized, however, that generational accounting is a very recent technique and in many respects is still undergoing enhancement. For instance, New Zealand has included education expenditures in addition to health care expenditures in its recently prepared generational accounts. In cases where a direct relationship between age groups and expenditures is hard to establish, certain expenditures are grouped as predominantly serving the young or the elderly, and use a per capita basis for distribution. Moreover, generational accounts can be enhanced by dividing more expenditure categories across generations and by incorporating a retrospective time horizon whereby taxes and benefits are calculated not only for the remaining lifetime of each generation, but also for what the generation has already paid in taxes and received in benefits in previous years. This will provide for better comparisons between generations.³⁰

2. Cost measurement

a. Objectives

112. Experiences in measuring central government costs on a wide scale date from 1949, when a comprehensive exercise of performance budgeting was launched in the U.S. following the recommendations of the Hoover Commission. As discussed in chapter 3, this experience was not successful.³¹ Concerning cost measurement, difficulties were due both to technical problems and to the fact that "the government was more concerned with providing a service than recovering costs."³² A new impetus has recently been given to cost measurement in several countries, aimed at setting-up instruments to improve the performance of government services.

113. Cost information can be used in the following areas.³³

- *Budgeting and cost control.* Information on the costs of program activities can be used as a basis to estimate future costs in preparing and reviewing

budgets. Once budgets are approved and executed, cost information serves as feedback to the next budgets;

- *Performance measurement.* Measuring costs is an integral part of measuring the efficiency and effectiveness of performance. Efficiency is measured in terms of the cost per unit of output. Effectiveness is measured by the outcome or the degree to which a predetermined objective is met (see chapter 15 for a full discussion).
- *Determining reimbursements and setting fees and prices.* Setting prices in social sectors may be a policy matter, but a good measurement of costs of services delivered is needed to assess the cost of policy choices.
- *Program evaluation.* Information on program costs provides a basis for cost-benefit considerations.
- *Market testing.* As mentioned in chapter 6, market testing requires cost comparisons among several alternatives.

b. Cost measurement systems

114. Total costs comprise: (i) direct or variable costs that can be assigned to a product, such as raw materials; and (ii) indirect or fixed costs (overhead) that are shared among several outputs. Within government departments, the problem of allocating overhead to output is particularly important, since the share of resources that cannot be assigned to a single output is generally significant. Often this allocation is arbitrary or biased or derived from a simple ratio, for example, from the direct labor cost of the output. Using arbitrary methods diminishes considerably the utility of cost measurement for management or decision making.

115. Costing methods are essential elements of management systems.³⁴ They aim notably at addressing problems related to the allocation of overheads. Activity-based costing (ABC) has gained broad acceptance by the manufacturing and service

industries. It is used within some governments, sometimes along with other costing methods.³⁵

116. ABC systems trace individual costs back to the primary activity. This approach consists of the following steps.³⁶ (i) identifying activities within the organizational unit or the project; (ii) assigning resources to the activities (resource costs may be assigned to activities through direct tracing or estimation based, for instance, on surveys); (iii) identifying the outputs of the activities (the outputs can be products or services provided); and (iv) assigning activity costs to the outputs, through cost drivers. A driver may be the number of times an activity is performed in producing a specific type of output, the length of time an activity is performed, etc.

117. Costing methods provide tools for analyzing costs, but operations and activities conducted within the organization must be analyzed in detail, appropriate accounting and information systems must be set up, information must be updated regularly, etc. The allocation of costs is not an objective science and the successful introduction of activity-based costing requires the active cooperation of management and staff. Whether or not it is worth the trouble depends on country-specific considerations.

Box 30
An Example of Activity-Based Costing

**The Unit Cost of a Veteran's Benefit Check Processed for the
Compensation and Pension (C&P) Service by the Finance Department.**

- Direct labor incurred by the Finance Department in processing 700,000 C&P checks **\$700,000**
- Direct materials incurred by the Finance Department in processing 700,000 C&P checks **\$20,000**
- Indirect materials are assigned to C&P based upon C&P's share of total checks processed by the Finance Department. Assume that the Finance Department processed 1,000,000 checks during the fiscal year, 700,000 of which belonged to C&P, and that total indirect expenses incurred by the Finance Department during the current fiscal year amounted to 500,000. Therefore, C&P's assignment of indirect costs is **\$ 350,000**

Total expenses assigned to C&P for processing 700,000 checks \$1,070,000 divided by 700,000 checks processed for C&P equals the unit cost of processing one check \$1.53

In traditional federal accounting, costs are accumulated by object class categories such as salaries and benefits, office supplies, travel, and equipment. With ABC, costs are calculated by activity or process such as conducting biennial user fee reviews, or writing cost accounting policy.

Source: U.S. government, *Managerial cost accounting implementation guide*, 1998.

c. Relevance of cost measurement

118. Currently, only a few developed countries are implementing cost measurement on a large scale. In New Zealand, output budgeting implies a direct relationship between cost measurement and budgeting, but developing cost measurement systems needs time. In the U.S., the relationship between cost measurement and budgeting is indirect. Cost measurement is seen as a tool for improving performance, helping budget decision making, and giving feedback, but appropriations for the running costs of departments are cash based.

119. In developing countries and transition economies, implementing cost measurement should be considered only for special programs or agencies, notably agencies that recover costs from the users and development projects of a significant size (e.g., a large agricultural development project). However, to determine the extent

on which cost measurement can be implemented within a government, the cost effectiveness of carrying out this exercise must be assessed.

3. Capital charges

120. To account for the full costs of capital assets used in the provision of goods and services, it is necessary to take into account both (i) depreciation; and (ii) the remuneration of capital employed. Only a handful of countries have introduced a capital charge, explicitly shown as an expenditure item in the budget of departments or agencies.³⁷ This capital charge is calculated by applying a charge rate to the departmental or agency assets.

121. Thus, in New Zealand, a charge for the use of capital was introduced in 1991. A charge rate of 13 percent was applied to the assets of agencies and departments, the payment of the charges being imputed to their budget (later a number of departments negotiated particular rates with the Treasury).³⁸

122. Introducing a capital charge can give incentives to spending agencies to use their capital more efficiently and can improve cost estimates, which are needed for establishing cost recovery. However, if applied without any change in management, there is a risk that capital charge would just be a formal procedure, compensated by an equivalent increase in budget appropriation. Its implementation requires appropriate systems for registering assets, and clearly delineating the organization responsible for asset acquisition and disposal. The capital charge needs to be integrated within appropriate cost management and cost measurement systems. It is only one of the many elements needed to improve management and cost consciousness.

123. In theory, the capital charge could be used as an instrument for allocating resources, for example, for distributing grants among local governments or among spending units that perform the same kind of activities. However, to assume that inherently political choices are amenable to “technical” solutions is a technocratic illusion that was dispelled in the 1930’s.³⁹

¹ A pioneer operation to prepare a modified accrual accounting framework was carried out in Africa by the UDEAC in the 1970s.

² See Premchand (1993), page 267.

³ See, for example, Peter Dean, Government accounting in developing countries in Naomi Caiden, *Public budgeting and financial administration*, Jai Press, 1996.

⁴ IFAC Financial reporting by national governments, 1991. IFAC (International Federation of Accountants) is an association of professional accounting bodies in 84 countries, which seeks to recommend unified standards of accounting. Its Public Sector Committee (PSC) deals with accounting standards for government and public entities.

⁵ "Statistics based on payment are to be preferred for total revenue and expenditure, measuring aggregate impact on the monetary accounts and the rest of the economy. Payments data represent the best ready approximation of the flows of funds and resources; they avoid problems of valuing resource flows; they correspond most closely with other financial statistics; and they constitute the basis on which most governments keep their accounts", IMF *Manual on Government Finance Statistics (GFS)*, 1986, page 31; as noted in chapter 2, GFS is in the process of being modified incorporate accrual accounting elements).

⁶ Besides this, payments during the complementary period are reported as movements of cash balances of the year at which they occur and debit of a "previous year budgetary expenditures" account.

⁷ Or more simply accrual accounting. In this volume, the adjective full is added to avoid confusion with the terms modified accrual accounting or expenditure (at the verification stage) accounting which are often confused with accrual accounting" proper.

⁸ IFAC (1991),

⁹ GAAP are the principles defined by the accountants' professional organizations (see reference).

¹⁰ In the U.S., the budget is mainly cash-based. However, appropriations for government lending are on an accrual basis, and for some other programs they are obligation-based. Full accrual accounting is made for operating assets and liabilities, but not for "stewardship" resources (military assets, national parks, etc.), for which separate statements on a full accrual basis are prepared.

¹¹ The Australian system, which until 1998 was centralizing each transaction, is in the process of adopting a consolidated approach for accounting ("AIMS will not record agency payments and receipts transaction data. Agencies will provide a summary of actual monthly data to the central system for consolidated reporting purposes." Presentation of the AIMS system, Department of Finance and Administration. Australia. 1998).

¹² Concerning countries that accumulate tax arrears that will never be collected, the SNA manual states: It may be preferable for analytic and policy purposes to ignore unpaid taxes liabilities and confine the measurement of taxes within the System to those actually paid (SNA. 1993, page 192).

¹³ See Glenn Ross and John J Kelly, From cash to accrual: The Canadian experience in IFAC *Perspectives on accrual accounting*, 1997.

¹⁴ FASAB Accounting for liabilities of the federal government, 1995.

¹⁵ Many of these devices were employed, or alleged to be employed, by some member states of the European Union before 1998 to meet the fiscal deficit requirements for a mission to the common European currency, the euro.

¹⁶ E.g., military equipment is considered as a consumption in the SNA and as an asset in New Zealand. The U.S. has adopted an intermediate position (see above).

¹⁷ Not to be confused with the operational deficit defined in chapter 4.D.1.

¹⁸ For a discussion of the advantages of the operating deficit, see Builter, Measurement of the public sector deficit and its Implications for policy evaluation and design, in Mario Blejert and Adrienne Cheasty, *How to measure the fiscal deficit*, IMF, 1993.

¹⁹ "[The scope for creative accounting] is greatest where there is trading, accrual accounting and ambiguity in the rules. It is least with cash accounting and clear rules. With commercial style accounts. there are further pressures which reflect the much greater creative accounting possibilities of the private sector, (Liekerman).

²⁰ " According to certain critics of accrual budgeting, even in a country such as the United Kingdom with a tradition of budget discipline and plenty of skilled accountants, accrual budgeting may weaken compliance and increase red tape Resource Accounting Budgeting (RAB) [i.e. accrual-budgeting] may weaken control of public expenditure; attention is likely to be diverted from a manageable concern with revenue raised and with the money spent in a particular year to a more speculative concern with outputs and results achieved over a longer period, and with the full costs and benefits of operations, over all of which there is scope for

considerable disagreement. The system tips the balance more in favor of expenditure advocates than watchdogs, and constitutes an inflationary pressure. RAB will be a costly venture. RAB will encourage further centralization in an already highly centralized state. Central government will require more central budget staff. RAB may erode the process of audit, by turning attention away from traditional auditing concerns, like compliance with spending limits", George Jones, London School of Economics, "Resource accounting and budgeting: another false Trail?" in IFAC *Perspectives on accrual accounting*, 1996.

²¹ In France, for example, it is compulsory to include in local government budgets depreciation allowances and other reserves. This, together with the golden rule limit, is seen as an instrument to keep the local government budget under control (see Jean-Francois Copé and François Werner, *Finances locales, Economica*, 1997).

²² "Why does not the *Wall Street Journal* run an article when the Consolidated Financial Statement report comes out, when they [the press] do cover it [audit report], the political writers cover it instead of business writer", Edwards, Accounting systems in newly-independent nations", Internal consortium on government financial management, February 1998.

²³ This issue is discussed in William Buiter, Measurement of the public sector deficit and its implication for policy design; Mario I. Blejer and Adrienne Cheasty, The deficit as an indicator of government solvency: changes in public sector net worth" in Blejer and Cheasty.

²⁴ See Christopher M. Towe in How to measure the fiscal deficit", Blejer and Cheasty.

²⁵ See IMF Generational accounts. Aggregate savings and intergenerational distribution, July 1996.

²⁶ A generation is defined as persons born in the same year, and differentiated into male and female. This differentiation recognizes the different lifetime patterns of tax payments and benefit receipts for the two groups. For more discussion, see Generational accounts, Aggregate savings and Intergenerational distribution, Willem H. Buiter, July 1996.

²⁷ Refer to pp. 14-15 of Budgeting for the future, OECD working paper vol. 5 for a more detailed discussion.

²⁸ See, for example, Robert Hagemann and C. John, The fiscal stance in Sweden: A generational accounting perspective, IMF, 1995.

²⁹ Premchand, *Effective government accounting*, 1995; An analysis of the conditions of validity of the generational accounting methodology can be found in IMF Generational accounts. aggregate savings and intergenerational distribution, July 1996.

³⁰ Refer to pp. 16-18 of "Budgeting for the future for further discussion of more issues.

³¹ A presentation of this performance budgeting experience may be found in GAO, Performance budgeting: past initiatives offer insight for GPRA implementation and in Premchand (1983).

³² Premchand, *Effective government accounting*, IMF, 1993.

³³ Drawn in large part from Office of Management and Budget, Managerial Cost Accounting Concepts and Standards for the federal government, Statement of recommended accounting standards number 4, 1995.

³⁴ Issues related to cost management systems and their application within the Government are reviewed in Premchand, 1993.

³⁵ As in the U.S. and New Zealand.

³⁶ From OMB, op. cit.

³⁷ As in New Zealand for all departments, and United Kingdom for trading units and the National Health Service.

³⁸ Graham C. Scott, op cit.

³⁹ This is illustrated by the public funding of New Zealand universities, where much effort has been devoted to the development of capital charging without so far securing implementation. In reality, what has held up the process is not a technical issue, but the allocation of funds among universities. The UK reader might reflect on what would happen if a proposed capital charge in this country were to make one particular university a major gainer at the expense of another major university, David Heald and Alison Dowdall, Capital charging as an efficiency mechanism in central government, a paper presented to the Public Sector Management Conference for the Next Century, Manchester, 1997.

Chapter 11. REPORTING

A. REPORTING

1. Objectives of reporting¹

Traditionally, reporting was aimed at showing compliance with the budget. While this function is met in countries with a parliamentary tradition and adequate audit capacity, in other countries, improving compliance remains the priority challenge. Nevertheless, transparency and accountability call for wider scope of reporting.

A budget reporting system should provide a means of assessing how well the government is doing. Ideally, therefore it should answer following questions:

- *Budgetary integrity.* Have resources been used in conformity with legal authorizations and mandatory requirements? What is the status of resources and expenditures (uncommitted balances and undisbursed commitments)?
- *Operating performance.* How much do programs cost? How were they financed? What was achieved? What are the liabilities arising from their execution? How has the government managed its assets?
- *Stewardship.* Did the governments financial condition improve or deteriorate? What provision has been made for the future?
- *Systems and control.* Are there systems to ensure effective compliance, proper management of assets and adequate performance?

Reports are an important instrument for planning and policy formulation. For this purpose, they should provide information on ongoing programs and the main objectives of government departments. Reports can also be used for public relations and be a source of facts and figures. They give an organization the opportunity to present a statement of its achievements, and to provide information for a wide variety of purposes.

Reporting must take into account the needs of different groups of users including: (i) the Cabinet, core ministries, line ministries, agencies, and program managers; (ii) the legislature; and (iii) outside the government, individual citizens, the media, corporations, universities, interest groups, investors, and creditors.

According to surveys carried out in several developed countries,² all users need comprehensive and timely information on the budget. The executive branch of government needs periodic information about the status of budgetary resources to ensure efficient budget implementation and to assess the comparative the costs of different programs. Citizens and the legislature need information on costs and performance of programs that affect them or concern their constituency. Financial markets need cashbased information, etc.

2. Principles of reporting³

Reports prepared by the government for internal and external use are governed by the following principles:

- *Completeness.* The measures, in the aggregate, should cover all aspects of the reporting entity's mission.
- *Legitimacy.* Reports should be appropriate for the intended users and consistent in form and content with accepted standards.
- *User friendliness.* Reports should be understandable to reasonably informed and interested users, and should permit information to be captured quickly and communicated easily. They should include explanations and interpretations for legislators and citizens who are not familiar with budgetary jargon and methodological issues. Financial statements can be difficult for nonaccountants; where possible, charts and illustrations should be used to improve readability. Of course, reports should not exclude essential information merely because it is difficult to understand or because some report users choose not to use it.

- *Reliability.* The information presented in the reports should be verifiable and free of bias and faithfully represent what it purports to represent. Reliability does not imply precision or certainty. For certain items, a properly explained estimate provides more meaningful information than no estimate at all (for example, tax expenditures, contingencies, or superannuation liabilities).
- *Relevance.* Information is provided in response to an explicitly recognized need. The traditional function of year-end reports is to allow the legislature to verify budget execution. The broader objectives of financial reporting require that reports take into account the different needs of various users. A frequent criticism of government financial reports is that they are at the same time overloaded and useless.
- *Consistency.* Consistency is required not only internally, but also over time, that is, once an accounting or reporting method is adopted, it should be used for all similar transactions unless there is good cause to change it. If methods or the coverage of reports have changed or if the financial reporting entity has changed, the effect of the change should be shown in the reports.
- *Timeliness.* The passage of time usually diminishes the usefulness of information. A timely estimate may then be more useful than precise information that takes longer to produce. However, the value of timeliness should not preclude compilation and data checking even after the preliminary reports have been published.
- *Comparability.* Financial reporting should help report users make relevant comparisons among similar reporting units, such as comparisons of the costs of specific functions or activities.
- *Usefulness.* Agency reports, to be useful both inside and outside the agency, reports should contribute to an understanding of the current and future activities of the agency, its sources and uses of funds, and the diligence shown in the use of funds.

d. Special and general purpose reports

A distinction between special purpose reports, prepared to meet specific needs, and "general-purpose financial reports, prepared for a large public,⁴ can help to define the presentation and the mode of dissemination of the reports. For example, reports needed to monitor budget implementation are special-purpose reports while financial statements should be considered as general-purpose reports. However, the distinction is partly subjective and depends on the country context. Many governments have special reporting requirements , e.g., environmental reporting (resulting from environmental audits) or retirement fund reporting (for pension policy), and the like. This type of reporting is becoming more frequent as governments face the need to respond to pressures from various interest groups.

3. Budget execution reports

a. Budget implementation management

For managing budget execution the following reports are needed:

- Daily flash reports on cash flows. These reports should distinguish inflows and outflows, but it is better for cash flow forecasting to have a breakdown of expenditure and revenue by broad economic categories (at least weekly).
- Monthly reports on budget execution based on the budget classification system. These reports must specify:
 - Initial appropriation;
 - Revision appropriation (if any);
 - Amount apportioned;
 - Commitments, expenditures at the verification stage, payments, or (at least) arrears and payment;

b. Appropriation Account

In a majority of countries, an annual appropriation report (or budget enforcement report) is generally submitted to the audit office and the legislature. This report is essential, but is insufficient to provide information on fiscal sustainability and performance and should be only one element of the reporting system. In many developing countries, the production and the publication of the annual report takes at least a year, making it useless for external users. Moreover, taking into account time needed to audit these accounts, preliminary information on budget execution must be available and published no later than two months after the end of the budget period.

4. Financial reporting

Financial Statements, as currently defined, fit better an accrual accounting system than a cash accounting system. However, regardless of the accounting system, certain minimum reporting requirements should be met in any country. Sample tables for each of the reports discussed below are shown in annex X.

a. Minimum financial reporting requirements

Whatever the accounting system, the objective should be to produce the following reports, and therefore to keep appropriate accounting books or ancillary registers:

1. *Consolidated accounts.* The government should publish an analytical report on consolidated financial operations of the government. This report should be prepared in accordance with GFS standards, complemented with accrual information for debt, information on expenditures at the verification stage, and information on arrears. This report consists of three tables showing the government financial operations for (i) central government; (ii) local governments; and (iii) general government. Financial information for “funds” should be consolidated into the accounts of the relevant level of government. The report should cover at least two fiscal years to allow comparisons. Box 33 shows the main elements to be included in the government consolidated accounts.

Box 33
Elements to be Included in the Government Consolidated Account

Cash basis

Revenues, broken down into broad categories;

Grants, including grants-in-kind and debt remission;

- Non interest expenditures;
- Interest;
- Capital expenditure broken down by financing source (i.e., domestic, project loans and grants);
- Lending minus repayment. preferably to divided between gross lending, repayments, no sales of assets, rather than shown as net lending;
- Deficit on a cash basis;
- External financing (project loans, other loans, amortization, debt rescheduling);
- Domestic financing (central banks, commercial banks, nonbank lending)

Commitment basis

- Wages and salaries;
- Other goods and services, preferably at the verification stage;
- Capital expenditures, preferably at the verification stage;
- Interest on an accrual basis;
- Deficit on a commitment basis;
- Flows of arrears (domestic and external), including any undelivered orders on a separate line;
- Adjustment for project loans (drawings less expenditures).

Either in the tables or as a memo item to show, when practical:

- Breakdown of expenditure between true capital expenditures and current expenditures;
- Breakdown of expenditures between the recurrent budget, the capital budget, and funds.

Some developing countries do not prepare the consolidated accounts of the government on a consistent accounting basis. When preparing a financial program with the IMF, they gather data from budget monitoring reports, from the central bank, extra budgetary information, etc. Outflows and inflows estimated in such a manner cannot be balanced. As a result, the consolidated accounts show a gap, which is often hidden under the catch-all heading of arrears.

This information should be derived from the government accounts. When extra-accounting elements are introduced in the consolidated table, they should follow a double-entry procedure should be followed. For example, if arrears for utility consumption are estimated from data not recorded in the government accounts, they should be posted both as expenditure and as arrears.

2. *Statement on stock and flows of domestic arrears.* This report separates arrears to the private sector from arrears, to subnational government entities and to the non government public sector.
3. *Summary report on the execution of the government expenditure program.* This report covers expenditure from the budget and funds by broad function and programs (if any). It should distinguish between current and capital expenditures, show previous years for comparison, and give estimates for the following year if the country prepares multi year estimates. The report should cover at least two fiscal years to allow the user to make comparisons. It should include a narrative statement on government expenditure policy.

A consolidated report should be prepared for (i) the central government; (ii) local governments; and (iii) the general government. All tables or memo items required for comparison with the annual budget report and other reports (e.g., local government execution budget and funds reports) should be annexed to this report.

In a country with an arrears problem, this summary statement should be produced for both cash payments and expenditures at the verification stage.

4. *Report on medium-term external debt.* The report on the medium-term external debt should include the following statements:
- * Debt outstanding and disbursed (DOD) for medium-term external public debt, classified into the following categories:
 - DOD without arrears, with interest arrears, and with principal arrears;
 - Directly contracted debt and guarantees;
 - Broad categories of creditors (e.g., Multilateral Institutions; Commercial Creditors);
 - Broad categories of beneficiaries of guarantees (e.g., industrial state enterprises; agricultural enterprises);
 - Debt instruments (loans and other obligations).
 - * Objections of public debt service for the next five to ten years, distinguishing:
 - Directly contracted debt, and guaranteed debt, by broad category of creditor;
 - Projections on both an accrual basis and cash basis for partly rescheduled debt;
 - New borrowings;
 - Rescheduling over the period.
5. *Report on short-term borrowing.* The format of this report depends on the level of development of the financial markets in the country. Depending on the composition of its debt and on the organizational arrangements within the country, the report can be consolidated with the report on medium-term debt or prepared separately.
6. *Report on grants.* This report should show donor pledges, disbursements (from the donor's point of view), and estimated of receipts (see discussion below).
7. *Report on lending and on-lending.* This report shows loans contracted, interest and principal payments over the period, and stock and flows of arrears by major

category of beneficiary. It should include a narrative on any problems met in collecting payments from debtors, and assessment of future risks.

8. *Statement on forward commitments.* In fulfillment of accountability to the legislature, the report on forward (multi year) commitments should show forward commitments and the projected payment schedule by function/program and line ministry/agency.
9. *Statement of cash flows.* Like a normal commercial bank monthly statement, this statement shows flows of cash revenues and cash payments, and opening and closing cash balances. It covers all government cash and bank accounts, and is normally produced directly from government accounts.
10. *Statement of tax expenditures.* It is desirable to give estimates on tax expenditures by sector/function and type of tax concession.
11. *Statement of other liabilities and other contingent liabilities.* If possible, in addition to the debt reports, this statement could be prepared to show other liabilities and contingencies, such as pension liabilities, insurance contingencies.
12. *Statements on physical assets and investments for selected sectors/programs.* For the infrastructure sector, it can be useful to produce statements showing the most significant assets, the investment made on an accrual basis (i.e., the increase in physical assets which can be very different from expenditures), and maintenance, including deferred maintenance. This statement can be included in the report on development expenditures mentioned in section 6 below. Generally, other statements of assets concern the internal management of the agencies or are inputs to the preparation of performance indicators.

b. Financial statements under an accrual accounting system⁵

Accrual accounting systems allow the preparation statements that give a much more complete view of the financial situation of the government, and a consistent and comprehensive framework for preparing the reports mentioned in the previous section.

Moreover, financial reports prepared by ministries and agencies on the basis of full accrual accounting can be used in assessing their performance.

An accrual accounting system commonly entails the preparation of the following financial statements:

- *Financial position statement (or balance sheet)*. The statement of financial position includes details of all recognized assets and liabilities. The balance of assets less liabilities is the net worth.
- *Financial performance statement (or Operating statement)*. Under full accrual accounting the statement of financial performance includes details of all recognized revenues and expenses, and the operating deficit. To avoid confusion, it is essential that the deficit on an accrual basis be compared to the deficit on a cash or commitment basis. Adequate caution must be given to the report users on this crucial issue to avoid giving a misleading assessment of the macroeconomic situation.
- *Statements of movements in net worth*. This statement links the statement of financial performance to the statement of financial position and explains movements in the opening and closing balances.
- *Statement of cash flows* (see discussion in A.4.a).

Notes to the financial statements should provide as much detail as needed to interpret the statements correctly and also a statement of accounting policies

These statements must be complemented with the reports mentioned in paragraph E.4.a above for the fields that they cannot cover or do not detail sufficiently (e.g., commitment, contingencies, tax expenditures, details on debt and borrowing).

d. *Coverage of financial reports within the government*⁶

Financial reports should cover all government entities. Fund accounting poses a problem in many countries. As explained in chapter 2, these funds include both independent funds and special accounts managed by the Ministry of Finance or the Treasury. When fund accounting is not consolidated line by line, the revenues and expenditures of the government are inflated by transactions between funds, which constitute instead a mere transfer within the government sector. Moreover, under accrual accounting, when revenues attributed to a fund are greater than its expenditure, the excess revenue is included as a liability on the government's books, while any excess of deficiency of expenditure appears as an asset⁷. When, these funds, in the aggregate, have significant financial imbalances, the financial position of the government can be seriously distorted.

Whether extrabudgetary funds are or are not justified in a particular country, there is no reason to exempt them from the accounting and reporting obligations to which all other government entities are subject. All funds and accounts of all entities of the government must be consolidated. To make this consolidation possible, the chart of accounts of government entities and the economic and functional classification of their budget must fit a common set of accounts and classification determined at the central level (the general ledger discussed earlier).

Good financial reporting is required for accountability. However, the allocation of resources is made through the budget process, and implementing a sound financial reporting system for existing extrabudgetary funds will in no way strengthens the case for their retention.

e. *Nongovernment public entities*

While the scope of the budget is limited to the government, as defined in chapter 2, a broader scope should be considered for financial reporting. Entities controlled or owned by the government should produce regular financial reports. The accounts of entities carrying out business activities should be on a full accrual basis, and their financial statements should be those required under accrual accounting. These accounts

should be consolidated by the government and published. Such information is needed by the public and for policy making, notably subsidies, the financing capital expenditures of public enterprises, on-lending, etc.

Some countries have adopted the concept of “the government financial reporting entity,”⁸ i.e., the set of entities, transactions, and activities for which the government is accountable and that are to be covered by government financial reports. Criteria for defining the boundaries of the entity are financing, ownership and control. Control is the criterion that is more consistent with the objective of financial reporting, since government should be accountable for the resources and entities it controls, regardless of government financing or degree of ownership. However, this criterion requires a greater element of subjective judgment.

Rules for identifying the government entities that must produce financial statements are established either via legislation (as in Bangladesh, Taiwan, France, and Italy) or through accounting principles, such as the notion of control and the existence of users for which the information will be useful (as in Australia and New Zealand).

5. Departmental reports⁹

Departmental reports show the activities of line ministries and government spending agencies, and give important information for deciding the intersectoral allocation of resources. If they are available before the start of budget preparation (which is desirable), they can be useful in preparing the initial budget ceilings. In some countries, these reports are discussed in legislative committees and made public.

There is no standard presentation for a departmental report. Ideally, it should include the following elements:

- Major issues in the sector;
- Goals of the department and policies to meet them;
- Programs and activities of the department;
- Fiscal performance and financial statements;
- Estimated expenditures in future years;

- Performance indicators;
- Other relevant information, e.g., tax expenditures in the sector.

6. Development/Investment expenditures reports

The system of reporting on investment expenditures depends on the organizational arrangements. In any event, the presentation of investment expenditures in a unified report or as an identifiable part of a departmental report is systematically required in aid-dependent countries and generally desirable in other countries. Reports on development/investment expenditures should show, by program/project:

- Actual expenditures at the verification stage (not only the cash payments) during the fiscal year ;
- Actual expenditures of the previous fiscal year;
- Estimate costs of ongoing programs/projects for the three or four assignment years.

In a small country, investment expenditures are presented by project. In a large country, this report should be presented by program. However, ongoing projects of national importance and significant size should be identified. For each project, the report should indicate: (i) annual projected costs over a period of three to four years; (ii) total costs; and (iii) the balance required to complete the project after the three or four year period.

In addition, accrual-based information on the progress of projects is important, especially in transport, communication, energy and public works, where payment schedules do not necessarily coincide with physical implementation. For large infrastructure projects, the increase in asset value can be presented, along with the indicators of physical progress. For programs, performance indicators can be measured as well, particularly in the social and agriculture sectors. (issues related to performance measurement are discussed in chapter 15.)

Information on projects financed with external loans should be presented at the verification stage. Information on financing presented in the government account is

based on disbursements. No matter how efficient the system of data collection within the country, there is always a time-lag between drawings from loans and verified expenditures, and the length of the time-lag depends largely on the procedures of the lender. Because the difference between drawings and expenditures may be large, these data must be compared the difference and explained. Drawings and expenditures made from special funds must also be required.

In principle, grants-in-kind should be reported at the time when these are received. Discrepancies with information from donors should be identified and explained. In practice, however, many aid-dependent countries rely on information from donors to estimate expenditures financed grants-in-kind. This often leads to mixing cash-based information from some donors with commitments or “pledges” from other donors. A better monitoring of grants is needed in most aid-dependent countries. Except when special disbursement procedures have been established, this monitoring should be done at the project level, the only level where expenditures financed with grants can be reliably estimated. Even then, data from donors must be collected and compared with the data from the projects.

B. MAIN ISSUES AND DIRECTIONS IN REFORMS

1. Main Issues

a. Accounting systems

Accounting and reporting systems are crucial for budget management, accountability, and policy decision making.

For financial reporting, accounting systems are classified into the following categories:

- Cash accounting, which focuses on cash flows and cash balances. Provided that it is supplemented that it is complemented by an adequate system for recording commitments and reporting on arrears, cash accounting can fit expenditure control needs.

- Modified cash accounting, which includes a complementary period for recognizing end-of-year payments.
- Modified accrual accounting, which covers liabilities and financial assets. Modified accrual accounting gives a complete framework for registering liabilities and expenditures;
- Full accrual accounting, which is similar to the accounting systems of commercial enterprises. Accrual accounting gives an appropriate framework for assessing full costs and performance and also for registering all assets and liabilities. However, it has tough implementation requirements.

a. *Accounting: Minimum Requirements*

Whatever the basis of accounting, the accounting system should have the following features :

- Adequate bookkeeping procedure, systematic recording of transactions, adequate security, and systematic comparison with banking statements;
- Recording of all expenditure and revenue transactions in the accounts, according to the same methodology, including, notably, expenditures from funds and autonomous agencies, and foreign financed aid (see chapter 3);
- A common set of classifications for expenditure into functional and economic categories (see chapter 2);
- Clear and well-documented accounting procedures;
- Regularly produced statements (see section on reporting below);
- System for tracking the use of appropriations (budgetary accounting, at each stage of the expenditure cycle (commitment, verification, payment));

- Clear procedures and full disclosure of operations made below the line or through liability accounts.

b. Reporting System

The reporting system must be designed to fit the needs of the different report users (the public, budget managers, policy decision makers, etc.). Minimum reporting requirements include:

- Budget management reports showing all movements in appropriations and line items (allotments, supplementary estimates, virements, etc.);
- Accountability reports to the legislature,
- Financial reports: consolidated accounts of the general government, statement of arrears, report on debt and contingent liabilities, and report on lending;
- Reports assessing budget policy, and
- Departmental reports.

2. Accounting and reporting improvements

a. Immediate actions

In a majority of developing countries, it is necessary first to focus on the following:

- Implementing a commitment register and an ancillary book for outstanding payments, countries that monitor only payments and more generally, implementing a comprehensive budgetary accounting system and register

expenditure at each stage of the expenditure cycle. Budget execution reports must show expenditures at each stage of the expenditure cycle.

- Developing a dept accrual accounting system if none exists, and preparing comprehensive reports on debt.
- Consolidating fund operations (if any) and ensuring that all government entities submit reports based on the same set of classification must be set up.
- Recording contingent liabilities, and preparing and publishing statements of these liabilities.

b. Further improvements

Further steps should include:

- Implementing of a modified accrual accounting system, to have a comprehensive framework for reporting on liabilities, and systematic recording of contingent liabilities.
- Publishing financial statements.
- Implementing asset registers, at least for the categories of assets that need to be carefully monitored.

Box 34**Canada's Awards for Excellence in Annual Reporting by Public Corporations**

In 1993, the Auditor General of Canada announced a five-year award program for Excellence in Annual Reporting by Crown Corporations. The award is intended to recognize corporations that have prepared exemplary annual reports as accountability documents and to encourage and guide Crown corporations in improving corporate reporting. It is a response to the growing recognition throughout the public and private sectors, in Canada and elsewhere, of the importance of more information on corporate performance in enhancing accountability. Improved performance reporting is especially important in the case of state enterprises wholly-owned by Crown corporations because they deliver a mix of public policy and commercial objectives.

In times of fiscal restraint and deficits, performance reporting becomes even more important. Information on financial results alone does not adequately address the full range of stakeholders' interests and information requirements. While Crown corporations are distinct legal entities, they are accountable to Parliament through the responsible minister. More attention needs to be given to providing more comparable and consistent information on parliamentary funding. The establishment of annual award for Crown corporations will encourage greater accountability to Parliament among these corporations through improved reporting.

The Auditor General Awards for Excellence in Annual Reporting by Crown Corporations are given on the basis of four main factors: excellence in reporting both financial and operational performance; provision of clear, relevant, and meaningful objectives that can serve as indicators for measurement and reporting; emphasis on the corporate environment and the risks inherent in operations; and discussion of future directions and plans.

An assessment was carried out during the year to determine whether the award program had a positive impact on the corporations' performance reporting and whether it would be worthwhile to continue the program. The corporate plan summaries and annual reports of a number of Crown corporations for years 1 and 4 were compared to determine whether the reporting had improved and Crown corporations were consulted to determine whether the program had a positive impact on their performance. Almost 80 percent of the corporations in the sample were found to have improved their reporting performance.

A majority of the respondents in the survey likewise believed that the program should be extended and expanded to include other agencies, corporations, and departments. The award program has developed in these corporations a sense of pride, and a competitive spirit, and has focused more attention on the quality of reporting. One respondent commented, "Although we were fortunate enough to win the award in 1994 to 95, this has not stopped us from continuing our efforts each year to improve and hopefully, to win again."

Source: William Radburn

c. *Accrual accounting*

If (and only if) the previous actions has been implemented, the government can consider implementing a full accrual accounting system and a financial reporting system based on accrual accounting. Taking into account their implementation requirements, the systems could be implemented gradually, beginning with agencies with a greater need for full cost assessments. Cost measurement systems must be developed for this purpose.

¹ Drawn from Office of Management and Budget, Objectives of Federal Financial Reporting Statement of Federal Financial Accounting Concepts, Statements no. 1 and no. 2, 1993; and Lieberman, What are the Rules for Financial Reporting?" in D. Henley & Lieberman, et al., "Public accounting and financial control, Chapman and Hall, 1993.

² For more detailed survey results see Premchand, 1993.

³ Drawn from Premchand, OMB; and Lieberman, op. cit.

⁴ See, for example OMB, op. cit.

⁵ See PSC of IFAC, "Financial Reporting"; and Premchand, op. Cit.

⁶ The term government in this paragraph refers to any government authority which can be the central government or a local government.

⁷ IFAC "From cash to accrual: the Canadian experience in *Perspectives on accrual accounting*,

⁸ See "The government financial reporting entity", IFAC.

⁹ See Premchand and Lieberman, op. cit.

Chapter 12. THE PROGRAMMING OF PUBLIC INVESTMENT AND THE MANAGEMENT OF EXTERNAL ASSISTANCE

Throughout this volume, we have pointed out the budgetary implications of dependence on external aid, which is typical of most developing countries. It is now time to tackle the major implications. First, the relatively large amount of funds flowing in from external aid calls for careful programming by the recipient country. As most external aid is for investment purposes, the Public Investment Program (PIP) has been elaborated and implemented in many developing countries with the aim of fitting the resources into overall public expenditures and development plans. Second, the effective management of external assistance requires a variety of organizational measures and should meet a number of criteria. The first section of this chapter describes the PIP and its uses and limitations, and the second section summarizes the lessons of experience in the management of external assistance.¹ (The next chapter reviews the technical aspects of a comprehensive Medium-Term Expenditure Framework (MTEF), toward which a well-prepared PIP is an intermediate stage.)

A. THE PROGRAMMING OF PUBLIC INVESTMENT

1. What is a Public Investment Program (PIP)?

In the 1970s, most developing countries prepared a four- to six-year development plan to define and implement their medium-term economic and social objectives. However, plans with a fixed horizon and established episodically were often unrealistic, and proved insufficiently flexible to take into account changes in the economic environment. In several countries, fixed plans originally designed in periods of high commodity prices or plentiful external aid contributed to destabilizing public finances, and without any appreciable impact on hastening growth. Such rigid medium-term planning is less widespread today, but in Asia several countries still prepare medium-term plans.²

Aside from the question of the unsound and unrealistic policies they incorporated, the major problems of medium-term development plans were: (i) lack of

flexibility and adaptability; (ii) insufficient coordination with the budget process, where actual expenditure decisions were made; and (iii) a “needs” approach which typically led to unrealistic plans.

Consequently, in the 1980s many developing countries moved to rolling public investment plans, generally with the encouragement and along the recommendations of the World Bank. These rolling investment plans are usually named Public Investment Programs (PIP). They are widely used in aid-dependent countries, since one of their aims is to improve aid coordination, and are less common in middle-income countries. Recently, with the assistance of the World Bank and the European Union, PIPs have been newly introduced in a number of transition countries.

In some developing countries, a PIP became a simple wish list, used to attract aid from donors and international financial institutions, or even just to fulfill a formalistic requirement of Consultative Groups and other donor meetings. Often such wish lists are prepared hastily for the meetings with the assistance of external consultants and little genuine involvement of local officials. The role of these wish lists of projects in the formulation of the budget is generally weak or nil. Worse, because these PIPs are shopping lists rather than programming tools, they invariably include a variety of weak, unsound, or undocumented project proposals. Even the marginal usefulness of these PIPs as documentation for a donor meeting is swamped by the risk of financing bad projects; by the implicit transfer of control over the development agenda from the government to the external donors; and by the generalized loss of credibility of the programming process. It would be better if they were not prepared at all (or externally requested).

One does not, however, dismiss an economic programming tool because it is often misused or abused in practice. The following discussion examines the utility of PIPs when they are genuine medium-term *programs* for public investment. If it is concluded that this tool is appropriate to a particular country, then it becomes necessary to assure that it is designed and used properly. In any case, the relatively large donor funding will either be appropriately programmed, in relation to the policy priorities of the recipient country, or *still* be distributed, but without *any* central scrutiny of project quality, consistency with policy, or coordination with the budgeting of domestic resources.³

A good PIP is aimed at ensuring five different (although interrelated) functions:⁴

- improving economic management, to ensure that macroeconomic sector strategies are translated into programs and projects;
- improving aid coordination and channeling external resources to priority areas;
- strengthening the hand of the government in negotiating with external donors;
- assisting public financial management, by balancing (partial) commitments and resources over a multi-year framework; and
- strengthening the project cycle by providing a framework within which project preparation, implementation, and monitoring can occur.

Perhaps the most significant benefit that aid-dependent developing countries receive from good PIPs is that the process of PIP preparation itself gives an opportunity to review, and then integrate into the budget, aid-financed expenditures that were previously nonbudgeted. (As chapter 2 stressed, the budget should be comprehensive and should include all government expenditures, however financed.) PIP exercises contribute also to extending the horizon of financial programming and planning beyond the annual budget, and the perspective of policymakers in a more realistic way than previous five-year plans. Finally, if conducted rigorously and with full local participation, the process can be an invaluable capacity-building tool, and a way to introduce financial discipline and the awareness of opportunity cost into the informal rules of the local bureaucracy. Finally, a good PIP process can set the stage for the eventual medium-term programming of all expenditure which is the optional way of incorporating the needed multi-year perspective into the budget process.

2. Coverage of PIPs and investment budgets

a. Hybrid investment budgets

Most developing countries have adopted a “management approach” to delimiting the boundaries of the investment budget (and the PIP, where it is prepared). In addition to investment expenditure proper, the investment budget (and the PIP) also includes current expenditures that are managed within the investment projects rather than directly by the

administrative divisions concerned⁵. Procedures for administering the recurrent budget are generally not suitable to the management of some categories of expenditure, particularly expenditures by external sources. Generally, regulations to implement the investment budget are much more flexible than those for the recurrent budget. Therefore, administrative considerations are in practice more influential than economic considerations on the decision of whether a given expenditure is included in the current or the investment budget. As a result, the recurrent budget usually contains some miscellaneous investment expenditure, while the investment budget almost invariably has a significant component of current spending.

The hybrid nature of “investment” budgets creates loopholes. Line ministries may try to include alleged projects in the investment budget to finance recurrent spending and obtain additional resources. Or, projects previously financed by external sources may be kept artificially alive after the closure date of the aid agreements, to avoid either increasing regular personnel expenditure or dismissing the project staff.⁶

The approach adopted in transition economies is generally more economic than the management approach mentioned above. In these countries, the traditional State Annual Investment Program has a narrower coverage than the investment budget in developing countries. It often covers only net investment, i.e. the creation of new capacities. Investments financed under the State Annual Investment Program are included in the “capital expenditures” items of the budget.

b. Is reclassification desirable?

To transform most “investment” budgets into “true” capital budgets would require a major reclassification of expenditures. In countries that finance investment mainly from their own resources, this should be systematically undertaken and will facilitate analysis of the budget and eliminate the loopholes mentioned above. However, improving the recurrent budget procedures, and making them more flexible (as discussed in chapter 6), may be a prerequisite for either establishing a more homogenous context for each of the two budgets, or merging the budgets altogether.

In aid-dependent countries, to separate out the “true” investment expenditure, it would be necessary to divide projects into two subprojects straddling two budgets. This would have significant inconveniences for project management, notably for donor-financed projects in the social sectors, which typically include a high share of current expenditure. Because external aid is normally channeled through projects, the only satisfactory way of identifying the “true” capital component of the budget is to implement an economic classification for both the current and the capital budgets, along the lines suggested in chapter 3.

This would be particularly appropriate to a before-and-after comparison in countries undergoing structural adjustment programs, if one wished to ascertain the true impact of the adjustment program on the composition of expenditure. Typically, some current expenditures are protected from austerity because they were hidden within the investment budget or shifted opportunely into the investment budget—with or without the consent of external donors. Therefore, the decline in current expenditure through the adjustment program is overestimated, and public investment in reality is curtailed by more than the figures show. Because, as noted earlier, the figures point to a contraction of public instrument in countries under structural adjustment, the reduction in public investment is significant—even under good public investment programming.

3. Preparing a good PIP

a. General characteristics

It is generally accepted that the PIP should be organized along the following lines:

- The PIP includes a period of three or four years in which annual costs of projects are shown, along with the balance of funds required to complete them, and hence also the total costs of each project;
- To adapt to permanent changes in the economic and financial environment, the PIP is prepared annually, on a rolling basis. For a 3-year PIP, in year t the program $t+1$ to $t+3$ is prepared, in year $t+1$ the PIP for $t+2$ to $t+4$ is prepared etc.;

- While the first year of the PIP includes only projects for which implementation has been firmly decided, the later years are indicative for both the estimates of costs and the list of projects included. The annual costs of ongoing projects and the previous list of new projects are of course to be revised when preparing the next PIP;
- The investment budget (also called “capital” budget or “development” budget) includes expenditure on the projects for the first year of the PIP financed by the central government, either from domestic or external resources;
- In aid-dependent countries, the following approach is often adopted: (i) the first year of the PIP includes only projects for which the financing has already been granted or is under well-advanced negotiation so that external financing for the annual segment of the PIP to be included in the capital budget is secure; (ii) the second year includes projects for which the financing has clearly been identified; (iii) the third year holds projects for which the financing is probable but the source has not yet been identified. As discussed below, a more restrictive approach for the second and the third year would be preferable;
- The first year of the PIP must be consistent with the Budget. Both the provision of adequate domestic resources and expenditures financed by external sources must be included in the budget. For the outyears needs for domestic resources must be compatible with the medium-term fiscal framework. With or without a PIP, sound estimates of the forward costs of projects and of needs for domestic resources are required for financial programming. These estimates are not easy, but they are essential;
- PIPs cover investments by the central government and investments by public entities that are financed fully or partly by the central government. In a few countries, PIPs also cover investments of public enterprises and/or local governments that are not financed by the central government. This practice is questionable, since these entities have (or should have) autonomy in management. However, showing these expenditures in the PIP for information

only, would give a more complete view of public sector investment;

- Ideally, only projects evaluated as economically sound should be included in the PIP. As for the financing, for the first planned year the economic analysis of projects must be imperatively complete and convincing; for the outyears, it is important to try to keep out altogether projects that do not meet at least the “double-sense criterion”: development sense and common sense. No commitment should be taken for projects that have not been fully studied. The time to fight off bad ideas is when they first surface. This is because bureaucratic inertia (and vested interests, both internal and external) may eventually cause a bad project to be financed and executed. The hunt for white elephants should never be called off, but it’s best if they are not born in the first place;
- Sometimes, both a “core” PIP and a “noncore” PIP are prepared. This practice is highly inadvisable: it skirts hard choices and increases the risk of including bad projects. (In fact, this is sometimes precisely the motivation for the practice.) If a project is good, it should be included in the “core PIP”; if it is not good, or insufficiently examined, it should not be included in *any* program. In many ways, a dual PIP is inherently a bad PIP.

Because aid is fungible, if the government would implement a particular project in any case, aid earmarked for it releases governmental resources to finance a “marginal project of which the donor knows nothing. The aid in effect finances the latter project, and the earmarking is an illusion. Hence, if the quality of governance or of public management is seriously deficient, donor control over the investment program as a whole may be the only way for aid moneys to have a positive development impact. (A far stronger impact, however, would result from assistance or insistence to improve governance in the first place.) In most developing countries, instead, donor financing for a project which the government does not consider a priority can distort resource allocation and create other adverse incentive problems and moral hazards which more than offset the direct positive impact of the assistance itself. Hence, strong coordination and direction by the recipient country’s government are essential to the development impact of the assistance. The implications of aid fungibility for the investment program

under different assumptions have been examined long ago⁷ and have been recently rediscovered.

b. Other general requirements

First, as noted, a good PIP must contain good projects, and improvement in project preparation and screening at sector level is generally needed. In aid-dependent countries a significant number of projects are appraised and screened with the assistance of donors. This alleviates the weakness in local capacity in appraising projects. Over the longer term, however, prolonged reliance on external expertise is not conducive to local capacity improvement, which is essential for economic development. In point of fact, inefficient allocation of resources and loose financial constraints are more serious risks of a bad PIP than weakness in local capacity in itself.

Regarding resource allocation, the linkages between the projects and government policy are often not systematically considered. The fragmentation of the budget into projects financed by donors with different policy agenda impedes a sound allocation of resources. Even without taking into account the “cosmetic PIPs” that are nothing more than wish lists, in such a weak PIP the total costs of the projects over the planned period often exceeds government capacities to finance these projects. Counterpart funding problems become inevitable, and the insufficient budgetary resources are allocated to projects financed by more influential donors (or worse, to salary bonuses or outright bribery) and not necessarily to the projects that are more valuable for the country’s development.

Regarding the loosening of financial constraints, since the second and third year of the PIPs are generally indicative, when confronted with excessive requests the Ministry of Planning follows an escape strategy that consists of systematically including poor projects in the second and third years of the PIP, with the intention of eventually dropping them. Therefore, the outyears of the PIP become simple wish lists, to which nobody pays attention. (Alternatively, and worse, some of the bad projects may in fact find financing and be carried out.) This problem is not confined to PIPs in developing countries. On the contrary, avoiding distortions in the annual distribution of expenditures is an important challenge in any multi-year expenditure framework system.⁸

To avoid an overloaded PIP, it is necessary to frame strictly the preparation of the PIP for each year of the planned period, with ceilings derived from the macroeconomic and fiscal framework. Of course, the outyears of the PIPs are inevitably indicative, and in fact doubly so, both for the cost estimates and for the list of projects included. Naturally, cost estimates beyond the fiscal year can only be indicative. However, concerning the projects to be included in the PIPs a more stringent approach for the second and the third year would be preferable, by including only projects for which a decision has been firmly made and the source of financing is certain (or at least highly probable). As a result, projects included would generally be of better quality, and the PIP would in effect incorporate only ongoing policies, as recommended for multi-year expenditure estimates (see chapters 4 and 13). For example, in Sri Lanka a cautious approach was adopted in including projects into the PIP. The PIP includes only funded projects, that is the projects included in the Budget of its first planned year and projects for which an external financing is already available. Therefore, the total annual costs of projects included in the PIP are slightly decreasing at end of the planned period. Besides, these funded projects the PIP includes a line "additional provisions to be identified", in order to give an indication on the total amount of resources that the government intend to allocate to investment over the planned period.

This last suggestion may well diminish the role of the PIP as an instrument for negotiating additional project aid. However, in practice, overloaded PIPs are not conducive to successful external negotiations. The trick might work once, but not again. Presenting in the PIP only the costs of programs and projects already decided could facilitate the assessment of the margin of maneuver to include new projects. It is true that a partial contradiction exists between the documentary needs of a Consultative Group meeting and the requirements of sound financial programming, but the contradiction could be overcome by producing along with a stringent PIP a supplementary document of strategic orientations and directions of further development actions.⁹ Furthermore, it is the responsibility of external donors, to encourage a move toward better country programming while assuring at the same time better donor coordination in the interest of the recipient country's development.

Figures 12 and 13 show schematically the classic PIP process and its stringent variant.

[Please see attached Figure 12.xls and Figure 13.xls].

The preparation of a PIP includes two main processes:

- Project selection and overall investment programming.
- Project preparation and appraisal. The project cycle includes identification, preparation, and appraisal. Project identification is normally carried out by the line ministries and precedes the PIP process. As noted, it is important that bad project ideas be prevented from getting a foothold on the programming process. A few well-chosen and well-publicized rejections of projects proposed by line ministries can be very helpful in encouraging them to present only good project ideas in the future.

These two processes are interdependent. At different stages of the project cycle choices between projects must be made (i.e., when launching studies on identified projects, when appraising those studies, and when making the final go/no-go decision). Nevertheless, these two processes should not be confused. Sound investment programs require good projects and the preparation of good projects requires sound investment programs, but investment programming must be set in a broader policy-focused framework than the isolated analysis of individual projects. A good PIP is more than a mere collage of projects, examined in isolation, even if they are good projects, as explained below.

c. Strategic prioritization

Projects are a part of an overall development strategy, which they must fit. The government must allocate available resources between competing sectors and competing programs. Project analysis helps, but cannot be relied upon exclusively to achieve the optimal balance of objectives.¹⁰ Criteria other than the quality of individual projects are needed when scrutinizing a Public Investment Program, e.g., Are balances between sectors and subsectors consistent with the government strategy? Is the investment program appropriate to the economic and social environment? Is it compatible with the

macroeconomic framework? Are externalities adequately taken into account?

A "strategic" approach to investment programming should involve three elements: (i) definition of objectives; (ii) determination of available resources; and (iii) identification of alternatives for using resources to meet the stated objectives. Thus, the programming process should aim to ensure that policies drive programs: that programs drive projects; and that the most efficient projects to implement the programs have been selected. This is of course, an ideal, but it is a guideline to be applied. And, like all economic and policy processes, a strategic PIP too, is iterative. For example, difficulties in preparing the "right" projects should feed back into scaling down the corresponding programs and objectives (and/or absorb a smaller amount of resources). Equally important, good new projects (i.e., economically sound, consistent with the policy goals, and with attractive external financing) might justify an additional domestic resource mobilization effort. Clearly, the right starting point does matter, and that starting point is the definition of goals and available resources. *However, the essence of a good programming process is the ease with which relevant information travels up and down the decision chain, in relationship of reciprocity among objectives, means, and activities.* Capacity building for investment programming (indeed, for public sector management in general) must therefore pay as much attention to strengthening the linkages among the components (and the actors) as it does to improving goal definition or resource forecasting or, for that matter, project preparation.

It should be evident by now that a good PIP preparation process is similar to a multi-year estimates process and to budget preparation, combining: (i) a top-down definition of financial envelopes in conformity with government strategy and compatible with fiscal targets; (ii) a bottom-up approach with line ministries submitting their draft investment budgets; and (iii) successive iteration and information exchange converging onto a *program* that is vertically and horizontally consistent with both policy and financial means.

Thus, whatever the institutional distribution of responsibilities in preparing the current budget, the investment budget and the PIP, the three processes should be integrated or at least closely coordinated—with the budget preparation calendar containing explicit and prescriptive steps, and bureaucratic incentives oriented to assuring that such

coordination happens.

d. Screening Projects

Economic analysis of projects, and selection of the most cost-effective variants, is required for projects to which cost-benefit analysis is applicable. Moreover, every project of any significant size must be screened to verify its consistency with government priorities, direct and indirect impact, sustainability, etc. The main screening criteria are as follows:¹¹

- Is the project consistent with the role of the government in the economy?
- Is the project consistent with the sector strategy?
- Is the variant being considered the most cost-effective variant and (when the main benefits are tangible) is the economic rate of return of the project acceptable? Specifically, will the project increase external debt-servicing capacity by more than its financing and operation add to external debt?
- Is the project a feasible alternative to the rehabilitation of existing facilities?
- Are the recurrent costs realistically estimated?
- Are the overall recurrent costs compatible with budget forecasts (notably in the health and education sectors)?
- Is the project financially and institutionally sustainable?
- What are the project's external effects, negative (e.g., environmental) or positive (e.g., social-capital generation)?

For small projects, screening can consist of a quick qualitative judgment on the above criteria, based on realism and common sense. For large projects, more formal methodologies are appropriate. In any case, good screening is needed more for the

purpose of excluding projects from the PIP than for including them. Typically, the aggregate of “good” projects requires financing in excess of the available amount. When greater mobilization of resources is not considered appropriate, a difficult qualitative selection must be made. Therefore, the basic operational principle is to place the burden of proof on those who advocate including a project in the PIP, and not on those who believe it should be excluded.

Sometimes project-ranking methods have been suggested. In the 1970s it was often stated that projects could be ranked by rate of return, and the highest ranked selected in turn until the financial envelope was filled. This approach has been attempted, unsuccessfully, in a few countries. Comparing projects from different sectors according to quantitative criteria is always hazardous, and in fact impossible. Moreover, ranking a set of projects depends on the total financial envelope granted to the set of projects and not vice versa.¹² To reiterate: the choice of allocating investment resources among sectors cannot be based only on the analysis of individual investment projects.

4. Sector investment programs (SIP)

SIPs have attracted attention recently (Harrold et al. 1995; Jones, 1997). They provide a vehicle for implementing the “broad-sector” approach favored by several major donors. The World Bank recommends that “an SIP move away from the distinction between recurrent and capital expenditure and focus on overall expenditures”.¹³ SIPs are intended to address weaknesses in the practice of development aid. An SIP is an integrated program agreed between donor(s) and the Government comprising a sector strategy, a government investment expenditure program, mutually agreed implementation procedures, and funding arrangements. It has six defining characteristics: sector-wide scope; a clear sector strategy; management by nationals; the participation of all main donors participating; common implementation arrangements; and the use of local rather than foreign capacity. SIPs are alleged to correct problems associated with donor assistance such as donor-driven agendas; diversion of funds to activities other than those intended by donors; fragmentation of government aid management; and generic developing-country problems such as weak sectoral performance, weak public expenditure management and lack of linkage between capital expenditure and its recurrent costs (Jones, 1997).

A positive view is that SIPs fill the gap between good individual projects and good macroeconomic investment programming. Also, the process of formulating a SIP may help in terms of the key issue identified above i.e., lack of coordination *within* line ministries. Of course, to the extent that donors are prepared to assist sectors via general budget support, an SIP can reduce some of the negative effects of project-tied assistance; however, general budget support not linked to good public expenditure management but not to specific sectors would be preferable. One could therefore view good sector investment programs as a step toward the comprehensive medium-term expenditure framework discussed in chapter 13. None of this is likely to happen, however, unless the recipient government exercises some control over the allocation and management of external assistance.

B. THE MANAGEMENT OF EXTERNAL ASSISTANCE

1. The context

Chapter 17 will discuss the “efficient nucleus” and “strengthening linkages” approaches to improving public expenditure management. These approaches are also applicable to the management of external assistance, because often such assistance provides the only degree of financial freedom to hard-pressed developing countries confronted with the need to control expenditures at a time of slow domestic revenue growth. In turn, this means that more efficient organizational arrangements in this area are particularly visible and are more likely source of positive demonstration effects.

The record of aid management is as mixed as the record of PIPs. In many developing countries, the organizational framework for aid management is weak or inoperative in practice, with external donors *de facto* determining expenditure priority. This is invariably the case when the PIP process is weak or purely formalistic. As already explained, a key advantage of a good PIP is its assertion of a measure of government control over the allocation of aid funds. Governments’ effective supervision over the aid process is essential to assure that external resources are integrated with domestic resources in pursuit of national fiscal policy.

The mobilization and effective use of external resources depends crucially on creating the institutions and the organizational capacity needed to coordinate internally and manage the different kinds of aid. The organizational arrangements for aid management should be country-specific (including the key issue of institutional location). However, past country practices and recent experience show that certain minimum criteria must be met. These “musts” of aid management are also consistent with the conceptual basis of the new institutional economics and with the lessons of institutional change in the key public sector areas, as discussed in chapter 1. Consequently, the key criteria are simply listed below with a minimum of elaboration and explanation. That many of these criteria are obvious and intuitive should not mislead the reader into thinking that they are normally applied.

2. The ten commandments of aid management

The following are not utopian recommendations. Even though they are followed effectively in a minority of developing countries (e.g., Sri Lanka), they call for neither large resources nor difficult administrative choices. They have been derived from the actual experience in developing countries over a long period of time.

- i. *Responsibility for managing external resources rests with the recipient government.* External donors often have in practice undue influence on project choice and the allocation of assistance. This first commandment in no way excludes the requirement and utility of donor participation in the supervision of the use of aid funds and the implementation of aid-financed activities, especially when corruption is a problem.
- ii. Aside from sovereignty considerations, the essential reason why aid management must be driven by the recipient government is that *external resources must be integrated within overall resource utilization*, in pursuit of national economic policy. It is clearly impossible for a government to formulate coherent economic policy if decisions on the allocation of a major portion of available resources are made elsewhere.
- iii. At the central government level, there should be *one aid management entity*

covering all external economic assistance, including technical assistance. The only possible exception should be emergency aid and some humanitarian aid, even though there is still a need for linkages between such assistance and the budget process.¹⁴ In theory, good coordination among different ministries charged with different aid management responsibilities is possible. In practice, such a system has rarely worked. Split aid management responsibilities have proven to be a recipe for confusion, waste and conflict. The frequent two-way split of responsibilities between a Ministry of Finance and a Ministry of economy may be problematic enough. (See chapter 3 for a discussion of “dual budgeting”). The occasional three-way split which includes a role for the Ministry of Foreign Affairs is next to impossible to administer. The practical outcome of split aid management responsibilities is that the government loses control of the exercise altogether, and aid decisions end up being driven by competing donor agendas.¹⁵

- iv. The aid management entity should normally be an *office in a core ministry*. Because it is a key regular function of government, aid management should in principle be exercised by a regular organ of government. The preference here is for the Ministry of Finance, owing to its responsibility to develop a coherent budget covering all available financing. In transition economies, it is possible to consider an autonomous aid management agency outside the regular structure of government, provided it is placed high enough to perform its role credibly, and reports to a regular structure of government such as the Prime Minister or an interministerial body from which fiscal policy guidance legitimately emanates. However, longer-term institutional development requires that the autonomous agency solution itself be transitional and incorporate a sunset clause. As time and organizational capacity permit, the aid management function should devolve to the Ministry of Finance.
- v. Aid management should be *organized along donor lines* (e.g., an “ADB desk”, a “World Bank desk”, an “EU desk”, a “UN-system desk”), to build expertise on procedural requirements of different donors, match different terms of aid with different projects, and help keep all donors “in the tent”—collaborating with a single government organization on an equal footing with one another.

The tempting option of organizing aid management along sector lines (e.g., “social sector” desk, etc.) has not worked in practice mainly because it hasn’t created the local capacity to negotiate effectively with the different donors. However, the aid management entity can *also* contain a sector coordination unit structured along types of assistance, where investment projects and technical assistance can be more effectively integrated within and across sectors, thus facilitating the interface with the line ministries concerned.

- vi. The aid management entity should be the *sole focal point* in the government for contacts with donors regarding aid programs, and must be systematically informed of ongoing activities by both donors and end-users. This does not in any way imply centralization of decision and a monopoly on information and contacts. On the contrary, as the next four criteria make clear, the purpose of having a single focal point for aid management is to support, not substitute for, the decision-making process of sector ministries.
- vii. The aid management entity must function to *facilitate not obstruct* relations between donors and their counterpart ministries. It should assure the availability of timely and complete aid information, and regulate the flow of missions and delegations traffic in the interest of all concerned. Thus, while the entity must be regularly informed of donor missions and of ministries’ requests, it need not have authority to clear donor missions.
- viii. It follows that the existence of a central aid management entity *does not exclude sectoral coordination mechanisms*. On the contrary, the effectiveness of the central entity depends crucially on good decision making in each sector ministry, which in turn requires an appropriate coordination capacity specific to the sector in question. This need for effective coordination has been stressed throughout the earlier chapters. On the other hand, to assure that the central aid management agency acts to facilitate and coordinate, and not to obstruct or supplant, careful limits on its role and provisions for accountability and transparency must be specified. At the same time, it is essential to have provisions that prevent sector ministries from making “end-runs” around the central agency, and to ensure that they work in cooperation

and in support of the central agency.

- ix. Similarly, the aid management entity *should not interfere in budget proposals and project selection*. It does need to be regularly informed of such decisions; to have authority to approach the “right” donor for financing the various projects; and to routinely participate in budget discussions in order to help ensure the adequate provision of local funding complementary to aid resources. (The latter is one major reason for locating an aid management entity in the Ministry of Finance.) But sectoral budget proposals and project selection decisions are the responsibility of the sector ministry concerned, within the programmatic priorities of the country; the overall investment program is the responsibility of the competent core ministry (usually a Ministry of Economy or of Planning); and budget formulation, of course, is the responsibility of the Ministry of Finance.
- x. Finally, the aid management entity should act to *strengthen links* with other agencies of government and help build financial planning and aid-coordination capacity in the sector ministries. Without such sectoral capacity, central aid management is built on sand, reform is a mere shuffling of organizational boxes and titles, and donor preferences in effect dominate the allocation of aid funds.

3. Organizational architectures

The actual organizational structure will normally be intermediate between the two depicted in the charts, depending on country-specific circumstances and capabilities. The links to other agencies of government (shown here as information/communication or guidance/instruction arrows) are not, strictly speaking, part of the organization of the aid management entity. It is important to stress once again, however, that the interagency links are essential ingredients of the aid management *function*, which must be exercised within the context of a coherent economic policy framework and public investment program. Thus, it would be futile to focus on the *organization* of aid management without at the same time defining and enforcing the rules—the *institutions*—of aid management, among which those governing the interaction with other agencies of government are

paramount.

4. The Four S's: Sensitivity, Selectivity, Stamina, and Staff

Whatever the arrangements for aid management by the recipient country, they are unlikely to function well without a measure of cooperation by the external donors. In addition to working within the organizational arrangements for aid management established by the recipient country, donors should follow four general rules.

First, sensitivity (understanding of the circumstances of the other parties, mutual respect, and open-mindedness) is even more important for the “ownership” of institutional change than in the general economic policy dialogue. One must particularly pay attention to the clarity of the message not only as it is broadcast, but also as it is received. This point leads, among other things, to the practical suggestion of asking the recipients of the technical advice to articulate *their* interpretation of the message being delivered—a simple but effective way to ensure that no misunderstandings occur.

Second, advice and assistance should be *selectively* focused in the areas where it can make a difference. The three main criteria are: importance of the area; feasibility of significant and identifiable regulatory or organizational change; and a potential for generalizing the change to include other parts of the public expenditure management system. (The last section of chapter 17 suggests priority actions to strengthen public expenditure management.)

Third, institutional change is slow by its very nature, and the concomitant organizational capacity can only grow over time (see chapter 1). Assistance with PEM, consequently, must be viewed as a long-term investment of time, imagination, and resources. The long-haul nature of institutional development requires commensurate commitment and stamina to stay the course. In general, this is true whether the intervention is by external donors or by the core government agencies vis-à-vis other public sector entities. While specific rapid improvements are sometimes possible, a general “quick-fix” approach invariably leads to trouble. It is possible, however, to conceive of external assistance as a catalyst—in the original and literal sense of the term—that can spark or facilitate an internal process of a potentially self-sustaining

character. It does not follow, therefore, that external agencies necessarily need to remain directly involved beyond the initial phase.

Finally, the fourth “S”, *staff*, is shorthand for resources. It is not worth elaborating on this obvious requirement, except for underlining the inverse correlation between the soundness of the design of assistance and the external and local resources required for its implementation and supervision. In particular, keeping PEM reforms simple will minimize the need for expatriate advisers and increase the chances that the reform will be sustainable. The best-designed assistance mechanism will still require sufficient material and human resources to be implemented. External assistance can help with the material side; it can also help somewhat with the human side, by providing competent advisers who understand their primary responsibility as including training of their local counterparts. External assistance cannot, however, provide the core staff charged with implementing and facilitating the process, nor create the incentive framework which is essential for their effectiveness. And when it is wrongly conceived, in pursuit of changes that are unnecessarily complex or unsuited to the local conditions, external assistance may well lead to *reducing* local administration and management capacity.

C. Key Points and Directions of Reform

1. Key Points

The latter approach is normally applied to “investment”, and has been common in aid-dependent developing countries under the name of Public Investment Program (PIP). PIPs arose in the early 1980s as a reaction to the rigidities of the “development planning” of the 1970s, and as a means to improve the programming of external aid—most of which is for investment purposes. PIPs are on a “rolling” basis and cover a 3-4 year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor moneys, and can harm the expenditure management process. However, like a good SEP, well-prepared PIP can improve the process as well as strengthen the recipient country’s control over aid. Ideally, a strong PIP should:

- include only economically sound projects that are clearly related to government policy. (For the out-years, the evaluation of projects may be

indicative, but projects must always meet the “double sense” criterion of “development sense” and “common sense” before they are included, in any form for any year);

- cover all central government investment and investments by other public entities which are financed by the central government;
- be strictly framed by the ceilings derived from the macroeconomic framework (but recall the iterative nature of macroeconomic programming—public investment should never be defined as a mere residual derived from the other targets);
- include in the first year only projects for which financing is *certain*;
- assure that adequate complementary local funding is included in the annual budget. “Counterpart funding” problems are likely in any event, but are a certainty if the aggregate budgetary provision for investment is insufficient;
- include in the outyears only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only “on-going policies”, as recommended for multi-year programming in general);
- prevent over-reliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important requirement. External expertise is needed. However, if the PIP process becomes inadvertently a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process, nor contribute to local capacity, nor, of course, lead toward a more comprehensive approach to multi-year expenditure programming. This risk, of course, exists in aid-dependent countries whether or not they have a public investment programming process.

For all three objectives of PEM require that the recipient government and not the donors should “drive” the allocation and utilization of aid funds—while respecting, of

course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are ten major requirements for robust aid management. Among these, the following are essential:

- external resources must be integrated with overall resource utilization, and thus included in the budget;
- there should be one, and only one, aid management entity (preferably in the Ministry of Finance) covering all external aid, including technical assistance;
- aid management should be structured along donor lines (e.g., an ADB “desk”, a World Bank “desk” etc.) rather than sectoral lines (e.g., a “health assistance” desk);
- the aid management entity should function to facilitate, not obstruct, and avoid interfering in ministries’ budget proposals or project selection.

2. Directions of Reform

The broad goals of public investment programming are to: (i) raise investment efficiency by improving project quality; (ii) bring investment allocation in line with country policies and priorities; (iii) assure consistency between investment programs and available financing at favorable terms; and (iv) lead in time to a more comprehensive multi-year expenditure framework.

All these goals require sufficient control by the recipient government over project selection and strategic allocation of aid moneys—assuming a reasonable degree of integrity and efficiency in the country’s governance and public management. Conversely, a good public investment programming process is most often the best practical way in which the recipient country’s government can get into the driver’s seat and stay there.

The directions and sequencing of reforms in public investment programming and aid management stem directly from those four goals. For better project quality and investment efficiency:

- The first priority is to design ironclad procedures against the birth of “white elephant” projects. Once a project of large size is on the drawing board, the bureaucratic dynamics from both donor and recipient sides make it very difficult to stop it. Among these procedures, involvement of high-level policy makers (and, for very large projects, the Cabinet) must be built in at a very early stage.
- Also essential is the capability for economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable, and selectivity is needed. Only projects of significant size should be analyzed in detail, with smaller projects “bundled” and the bundle evaluated only for its general correspondence with sectoral policies and common sense.
- Third, an agile procurement process that minimizes the opportunities for corruption, and effective physical monitoring of project implementation and completion are a must. Strengthening the audit function and obtaining systematic feedback from local entities can be extremely useful.

For the other three objectives of public investment programming:

- It is important to have a procedure for early decision of whether the investment allocation corresponds to aggregate and sectoral policies, and the ensuing preliminary definition of the sectoral expenditure envelopes.
- Also, through good aid management and coordination among donors, regulations are needed for assessment of the probability of financing for various projects, and strong regulation should be in place to assure that only projects with certain financing are included in the investment program.
- Finally, a realistic procedure and minimum capacity for estimating the total cost of investment projects and their recurrent costs is a must. This is always

preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process. Conversely, the experience gained through these forward estimates can be invaluable for the eventual move to a comprehensive multi-year expenditure approach.

¹The term "aid management", instead of "coordination", is used here to prevent confusion with the separable issue of coordination among donors. The second section is derived largely from Schiavo-Campo, 1994.

² See "The Control and Management of Government Expenditure". ESCAP. 1993.

³ This is the main reason why countries such as Chile, which has substantially reduced the role of the state in the last two decades, have nevertheless kept variants of the PIP instrument (see Petrei, 1998, pp. 259 ff.).

⁴ See Bird and Stevens, 1991.

⁵ The share of current expenditures included in the development budget is estimated to be from 20% to 30% in Nepal and Bangladesh (ESCAP, 1993).

⁶ In South Asian countries, legislative authorization is given for revenue and a capital/development budget. The distinction between the current and the capital components of these budgets remains entirely academic to the legislature, which, unless well-educated in the finer points of budget making generally does not discern and is not interested in the real size of the development component of their budget authorizations. (ESCAP, 1993).

⁷ See Schiavo-Campo and Singer, 1970.

⁸ Distortions were observed, for example, in the multi-year budget prepared in the United Kingdom in the 1970s: "The experience suggests that there is a bow-wave in expenditures implying higher expenditures for the immediate fiscal year and tapering outlays for future years... the spending units trade cuts in future years in order to maintain the present amounts". Premchand, 1983.

⁹ If this document includes a project list, it would be similar to the "noncore" PIP criticized earlier. The project list, if any, should therefore have the status of a "data bank", disseminated for information only, and projects therein should never be automatically integrated into the PIP and the budget. On balance, however, the risk that the process degenerates into a wish list is high enough to avoid listing any projects in the supplementary document.

¹⁰ Is one to conclude, for example, that a waste management urban project with an estimated rate of return of 20% is preferable to a rural transport project with a rate of return of 15%? Clearly, other criteria come into play.

¹¹ See also "Poland: Strategic Investment Review". World Bank. 1992.

¹² "The ranking issue...is a rather ambiguous notion. For a given investment budget... projects are either acceptable and should be included in the investment program or are not acceptable and should be excluded... The only ranking in such instances is between the 'ins' and the 'outs'... There is no single ranking of projects that are added or deleted from the program in accordance with variations in its size. Changes in the investment budget tend to affect its general composition and not simply marginal projects". Squire and Van der Tak, 1975.

¹³ Public Expenditure Management Handbook. World Bank 1998.

¹⁴ The IMF Code of Fiscal Transparency suggests a need for aid-in-kind to be recognized, reported and incorporated into the budget process in some appropriate way.

¹⁵ Ministry of Foreign Affairs, however, does have the important role of negotiating framework agreements with donors, governing the diplomatic aspects of the relationship.

Chapter 13. MULTI-YEAR EXPENDITURE PROGRAMMING APPROACHES

Chapter 4 explained at length how a multi-year perspective is important for good budgeting. It suggested methods that should be developed in every country to place, at least partly, the annual budget preparation process within such perspective (preparation of a macroeconomic framework completed with aggregate expenditure estimates and review of forward costs of programs). Special issues related to programming investment and aid-financed projects are reviewed in chapter 12.

Systems of “expenditure programming and forecasting”¹ aim at developing more comprehensive and formal instruments to place the budget into a multi-year perspective. Forecasting is mere prediction of the future while planning implies the formulation of goal and tools. “Expenditure programming” should not be confused with developmental planning, which was widespread in developing countries in the 1970s, and is still performed in a number of Asian countries. “The distinction between a development plan and formal expenditure programming is that the former represents an organized outlook into the future taken at a particular time, while the latter is a continuous process of making a forecast and assessing its validity as further progress is made in its implementation”².

"As we shall see, a great deal of confusion has been generated by using the same terminology to refer to different approaches. Therefore, throughout this chapter we generally use the term "expenditure programming" in order to differentiate it from "development planning". Also, a clear distinction is needed between the general objective of introducing a multi-year perspective, and the specific variant of that objective which has been popularized recently as "medium-term expenditure framework" (MTEF).³ Accordingly, we will reserve the word "framework" for the full-fledged MTEF, and use instead the term "approach" whenever referring to any other variants of multi-year expenditure programming."

Recently, the World Bank developed a "Medium-Term Expenditure Framework" (MTEF) approach. A number of developing and transition countries are currently implementing MTEFs, and preparing multi-year expenditure programs in this context.

This chapter reviews what is a multi-year (or forward) budget, the MTEF approach, and discusses the relevance of multi-year budgeting and expenditure programming instruments to developing and transition economies.

A. *MULTI-YEAR BUDGETING*

1. What is a multi-year budget?

A majority of industrialized countries prepare multi-year budgets,⁴ named depending on the country (rather than on differences in the approach, which do exist): “multi-year budget”, “forward budget”, “expenditure review”, “multi-year estimates”, “forward estimates”, etc. Sometimes, these expressions define broad expenditure policy frameworks or aggregate estimates. In this chapter, a “multi-year budget” (or “forward budget”) is defined as a document as detailed as the budget, or at least, showing relatively detailed forward estimates by spending agency and program. It differs, therefore, significantly from the aggregate estimates discussed in chapter 4, which should supplement the macroeconomic framework. The expression “Medium-Term Expenditure Framework” (MTEF) is becoming commonly used in developing countries and transition economies, to design some form of multi-year budget or more aggregate estimates. It is used, in this chapter, to describe the MTEF approach developed by the World Bank (see section B), not an instrument with a specified design.

Generally, multi-year budgets are rolled over every year. Every year policy changes are identified. If aggregate resources are greater than the costs of carrying out continuing policies, the excess resources are distributed according to expenditure priorities throughout the period covered by the framework. If, on the other hand, costs exceed resources, the lowest priority programs are cut in the same way. Of course, if aggregate resources and spending needs diverge significantly, revenues may have to adjust to the extent that this is possible. The planning period consists generally of three to five years.

Recently, the United Kingdom has implemented an outright three-year budget. Such instrument is quite different from a rolling budget. It does not fit the context of developing or transition countries, which should keep an annual budget, taking into account uncertainty in their economic environment. Implementing an outright three-year budget presents much more

difficulties and risks than a rolling forward budget, and will not be discussed further in this chapter.

Estimates of the first year of rolling multi-year budgets are fully consistent with the annual budget, while the outyears are generally indicative (for payments at least, multi-year commitments being based on the forward estimates in a number of countries –e.g. Italy and Australia). The role of a multi-year budget may differ significantly from one budget system to another. While in some developed countries multi-year budgeting has become an integral part of the formulation of the annual budget and is seen as a key instrument of expenditure control, in others the forward estimates provide only background to policy decision making⁵.

Ideally, a multi-year budget shows⁶: (i) the present level of expenditure; (ii) additional expenditure to provide the same service in future, for example, to maintain a pupil/teacher ratio in educational institutions; and (iii) additional expenditure, if the service is to be changed. Elements (i) and (ii) can be described as existing/continuing policy while (iii) can be defined as new policy. In reality, however, the distinctions between existing and new policies may be not clear and may be blurred depending on the nature of sector and the statistical data available. A base to define what is a new policy can be the level of service, policy changes representing an increased or decreased provision of services.

2. Problems met in past experiences

Multi-year budgeting was perceived in the 1970s mainly as an instrument for identifying new programs and allocating funds for them in future budgets. According to the OECD,⁷ two major problems were met in the 1970s and the 1980s, in the preparation of multi-year budgets: (i) the tendency to overestimate economic growth and resources available in the forecast period; and (ii) the tendency of spending agencies to view their forecasted expenditures as an entitlement. This makes subsequent downward revisions in expenditures difficult, even when it became clear that the economic assumptions were overoptimistic—which is frequently the case.

Until 1982, in the *United Kingdom*, multi-year expenditure programs were expressed in real terms rather than in nominal terms. When economic growth fell and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically. This created further pressure on public finances. Cash limits were thus introduced for the annual budget in 1976, and were

operated in parallel with the expenditure programs using constant prices until 1982. From 1982, programming in real terms was abandoned and expenditure estimates were expressed in nominal prices to ensure consistency with budget⁸ (see box 38). The United Kingdom abandoned the expenditure forecast system altogether in 1995; and moved to a flat three-year budget in 1998.

The *Australian* government has been preparing forward estimates since 1973,⁹ but they were of little relevance to the annual budget preparation and little attention was given to the estimates for the next years. At the start of budget preparation, spending agencies were required to submit to the Ministry of Finance the estimates of expenditure levels required to finance the ongoing programs over the next three years. Although these estimates were not supposed to cover new programs or significant extensions of existing programs, in effect they became similar to the well-known wish lists. The different interpretations of what is a continuing policy and its corresponding costs produced time-consuming negotiations and disputes had to be brought to the Cabinet. As discussed below, from 1986, these problems were addressed.

The Policy and Expenditure Management System (PEMS) implemented in *Canada* in the early 1980s included the preparation of a five-year rolling fiscal program, with clearly defined spending limits and measures to reinforce the cohesion between policy decision making and budgeting.¹⁰ Under the PEMS, federal government expenditure programs were grouped into nine to ten “policy envelopes”, and four policy committees were established to manage them within the fiscal framework. The policy committees assessed new policy proposals in the light of both the government priorities and financial constraints defined by the policy envelope. The results have been disappointing. The Canadian PEMS succeeded in its mechanical and procedural aspects, but is generally regarded as a failure in promoting coherent policy choices within clear constraints.

One of the causes of the failure of the Canadian PEMS was the incorporation of a “programming reserve” in the multi-year estimates, which was intended as a contingency to meet unforeseen needs. Although a contingency reserve is appropriate in the face of future uncertainty (see section B.5 above), the ministers got the message that the government was willing to spend at levels above existing sectoral commitments and were thus encouraged to bring new spending proposals forward to their respective policy committees to try to get their share of the available funding. "The supporting bureaucratic work under PEMS became

transactional rather than allocational, driven by new spending proposals.”¹¹ The system of policy envelopes was eliminated in 1989 and henceforth the policy committees concentrated on policy issues rather than on the management of policy financial envelopes and public spending decisions.

In other countries, where forward estimates were background document to the budget, benefits are difficult to assess. In the USA, some form of forward estimates are prepared since the early 1960s and became a formal part of the budget process in 1979. The exercise proved to be ineffective for expenditure control in the 1980s. Possibly, improvements in multi-year budgeting techniques made in 1990 contributed partly to recent achievements.

In the few developing countries that prepare a forward budget in the 1970s or the early 1980s, results are uneven also. The National Public Expenditure Plan (NPEP) prepared in *Papua New Guinea* during the late 1970s and early 1980s is seen to have been an effective instrument of macroeconomic policy, curbing the growth of expenditure, but in fact it has tended to be largely a year-to-year budget exercise. Two key weaknesses of the system were its overt linkages to political objectives (which of course changed) and the failure to establish sectoral programs that extended much beyond the annual budget.¹²

The forward budget was introduced in *Kenya* in 1973. However, despite a reinforcement of the forward budgeting process in 1985, expenditure cuts continued to be made in response to resource shortages without clear priorities. As a result the wage component of the budget was still increasing disproportionately and capital, maintenance and operating expenditures suffered. The expenditure ceilings set in the forward budgets effectively became a floor from which to negotiate higher budget provisions rather than a strict limit on expenditure.¹³ The forward budgeting system is currently a purely formal exercise. It is however, in the process of being strengthening.

Aside from the technical deficiencies in the expenditure programming system, the insufficient commitment of some governments to fiscal discipline explains why multi-year programming in the 1980s did not achieve its expected results, "the failure to act swiftly and decisively cannot be laid at the doorstep of the various decision-making systems".¹⁴ In 1992, a study for the European Union found that fiscal performance depends more on institutional

issues, such as the distribution of powers in budgeting, than on the application of long-term fiscal limits¹⁵.

3. Recent approaches in developed countries

a. Expenditure control objectives

From the mid-1980s, taking into account problems met in the past and need to keep expenditure under control objectives, multi-year budgeting systems shifted from an instrument for identifying new programs to an instrument for expenditure control, and allocation of resources. For example, William Allan identifies two main objectives for “expenditure programming and forecasting”:¹⁶

- Providing better information on the medium-term costs of current expenditure policies and thereby giving greater scope to initiate changes in budget policy that will take more than one year to implement; and
- Revealing links between capital expenditures and future recurrent costs and thereby facilitating analysis of the impact of public investments on the budget over the medium-term.

“Various OECD governments reoriented their multi-year budgets from plans to projections and from instruments of programs expansion to constraints on future spending. It was reflected (in a number of countries) in rules dictating that the projections be based on unchanged policy, that is, that they merely estimate the future cost of existing programs.”¹⁷ Such forward estimates provide a baseline for starting work on the budget. Even where the forward budget is only a background document, this baseline can convey a powerful message: existing policies have already claimed nearly all (or all) future resources and that there is no margin for new spending schemes, provided that there is strong political commitment to keep expenditure under control.

International practices concerning MTEFs vary widely, even among developed countries. The table below summarizes expenditure programming practices in OECD.¹⁸ Almost half of the

countries have no multi-year budgeting as such; the remainder shows a mix of practices of varying duration.

Table 4. Multi-Year Budgeting Practices in OECD Countries			
	Practiced? (Yes/No)	Period (years)	Comment
Australia	Y	1 plus 3	Forward estimates
Austria	Y	1 plus 3	Medium-term budget estimate
Belgium	N		
Canada	Y	1 plus 2	Multi-year operational programming system
Denmark	Y	1 plus 3	Multi-year estimates
Finland	Y	1 plus 3	Multi-year estimates and ceilings
France	N		
Germany	Y	1 plus 3	Medium-term financial program
Greece	N		
Ireland	N		(in course of adoption)
Italy	Y	1 plus 3	Multi-year estimates
Japan	N		
Netherlands	Y	1 plus 4	Multi-year projections
New Zealand	N		3-year projections are available to ministers
Norway	N		
Portugal	N		Only for investment and development expenditure
Spain	Y	1 plus 3	Multi-year programming of programs
Sweden	Y	1 plus 2	Multi-year estimates
Switzerland	Y	1 plus 2	Financial program
Turkey	N		5-year program
United Kingdom	N	1 plus 2	Since the OECD publication in 1995, the U.K. has abandoned its Public Expenditure Survey temporarily
USA	Y	1 plus 4	Baseline projections of receipts, expenditures and the deficit

Source: OECD, Budgeting for results: Perspectives on public expenditure management, 1995.

b. Highly Disciplined Approaches

Some developed countries (e.g. Australia and Scandinavian countries) have developed a highly disciplined and consistent approach for multi-year budgeting and ensuring proper linkage with the budget. In these countries, multi-year budgets are an effective instrument for expenditure control and allocation of resources. It is also an instrument for operational efficiency, through increased predictability and responsibilities of managers in preparing their programs under hard constraints.

For example, in Australia problems met earlier were addressed from 1986. Multi-year estimates were made public to expose the degree of fiscal discipline to which the Government was committed, and crucially, committed itself to no real growth in aggregate expenditure for the next four years. Then, multi-years estimates were integrated into the budget and increased responsibility was given to the Department of Finance in managing the multi-year estimates system. Annual budget preparation starts with updating of estimates of costs of ongoing programs, which give the margin of maneuver for incorporating new programs. Multi-year forward estimates are updated on technical grounds to take into account changes of various economic parameters such as inflation. Since Cabinet has already authorized the ongoing activities, they are not renegotiated during the following budget preparation process. This is a substantive administrative simplification, which also allows the proper focus and attention to be given to new policy proposals. The Ministry of Finance is responsible for managing forward estimates and has the full authority to decide on any adjustments requested by agency and whether implicit new policy is involved under the cloak of “on-going” activities¹⁹.

4. A possible model of reference

Taking into account lessons drawn from some recent OECD countries' experience, a disciplined and comprehensive forward budgeting system would have, ideally, the following features:

Preparation of forward estimates. Two “stages” are involved in the preparation of the forward budget. In the first, which is a “technical” stage (which we may call the “forecasting stage”) the medium-term expenditure implications of *ongoing policies* are projected. In the second stage (which we may call the “programming stage”), the cost implications of *changes in policies* (whether upward or downward expenditure adjustment) must be added to the “technical” projections. Therefore, the process is organized as follows:

- Costs estimates of ongoing programs are prepared before the start of the annual budget preparation process (“forecasting stage”), thus indicating the available margin for new programs in the annual budget.
- As for the annual budget, a “top-down” approach is needed at the beginning of the process, establishing: (i) the level of savings required on existing programs; and (ii)

the financial envelopes allocated to finance new programs over the multi-year period. (Recall from chapter 4 that hard constraints must be given to each spending agency at the start of the budget process).

Focusing on policy changes. The previous year's projections are updated by the "Ministry of Finance", but only to take into account changes in technical factors and in economic parameters. Since the government has approved the previous set of projections, budget preparation is free to focus on policy changes.

Conservative approach. The forward budget does not plan implementation of new policies beyond its first year. It may include a reserve for the cost of new policy in the outyears, but this should be conservatively estimated. This reserve should not create rights to commit expenditures and/or engage new policies, or must not exceed a very small percentage of the total estimates²⁰.

Coordinated processes. The preparation of the forward budget is closely coordinated with these annual budget formulation processes, and the first year of the forward budget must be fully consistent with the budget. In fact, the preparation of forward budget and the budget must be merged into a single process. Forward budget prepared long before the annual budget can be a source of confusion or conflict between core agencies and spending agencies, when unexpected changes in macroeconomic environment lead to revising downward the expenditure estimates for the budget under preparation. Multi-year estimates prepared after the annual budget may provide useful information but cannot play a significant role in the budget process itself and are, in fact, only expenditure forecasts.

Status of the forward budget. Forward estimates do not create "rights" for spending agencies, but should ensure predictability and therefore should be based on conservative assumptions in order to avoid disruptive future changes in expenditure programs. However, they are an instrument for planning multi-year commitments. To commit the government the forward budget is published.

Measures to increase operational efficiency. To assure predictability, forward budgets should be as detailed as the budget, or at least by program and spending agencies. At the same time, providing indicative funding levels at agency or program level has the strong advantage of

encouraging agencies to adapt their programs to the expenditure ceilings. Ministries are free to reallocate their resources, but under the hard budget constraint.

Strong role of the Ministry of Finance. Central agencies (notably the Ministry of Finance) have a strong role in the process, from the preparation of annual ceilings to ensuring that fiscal targets and updates of annual costs of ongoing programs and costing of new programs are made on a sound technical basis. For the role of the forward estimates projections in budget preparation to be effective, the agency that coordinates the preparation of the forward budget should also be responsible for the preparation of the annual budget.

Sound costs estimates. Explicit and realistic sound cost estimates are required in order to include new programs.

Such approach is not systematically applied in developed countries. The multi-year budget remains in a number of countries only a background document. Developing such system has numerous implementation requirements, and cannot be a general recommendation for developing countries. However, this scheme shows in which direction a forward budgeting could be progressively implemented. It shows which elements are missing in forward budgeting systems attempted in some developing countries, which are generally more ambitious concerning the programming/planning aspects, but do not impose discipline in programming.

5. Technical Issues

a. Design of the Instrument

For sound forward budgeting political commitment is essential, however also the system must be properly designed. The format of a multi-year budget and its coverage are important to determine its function and depends on the objectives assigned to the multi-year budgeting.

The more crucial aspects are the following:

- *Coverage.* Schematically, three types of forward budgets can be distinguished: (i) multi-year budgets that include mere forecasts of ongoing programs; (ii) multi-year budgets that are an instrument for managing policy changes, but do not plan new

policies in their outyears; and (iii) forward budgets that plan new policies in their outyears.

- *Length of the period*, covered by the multi-year budget and the period over which new programs can be planned. In some countries, the period covered by the multi-year budget consists of two periods: a “programming period” that can include new programs is followed by a “forecast period” that shows only the forward costs of the project planned in the programming period (e.g. in the USA, in the 1980s, the planning horizon was three years within a forward budget of five years).
- *Format*. The format of multi-year programming instruments is an important design element. Discussions in this section refer generally to a multi-year budget presented under the same degree of detail as the budget, or by spending agency and program. However, preparing more aggregated expenditure estimates can be an initial step towards some form of multi-year budgeting (see section C).
- *Role and Status*. A multi-year budget can be a mere background document to the budget or an annex prepared on the basis of the budget, or an instrument through which policy decisions are made. It can be a document for information only or a technical document, or an official document submitted to the Cabinet and Parliament for approval.

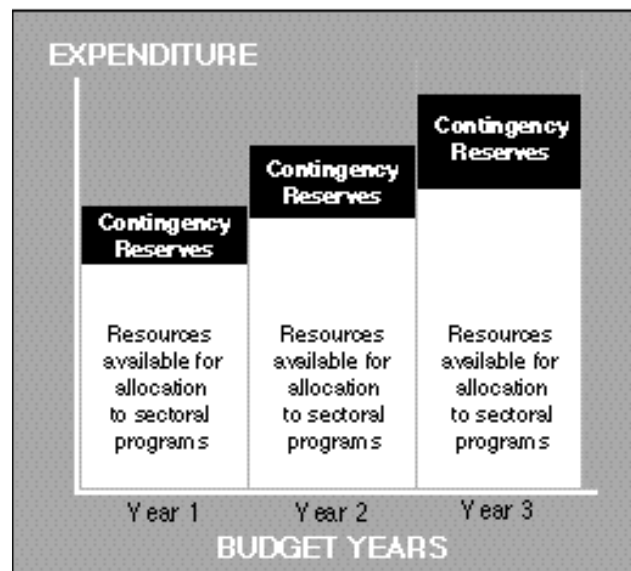
These essential design aspects of multi-year programming instruments are discussed in section C, when reviewing implementation issues (section C focuses on developing countries, but these aspects are crucial for every country). Other important issues concern the “contingency reserve” and the base of prices discussed below.

b. Contingencies

Although a multi-year budget per se cannot compensate for general lack of predictability, there are ways to adapt the MTEF design to suit less predictable circumstances. A simple way is to reserve a part of aggregate expenditures for contingencies and to increase the contingency reserve for more distant years.

Two types of reserves can be distinguished: (i) technical contingencies to take into account change in the economic parameters (e.g. inflation rate) and implementation of programs (e.g. unexpected costs increase of a construction project); and (ii) policy reserves, for future new programs not yet defined explicitly in the multi-year budget. Depending on how they are defined, policy reserves can either commit the government to allocate these resources (see Canada experience reviewed in section B) or be only an indicative forecast without any implication on future spending. The precise nature of a multi-year program (comprehensive expenditure plan or only estimates of ongoing policies) depends in a large part on the level of these policy reserves and on the role they play in the allocation of resources.

Figure 14: Contingency reserves



The figure shows a simple standard model for allowing contingencies. To make the simple model operational, there is a need to segregate existing and new policies and to cost them separately.

Obviously, the costs of existing policies vary with circumstances. For instance, the cost of free primary education cannot be determined without knowing its parameters and the numbers in the relevant age groups, participation rates and standards of provision. Therefore, the border between technical contingencies and policy contingencies may be difficult to

establish. To avoid debates, technical contingencies must refer to a precise set of activities rather than to “policies”, which can be interpreted in different manner. An alternative approach is to treat the current level of costs as the cost of existing policies. Cost increases can then be traced to changes in the volume of inputs acquired and can be termed as the cost of new policies. This conforms to the rule of traditional budgeting, wherein new expenditures must be separately explained.

c. Current versus constant prices

In a country with high inflation, it may seem more sensible to prepare multi-year estimates in real rather than nominal terms. However, inflation higher than the initial target would then require additional cuts in expenditure in real terms but with multi-year estimates expressed in constant prices, spending agencies are better able to resist the additional real cuts required. Lessons drawn from the UK experience in the 1970s show that multi-year budgeting in an inflationary environment puts pressure on the budget. When the multi-year estimate is prepared in constant prices, the Ministry of Finance should define clear rules for updating the price projections. Conversely, estimates prepared in nominal terms give an added incentive for prudent management and then, indirectly, may contribute somewhat to a lower inflation rate. In any case, it is uncertain whether multi-year estimates can be useful in a country without a minimum fiscal discipline and where predictability is not ensured, as it is generally the case of high inflation countries.

B. MEDIUM-TERM EXPENDITURE FRAMEWORK APPROACH²¹

The Public Expenditure Management Handbook of the World Bank defines a Medium Term expenditure Framework approach that aims at linking policy, planning and budgeting, while avoiding the negative outcomes of many past experiences in expenditure programming.

The handbook stresses the importance of institutional mechanisms to facilitate decision making. It notes, notably that beyond the technical aspects of the forward budgeting system discussed above, the lessons learned from the Australian experience are: “the key to adjustment is policy change (not funding change as had been the practice in the past and continues to be in most countries); a hard, top-down aggregate budget constraint plays an essential role; estimates are needed on the cost of government policies and programs beyond

the budget year; institutional mechanisms are needed at the center of the government to enable and demand that government reprioritize and reallocate resources based on priorities; and greater predictability of funding does contribute to improved operational performance.

The MTEF is defined “a whole-of-government strategic policy and expenditure framework within ministers and line ministers are provided with greater responsibility for resource allocation decisions and decisions use. The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and ultimately, the matching of these costs with available resources. The matching of costs should normally occur in the context of the annual budget process, which should focus on the need for policy change to reflect changing macroeconomic conditions as well as changes in strategic priorities of the government”.²²

To be an appropriate framework for resources allocation, an MTEF should encompass all sectors and all categories of expenditure.

The objectives of an MTEF are to:

- Improve macroeconomic balance by developing a consistent and realistic resource framework;
- Improve the allocation of resources to strategic priorities between and within sectors;
- Increase commitment to predictability of both policy and funding so that ministries can play ahead and programs can be sustained;
- Provide line agencies with a hard constraint and increased autonomy, thereby increasing incentives for efficient and effective uses of funds.

Preparation and implementation of an MTEF take place through an integrated bottom-up/top-down strategic planning process, framed by a macroeconomic framework. Major features of the MTEF approach include: strategic sector reviews, development of expenditure framework and approval by the Cabinet of sector policies and envelopes.

Strategic sector reviews consist of three stages: (i) questioning what is the role of the government in the sector, agreeing on objectives, outputs and assessing activities what activities should be carried out to meet these objectives and delivering the outputs; (ii)

reviewing/developing agreed programs and subprograms; (iii) costing agreed programs. These sectors reviews should cover all activities and organizations in the sector and focus should be on overall expenditures.

The Ministry of Finance prepares a medium-term frame (three to five years) and must include clear statement on the following: broad objectives of policy and the role of the government in the economy; the need for discipline in macroeconomic management; targets for broad aggregates of public revenue and expenditure; procedures for setting and revising the expenditure framework; the responsibilities of key ministries.

Sectoral resources allocations are made on the basis of affordability and intersectoral priorities are approved by the main-making decision body in government (Cabinet). This is the more crucial step of the MTEF process. The political aspects of resource allocation makes it wise to reach agreement on the criteria applied to allocations (consider cost recovery, recurrent costs of investment projects, identify what activities should be phased out, etc.).

As noted, in the World Bank Handbook, the approach to building an MTEF will depend on the conditions in the particular country and “for either form of MTEF, development will take a number of years because the MTEF needs to encompass all expenditures”.²³

The precise nature of the MTEFs that are implemented or in the process of being implemented varies from one country to another (set of procedures for strengthening a pre-existing multi-year budgeting system, multi-year budget including new programs in its outyears, aggregate expenditure estimates, etc.). Some countries put an emphasis on the development of a strategic sectoral approach, priority being given to sectors that deliver services to the Public. The disciplined forward budgeting system described in section A would fit an MTEF approach, but less demanding instruments also.

An important element in developing the MTEF approach, besides defining what is exactly the instrument (for example, multi-year budget or more aggregate expenditure estimates), is to assure an effective co-ordination with the budget processes. The sector review phase is not and should be not an open-ended phase. Hard constraints must frame these sector reviews. In some countries, it is projected to link the sector reviews and the budget preparation process through the preparation of “program profile forms” which describe by ministry the main

programs in the sector. These forms include (i) a brief narrative statement; (ii) some “performance indicators” by program; and (iii) projected expenditure over the programming period. Such forms can help scrutinizing the budget. To incite line ministries to prioritize their programs, initial envelopes should be communicated to line ministries before the preparation of the “program profile forms”. The process should be iterative, but time needed for sector review and sectoral planning should not lead to delay the notification of initial ceilings early in the process when preparing the budget or a forward budget, if any. Since the MTEF processes are rolling and to some extent permanent, this should not pose major problems, provided that an appropriate calendar is set up and fits recommendations made in chapter 4 for budget preparation.

The MTEF approach integrates within a multi-year framework the issues discussed in this volume (building hard constraints into budget, ensuring a strong budget-policy and development of a strategic overall and sectoral approach, increased commitment to predictability; and increased responsibilities of line ministries). By contrast, discussion in section C focuses on technical aspects of public expenditures programming instruments. However, the objectives of the MTEF approach described above must be kept in mind when implementing instruments for placing formally the budget into a multi-year framework.

C. *IMPLEMENTING MULTI-YEAR EXPENDITURE PROGRAMMING*

In some transition and developing countries, the development of an MTEF approach, or its first implementation stage, consists of the preparation of aggregate expenditure estimates by broad sector, the preparation of strategy papers and the development of sector expenditure program in few key sectors. Such approaches can contribute to effective improvements in budgeting and policy formulation.

However, in other countries, the implementation of an “MTEF” can turn to reviving old expenditure programming approaches under a new name. The “MTEF” is defined, in these countries, as a multi-year budget that includes new programs in its outyears. Despite the fact an MTEF approach cannot be mechanically implemented, there is little evidence of attempts in these developing countries to design their expenditure programming instrument from the start to suit country circumstances. Lessons from past experiences of the very country or other countries in expenditure programming have merely been taken into account. Rather, the

approach has been that of learning again on the job, and then adapting their instrument in the light of experience. A less expensive approach would be to do more rigorous analysis at the outset, and to create a product better adapted to individual circumstances.

As noted earlier, the feasibility of multi-year expenditure programming is greater when future circumstances are more predictable. In turn, other things being equal, future circumstances are more predictable if an economy is (i) larger and (ii) more developed, and least predictable for a small developing country. Yet, it is precisely in developing countries that the need for a multi-year perspective is greater, for it is there that resource allocation for development requires more frequent, and larger, changes. This dilemma suggests a building-block approach in developing countries. Government resolve and strict fiscal discipline are among the requirements for the success of this building-block approach to multi-year expenditure programming.

1. Conditions for effective multi-year programming

Virtually every stabilization program supported by the International Monetary Fund contained a medium-term fiscal framework. However, processes and requirements for developing an expenditure programming exercise are quite different from those for preparing macroeconomic projections or aggregated expenditure estimates. It is often noted that developing countries environment makes “very difficult to promote medium-term expenditure programming as a feasible means of improving budgeting...programs of technical assistance to help achieve improvements have a mixed record”.²⁴ Political, statistical and administrative conditions must be favorable to make them an effective tool for expenditure programming and budgeting.

a. A modicum of stability

Medium-term expenditure programming is hard to implement in unstable economic conditions.²⁵ Some agree that multi-year programming can itself be a means of increasing the stability of expenditures. Caiden and Wildavsky, however, do emphasize that stability makes multi-year budgeting easier; but reject the converse proposition that planning can create greater certainty for countries subject to fundamental instability. “An essential paradox of programming is that it is expected to create the conditions for its own success.”

Countries that face an unstable economic environment need imperatively (even more than other countries) sound macroeconomic works, assessment of the fiscal sustainability and vulnerability, and estimates of the forward costs of their programs. However, they should avoid policy commitments that will not be met in the future, in case of adverse economic development.

As discussed in chapter 4, adequate systems for revenue forecasting are necessary conditions for sound budgeting. They are required for multi-year expenditure programming also. But, in country facing uncertainty preparing medium-term revenue forecasts is obviously more difficult. In countries where revenues depend highly on commodities prices, an expenditure plan that seems realistic can turn out to be unrealistic, few months after it has been prepared. Forward budgeting requires in these countries an excellent fiscal discipline.

b. Good information

Multi-year expenditure programming requires reliable macroeconomic projections, linked to fiscal targets that are affordable in aggregate, and thus good forecasts of future resources. As discussed earlier, separating new policies or policy changes from continuing policies require both technical capacities in analyzing programs and disciplined policy decision making.

Other information needed is on the detailed pattern of expenditure over a period of time, which implies a satisfactory budget classification and accurate and timely accounting. All of these matters are discussed at length elsewhere in this volume..

c. Budgetary discipline

As repeatedly stressed, the annual budget by itself is a poor mechanism for shifting resources from lower to higher priority uses. The normal tendency is to spread resources across-the-board via a series of incremental adjustments, rather than to shift resources in relation to major changes in policies. As discussed in chapter 4, to avoid a pure incremental approach the budget must be placed into a multi-year perspective. A multi-year expenditure program can provide a formal mechanism for aligning budgets with policies. However, when lack of budgetary discipline causes large deviations between what is budgeted and what is spent, the usefulness of multi-year programming is in doubt. To illustrate, if it takes three years

to reduce military expenditure by 25%, while in the execution of each annual budget military expenditure exceeds the budgeted amount, the medium-term budget is made irrelevant.

d. Institutional support

Ideally, a forward budget should be the main instrument through which resources are allocated. However, in a majority of countries, it is doubtful that political decision-makers will accept such approach.

Participants must not be allowed to subvert the budget process via significant game playing. Evasion strategies are often developed when preparing the annual budget. Multi-year expenditure programming can have the advantage to impose reviews of the forward fiscal impact of current policy decisions, and, therefore limit some of these evasion strategies. However, a multi-year expenditure program can be also an excuse to developing evasion strategies, by pushing expenditure off to the outyears. It will lead, in such conditions, to claims for increased expenditures from line ministries, since new programs are easily transformed into “entitlements” as soon as they are included in the projections.

Medium-term expenditure programming is vulnerable to several problems: the mystique of the measurable (the measurable is treated as more important than the non-measurable, see chapter 4); the tyranny of formal systems (formal systems and processes are treated as more important than informal processes); rewarding the best presenters (good budget presentation is seen as an end in itself, which may cause real problems if medium-term expenditure programming is introduced on a selective basis for some programs, but not for others); and lack of objectivity if those who design and control the process use it as a vehicle for achieving a reordering of expenditure which they themselves favor.

2. Tailoring multi-year programming instruments

The budget literature contains cautionary tales regarding the implementation of template budgeting systems (such as PPBS, ZBB, etc. discussed in chapter 3). The concepts were oversold at inception, and later became discredited when it became obvious that they could not deliver on their promises. Therefore, before carrying out a multi-year budgeting exercise, an

objective critical appraisal is required. Convincing answers must be given to the following questions:

- Is the country ready for such exercise in the sense of having adequate supporting processes: effective system for revenue forecasting; procedures for estimating the forward costs of programs and assessing their soundness; adequate co-ordination mechanisms for budget preparation, including systematic joint review of the capital and current components of the budget; good budget discipline; etc?
- If supporting processes are working effectively, what is the more cost-effective approach; what could be the best mix of actions to meet the objectives in public expenditure management discussed in chapter 1?
- If the supporting processes are not working adequately, what are the priority actions? Should they be carried out before some partial approaches in multi-year expenditure programming or are they perquisite?

Every country should improve its budget system with a view of meeting the three major objectives described in chapter 1 (fiscal discipline and aggregate expenditure control; allocative efficiency; and operational efficiency). These objectives are inter-linked. However, the role in meeting these objectives that can play a particular reform or instrument depends of the country context and on the instrument. For example, in countries that make cash-budgeting, systematic sequestering, where the MOF interferes excessively in line ministries' budget management, etc., the priority actions to increase predictability and operational efficiency are not forward budgeting. This can have an incidence on the design of the instrument multi-year programming instruments, since it would be illusory to expect from them increased predictability, before other reforms of the budget system.

a. Aggregate or Detailed Estimates?

The objective of predictability requires to detail appropriately multi-year expenditure programs by program, projects and spending units. However, this may conflict with the objective of fiscal discipline. A more aggregate presentation is not only cost-effective but also prevents agencies from claiming "ownership" over future funding levels in case of downward revisions.

Therefore, a progressive approach could be to limit the exercise, in a first step, to the preparation of aggregate expenditure estimates (as suggested in chapter 4). Preparing aggregate estimates should not lead to abandon specific programming exercise and the review of crucial issues. Forward estimates for a broad program must be supported by adequate information. Otherwise, there could be a mean to hidden a white elephant under preparation or plans to increasing recruitment in a country with an already over-staffed civil service.

Aggregate estimates can be progressively detailed, along with other improvements in the budget and decision-making systems. Directions in detailing progressively these aggregate expenditure estimates depend on the country context. In countries that face arrears on wages or other crucial expenditure items, the expenditure program should clearly indicate the arrears targets/ceilings in these areas in order to lead spending agencies to identify the measures required to settle them. Other countries may need to develop first multi-year programs with a partial coverage (see section d below).

b. Planning new programs?

To ensure a strong link between policy formulation and expenditure programming, it could be seen that a multi-year program should cover all intended programs over the planning period. It would include, besides programs of the annual budget, new programs in its outyears. Such approach allows shifts in the composition of the expenditure program to be identified and facilitates dialogue with donors.

As discussed in chapter 4, however, frequent major weakness in budgeting is the “need” approach, which leads to expenditure programs that do not fit financial constraints, lack of adequate linkages between policy formulation and expenditure programming, excessive bargaining and the development of evasion strategy. These problems are aggravated when preparing multi-year programs, since planning beyond the budget year is seen as less compelling than annual budgeting, and the temptation to prepare wish lists instead of sound requests is simpler. Multi-year expenditure programming becomes an easy, but dangerous, exercise. In countries with poor fiscal discipline or weak government coordination, framing forward budgets by a macroeconomic framework is far from being sufficient to avoid these undesirable outcomes. Initial experience of some OECD countries reviewed in section B shows that such problems may happen also in developed countries. The main risk in implementing a

forward budget is the fact that it could be seen as only a five-year development plan, rather than a system for expenditure programming under hard budget constraints.

Focusing on immediate decisions, instead of adopting a full-fledged forward budgeting approach limit risks of perverse effects. Besides ongoing programs, the multi-year budget would include only the new programs of the annual budget and, for aid-dependent countries, programs for which an external financing is available. The difference between the revenue forecasts and the total annual costs of these programs should not be allocated. It could be shown in the programming documents, but only as a *purely indicative* reserve. To a large extent, this approach is similar to the approach adopted by OECD countries that focus on “continuing policies” when preparing multi-year estimates. It is also similar to the stringent PIP approach considered in chapter 12 for aid dependent countries.

It is certain, however, that such stringent approach may be difficult to implement in the developing countries context. The term “continuing policies”, often adopted by developed countries, can lead to bargaining. The term ongoing programs/projects is therefore preferable. More worrying, there is in developing countries a general tendency to give the greater place to planning future decisions, rather than reviewing first the future impact of decisions taken when preparing the annual budget. This is partly due to the traditional planning approach, but also to the donors, which require list of projects and future policy orientations to satisfy their own agenda.

In any case, even if this stringent approach cannot be adopted, multi-year estimates must be established on conservative assumptions in order to avoid future disruptive changes. The multi-year programming exercise would not be credible if the estimates prepared the previous year need constant downward revision when preparing the annual budget. In practice, expenditure estimates should be equal to the budget forecasts for the first year of the forward budget; and lower than to the level of expenditures projected in the macroeconomic scenario for the outyears.

c. *Length of the planning period*

"In expenditure programming as in any other field, there is a basic trade-off between certainty and relevance. Economic measures are more specific and implementable the shorter the period which they cover, but more relevant the longer the period covered. For example, a weekly budget would be pretty certain but next to useless as a policy instrument, while a 10-year budget would be highly relevant for policy change but entirely uncertain.²⁶ Hence, other things being equal, the feasibility of a multi-year expenditure approach is directly related to the predictability of future circumstances."

The length of the period over which new programs are planned, is a significant design feature of expenditure programming instrument. In principle, it should be shorter in countries facing major uncertainties. In expenditure programming as in any other field, there is a basic trade-off between certainty and relevance. Economic measures are more specific and implementable the shorter the period which they cover, but more relevant the longer the period covered. For example, a weekly budget would be pretty certain but next to useless as a policy instrument, while a 10-year budget would be highly relevant for policy change but entirely uncertain.²⁷ Generally, multi-year expenditure programs cover three to four years. Uncertainty could suggest limiting the first step in multi-year budgeting exercise to two years only.

However, a two-year period is too limited for making meaningful assessment of the policy directions and related adjustments, and to assess recurrent costs of investment. Also, developing countries needs also a longer to prepare decisions on aid financed projects, taking into time needed for project preparation, negotiation and procurement.

To reconcile these two opposite requirements, countries that face unstable economic environment should make a clear distinction between the "programming period" over which new programs and policy decisions are planned, and the "forecasting period" that merely shows the forward costs of programs. They could, for example, have a multi-year program where the first year (or the first two years) include new programs ("programming period"), while the outyears would show merely the forward costs of programs ("forecasting period"). The term "new/ongoing" programs should be in such cases interpreted in a restrictive sense (rather as "continuing policy"). In aid-dependent countries, however, the programming period need to be longer than one or two years for aid-financed projects. This special issue is discussed in chapter 12 ("stringent" investment programming approach).

Also, the expenditure programming activities should not be confined to the production of forward budget estimates. For technical purposes, more long-term forecasting may be also needed, for example to assess the impact of the debt or pension policy. In some sectors, the crucial issue of recurrent cost of investments may need special studies in some sectors. The fiscal of an investment program is generally more significant beyond the end-of-period of a forward budget than over the period (for example, taking into account periodic maintenance the more significant fiscal impact of a program of road construction program intervenes only several years after its completion). A variety of programming and forecasting documents are required for budgeting and policy formulation, although they should have the official status of the budget.

d. Partial coverage?

A number of countries prepare multi-year expenditure programs that concern only some sectors or subsectors or some category of expenditures, such as PIP, Sector Investment Program, Sector Expenditure Programs, Special Program Laws, etc.

These approaches do not allow trade-offs among sectors or categories of expenditures to be made in a consistent manner. “Partial” multi-year expenditure programs impede fiscal discipline, when a macroeconomic framework does not strictly frame them. Public Expenditure Programs (PEP) or Sector Investment Programs (SIP) are prepared in several developing countries.²⁸ Often, these sector programs show the “needs” of line ministries for both recurrent and investment expenditure, framed by the budget constraint for the first year, but often without clear financial constraints for the following years. They can be used by line ministries for sector policy formulation, or to bargain with the Ministry of Finance, or to discuss with donors, but are insufficient to ensure consistency between policy and fiscal targets. Of course, aggregating such sectoral programs yield a “program” of little value beyond the current year. Similar comments are made in chapter 12 on the wish lists of investment projects prepared for donors’ meetings in a number of developing countries.

Expenditure programs that cover all categories of expenditures are often opposed to programs that cover only investment (such as the PIP described in chapter 12). This opposition is relevant if the debate concerns mechanisms for policy formulation. Strategic allocation of resources cannot be confined to the review of an investment program. However, on a technical

point view, when assessing the forward fiscal impact of ongoing programs, a particular attention on investment projects is required, since these projects are generally of multi-year nature. Moreover, in aid dependent country special attention on domestic counterpart of project financed by external sources is also required. A sound macroeconomic framework, completed with aggregate expenditure estimates is needed to frame a PIP. On the other hand, however aggregate expenditure estimates should be completed by an investment programming document, which should show at least forward costs of projects of a significant size.

Partial multi-year programs present the advantage to focus on the areas in which multi-year programming is the more crucially needed. Often countries that prepare a multi-year program divert their attention towards bargaining minor projects, while programs of significant amount are only roughly estimated and not debated (especially when they are “political”). In such situations, it would be better to focus on areas where multi-year expenditure programming is the more crucial. Detailed forward budgets, or PIP, with hundreds of projects are often ineffective tools for making policy choices. Priority areas for detailed multi-year expenditure programming depend on each country context and policy priorities. For example, it is generally more important to prepare a multi-year program for road construction and maintenance than for an administrative ministry. As noted earlier, in aid-dependent countries, programming projects financed by external aid is crucial. Countries that must downsize significantly their civil service may need to focus first on personnel expenditure plans, etc.

Partial multi-year programs can be, therefore, useful for budgeting and decision-making. However, as stressed repeatedly in this volume, to identify broad policy directions, avoid fragmentation in expenditure programming, and unconsidered promises, a macroeconomic framework, completed with aggregated expenditure estimates by broad function, must *imperatively* frame them.

e. *Presentation of multi-year programs*

As discussed, in chapter 3, the budget should be presented along accountability and responsibility lines. The same recommendations apply to multi-year programs. Aggregate estimates are often only by broad function or sector. However, if they are in a second stage detailed this should be done by ministry and agency. The preparation of sector review or strategic planning is an important component of the MTEF approach. The sectoral programs

must be properly defined. Presenting programs by sector, preparing programs profile forms, etc. can improve sector budget and multi-year program formulation. However, it should not drift towards a program-budgeting exercise, in the sense of those unsuccessfully attempted in the 60s that attempted to surpass administrative and responsibility arrangements (see discussion in chapter 3).

f. Status of the instrument

To be an effective instrument for policy decision making, ideally a multi-year expenditure program should be a public document and, preferably, presented to Parliament with the budget. Making explicit and publishing expenditure commitments is important for accountability and predictability.

However, committing the government on the basis of estimates roughly prepared would hamper fiscal objectives. In practice, the status and the role of a multi-year expenditure programming document must depend on its quality. Therefore, in a number of developing countries, the first step should be to prepare an internal multi-year programming document, for information only. Such documents have limited objectives, but can contribute to developing progressively a multi-year programming approach.

3. Implementing multi-year budgets: Some illustrations

Developing comprehensive multi-year budgets can be when circumstances and capabilities permit an effective approach. When this is not the case, this would be a waste of time and resources, and might distract attention from the immediate needs for improving the annual budget process. Boxes 33, 34, 35, and 36, show different experiences in different countries, in implementing multi-year budgets, sometimes named “MTEF”, although it is far from being evident they have all adopted the MTEF approach described in section B above.

D. KEY POINTS AND DIRECTIONS OF REFORM

1. Key points

A number of countries prepare rolling multi-year budgets since the 1960s. The initial aim of multi-year budgeting was to provide a framework within which new programs and policies will be identified and programmed. Uneven results and need to strengthen expenditure control led to focus multi-year budgets on continuing policies and immediate policy changes, and avoid to plan new policies for the future. In some developed countries, multi-year budgeting aim merely at giving a baseline for the budget. This baseline shows what are the current constraints over a multi-year period. In other countries, multi-year budgeting and annual budgeting has a higher degree of integration. The multi-year budgeting processes frame effectively decision-making and allows budget preparation to focus on policy changes.

Multi-year budgets must be imperatively framed by a macroeconomic framework. Their preparation should be similar to the preparation of the budget and consist a combination of a top-down and bottom-up approaches, under hard financial constraints (see chapter 4). Under such conditions a multi-year budget can be an effective instrument for policy formulation and allocation of resources. It allows systematic reviews of the forward impact of policy decisions and supervision of their implementation over a multi-year period. It provides an adequate and formal framework to place the budget into a multi-year perspective, which must be done in any case (see chapter 4). Highly disciplined multi-year budgeting processes can contribute to increase predictability and, therefore, operational efficiency.

Recently the World Bank developed an MTEF approach that aims at assuring better fiscal discipline; strategic allocation of resources, through development of strategic planning both at the whole government and sector level; and operational efficiency, through increased predictability and increased responsibilities of line ministries.

In many developing and transition economies, uncertainty and lack of stability, insufficiently disciplined decision-making process, and insufficiencies in technical supporting processes make difficult multi-year expenditure programming.

Multi-year programming approaches must be tailored according to the country context. This can consist of limiting the length of the “programming period” that includes new programs and projects; developing aggregate expenditure estimates and detailing them progressively; and

developing aggregate estimates and partial programs (sector program in priority areas, investment program, etc.).

2. Directions in Reform

a. *Minimum Requirements*

At least, every country should project the forward costs of the major categories of expenditure and frame the budget by a realistic macroeconomic framework that allows major policy choices to be identified (see chapter 4). No new large initiative should be considered for funding when its future framework implications are not realistically assessed.

b. *Further Steps*

Concerning further steps, as a *general requirement*:

- The planning nature of the multi-year documents must be clearly and appropriately specified. Every country should focus on continuing policy and immediate policy changes to be decided within the annual budget process. *It is not recommended to plan new policies in the outyears of a multi-year expenditure program.*
- Every multi-year expenditure program, whatever its characteristics must be framed by a macroeconomic framework.

To tailor multi-year expenditure programming to country context, the following features of the programming instruments must be carefully designed:

- *Format.* A proper degree of detail in the presentation of the multi-year estimates is needed if the objective is to increase predictability, but detailed forward estimates can generate increased claims from spending agencies. Countries with limited technical capacities and/or with poor fiscal discipline should consider implementing (i) aggregate expenditure estimates; and (ii) detailed partial multi-year programs for only priority areas.

- *Length of the programming period.* It is important to show forward costs of ongoing programs over a several-year period, but countries with insufficient fiscal discipline or facing uncertainties *should avoid programming new projects/programs* in the outyears of their expenditure programs, even when these new programs correspond to ongoing policies. However, some exceptions may be needed notably for the treatment of aid-financed projects (see chapter 12).
- *Partial programs* focusing on priority sector or areas (e.g. investment) can be a cost-effective approach. Their scope depends on the country. Expenditure programs with partial coverage must be *imperatively framed* by aggregate expenditure estimates.
- Detailed multi-year expenditure programs must be presented along *accountability and responsibility lines.*
- *Status of the instrument.* Making explicit and publishing expenditure commitments is important for accountability and predictability, but committing the government on the basis of estimates roughly prepared could hamper fiscal objectives. If its quality is still not assured, the expenditure programming document should be seen as a working document.

Countries where conditions are conducive (stable macroeconomic environment, good fiscal discipline and technical capacities) may consider implementing, either progressively through the development of partial instruments, or immediately a comprehensive forward budgeting. This forward budgeting system and the annual budget system should be fully coordinated.

Box 33
Mozambique: A Premature MTEF?

Following a World Bank report in 1996 calling for improved fiscal management, the government of Mozambique prepared a reform program (Republica de Moçambique, 1997) which sets out a comprehensive program for expenditure management reform, including an MTEF. The strategy consists of improvements in several key processes: the budget law, budget classification and coverage, accounting and monitoring, cash management, debt management and auditing. As part of this strategy, a budget framework law was recently passed and a new system of budget classification was introduced. Much remains to be done, however, if public finance systems are to perform adequately because the starting point for reform is too basic: single-entry accounts (often handwritten); a proliferation of bank accounts for conducting government business; severe problems of cash flow; disregard of the budget calendar; extreme reliance on donor funding (most of which escapes budget disciplines); strictly segregated procedures (including budgeting and accounting) for recurrent and investment expenditures; and weak controls.

Having recently emerged from a long civil war, the country requires considerable fiscal adjustment, and even with debt relief, the budget deficit needs to be further reduced at a time when donor funding is decreasing. An MTEF is an attractive proposition, but potential problems could ensue because of lack of supporting systems particularly in the field of human resources. There is a severe lack of skilled staff needed for budgetary reforms. Problems include lack of basic skills, lack of staff with higher qualifications, loss of staff to the private sector, immense salary differentials between the public and private sectors, and moonlighting to supplement inadequate wages. The Ministry of Finance and Programming is said to be one of the weaker agencies in terms of skills.

Nevertheless, the government is introducing a rolling five-year MTEF starting with the preparation of the 1999 budget. The challenges now are to link the sectoral work with macroeconomic realities (defining the aggregate resources available) and to ensure that the 1999 budget is prepared within the MTEF framework (defining sectoral allocations and seeing that they are observed).

Clearly, the basic building blocks for an MTEF are not yet in place. The sentiment that "Mozambique has the advantage of not yet starting some of the reforms that other countries have implemented and can benefit from their experience"* needs to be balanced against the difficulty of making MTEF work in the present situation. The timetable for effective adoption will stretch to several years and given the weaknesses in budget and related systems, it might be more realistic to adopt a less demanding MTEF, one that is carefully designed to fit the present need of Mozambique. In the meantime, a five-year MTEF could be too ambitious, especially in view of the lack of real meaning attached to two- and three-year expenditure figures in far more predictable environment.

Box 34
South Africa: A Mature MTEF?

The Budget Speech for 1998 announced the adoption of a Medium-Term Expenditure Framework (MTEF), which was described as “the operational program by which we give substance to our reconstruction and development efforts”. Its goals are as follows: (i) to strengthen the political decision-making in the budget process; (ii) to enable the Cabinet to link budget allocations and services; (iii) to strengthen cooperative governance and decision making; (iv) to deliver better services; (v) to create a medium-term environment for public sector programming; and (vi) to achieve greater transparency and openness in budget policy making.

The MTEF is a three-year rolling process in which expenditures are expressed at estimated current prices. It applies to both national and provincial government and reflects government’s social and economic priorities and the country’s reconstruction and development commitments. Its adoption is expected to effectively allocate resources to priority areas and will lead to a more efficient programming and management of resources. It serves as a framework within which policy proposals can be assessed, promotes transparency in government, and reduces rollovers (expenditure commitments from previous years).

The MTEF of South Africa is comprehensive and contains all the necessary components for a successful implementation: a macroeconomic framework, a fiscal policy, medium-term expenditure forecasts for three years, an annual budget process linked to the MTEF, and draft sectoral programs. The components are linked to one another and there is strong political support for the entire process. The MTEF is still at an early stage of development but much has already been achieved. Significant work has been done in sectoral programs with the establishment of sectoral teams in August 1997.

The South African version of MTEF has additional links designed to increase its relevance and chances of success. First, it focuses on fiscal decentralization, translation of policy goals into service delivery, increased efficiency and transparency, and partnership between the public and private sectors. Second, budget reform is dependent on financial management, which receives specific incremental funding under the MTEF program. Third, the extent, cost and conditions of public sector employment are seen as significant issues within the MTEF program. The program specifically addresses personnel management, public service regulations, budgeting for personnel costs and decentralization of personnel decision making. This establishes a strong link between expenditure management and personnel issues, which is quite rare in public sector reform programs. This version deserves to succeed because it has been well conceived and programmed and addresses the right questions. Its chances of success are enhanced by strong government commitment and, if pursued with energy and determination, MTEF in South Africa has all the chances of achieving its central aims.

Box 35
Tanzania - A Failed Forward Budgeting System?

Tanzania's four-year rolling program and forward budget (RPFB) has been a disappointment. Its status in late 1997 was unclear: the analytical work was done for the three-year period to 1998/99 but not published, and it is not known whether RPFB will continue. Budget administration has been dominated by day-to-day issues of cash management, reinforcing skepticism concerning the feasibility of medium-term expenditure programming.

The World Bank (1997b) refers to the following problems in Tanzania: "Expenditures under the RPFB have always departed from the projected path and projections for the forward years have not been taken seriously. Although line ministries have prepared and presented combined submissions for their recurrent and development estimates, recurrent and development submissions have in practice been reviewed separately by Finance and Programming. A large proportion of aid flows has not been properly reported in the government budget and accounts. There are several reasons why the RPFB has so far failed to make the concept of a medium-term expenditure framework fully operational. Budget projections were over optimistic, thus evading the problem of attaining a realistic initial budget. The government's political commitment to the budget figures it announced was weak; thus there were frequently large reallocations early in the budget year. General expenditure discipline was poor, and budgets were also thrown off by expenditure arrears carried forward. The weaknesses in estimating, monitoring and accounting were another source of uncertainties" (page 71). Elsewhere in the report the World Bank notes "the RPFB exercises have been diluted by rapid departure from the main macroeconomic assumptions in the program. It is not evident whether the proposed macroeconomic framework was in fact consistent with maintenance of macroeconomic stability" (page 74). "The development budget accounts for a small fraction (10 percent) of the recorded budget and an even smaller proportion of actual disbursements" (page 75). "The number of projects is unmanageably large; projects are severely under-funded" (page 76); and "a comprehensive sector-wide view of requirements is inhibited by the fragmentation of expenditure programming between recurrent and development budgets" (page 79). "RPFB has tended to be crowded out by urgency of annual budget preparation and even annual expenditure projections have been quickly derailed by lack of discipline and failure to anticipate and control commitments effectively" (page 81).

In addition, the same report takes note of the following: as much as 80% of donor funding has not been recorded in the budget; ministries have been incurring significant expenditure commitments outside budget limits and consequently carrying forward large payment arrears; there is a high level of within-year deviation from budgets; only a fraction of the development budget is released during the budget year; spending agencies have weak supervisory controls and no disciplinary action for overspending; Exchequer Account reconciliation suffers from a two-year backlog and the consequent absence of final accounts.

Despite these reported failures, public expenditure reviews carried out by the World Bank in 1989 and 1994 still favorably recommended the RPFB approach. The World Bank's latest review concludes: "The principles and objectives of the RPFB approach remain appropriate. Given the present government's seriousness of purpose, the RPFB if suitably modified, can still be an effective instrument" (page 71). Comparing this situation with the conditions that would favor successful introduction of an MTEF, as listed in annex 3, the likelihood of a successful MTEF for Tanzania is indeed very low.

Box 36**Learning from qualified success: The Public Expenditure Survey in the United Kingdom**

This note reviews some of the difficulties faced by the UK Public Expenditure Survey (PES) in the early years of its 34-year life and discusses the measures that were adopted to overcome those difficulties.

The PES started in 1963 as a forward survey of public expenditure covering five years (the budget year and four further years) and was expressed in constant prices. In the mid-seventies, the U.K. economy had to adjust to the shock of sharply increased oil prices. With a depressed economy, its five-year public expenditure outlook in constant terms was no longer appropriate. Public expenditure was rising faster than national income. Economic pain was being shared unequally, with the public sector escaping scot-free. Inevitably, actual expenditures diverged from their programmed path and the irrelevance of PES figures became evident. The Select Committee on Expenditure at that time concluded that, "the Treasury's present methods of controlling public expenditure are inadequate in the sense that money can be spent on a scale not contemplated when the relevant policies were decided upon"^{*} In short, the five-year program bore very little relation to what was being spent.

A fundamental review revealed several weaknesses. An increased stability for public spending had proved largely illusory because public expenditures could not be insulated from short-term economic management. The constant price basis implied unaffordable levels of public expenditures during economic recession and undesirable growth at other times. In addition, it made it very difficult to reconcile PES figures with the annual budget. The five-year program was too long because expenditure figures for the last two years became unreliable and therefore largely irrelevant. The Treasury lacked reliable statistics and so was unable to closely monitor actual expenditures against programs. PES accounts became inadequate as control tools, in that they could not be used to make departmental spending conform to Treasury wishes.

At this point, PES could neither accurately program, nor adequately control public expenditure and this called for immediate remedial actions. From 1975 onward, the Treasury's procedures for collecting, updating and reviewing financial information were reviewed and a Financial Information System was designed, developed, and installed. Cash limits were introduced in 1976 and the constant-price basis of PES was abandoned in 1982. The duration of PES was progressively reduced from five to three years. The revised PES made extensive use of cash programming, enabling better control of aggregate public expenditure, better links between PES and annual budgets, an improved framework for managing public sector costs, and a lever for exacting efficiency gains from spending departments.

The U.K. experience serves as a relevant guide to achieving realistic expectations. The success of forward budgeting starts with the recognition of problems and how adjustments are made to be able to overcome them. The PES was hailed in 1973 as having reached full maturity, and as being "the most important innovation in its field in any Western nation".

* Thain and Wright, p.43.

¹ For a broader discussion of expenditure programming and forecasting, see Premchand, 1983 (chapter 7 "Expenditure Programming and Forecasting") and William Allan "Public Expenditure Programming and Forecasting" in Caiden, 1996.

² Premchand, 1983.

³ Public Expenditure Management Handbook, The World Bank, 1998.

⁴ In 1995, OECD listed Australia, Austria, Canada, Denmark, Finland, Germany, Italy, Netherlands, New Zealand, Spain, Sweden, United Kingdom, USA (OECD, 1995).

⁵ Allan op.cit. See comparisons of forward budgeting systems in Premchand, "Expenditure Controls: Institutional and Operational Issues" in Premchand, "Government Financial Management: Issues and Country Studies", IMF, 1990.

⁶ Drawn up from Premchand, 1983, page 218.

⁷ Budgeting for the Future, OECD, 1997.

⁸ See Likierman, "Government accounting in the United Kingdom" in Premchand, 1990.

⁹ See M. Keating and D. Rosalky, "Rolling expenditure programs: Australian experience and prognosis" in Premchand, 1990.

¹⁰ Description and comments on the PEMS are drawn from H. Sims, "Policy and Budgetary Disharmony: Canada's Experience Since the 1960's" in OECD, 1996.

¹¹ H.Sims, op. cit.

¹² Drawn up from Lacey, 1989; and William Allan, "Public Expenditure Programming and Forecasting" in Caiden, 1996.

¹³ Drawn up from Lacey, 1989, and Allan op.cit.

¹⁴ H.Sims op. cit.

¹⁵ See Allan op.cit. and Von Hagen, "Budgeting Procedures and Fiscal Performance in the European Communities", Commission of the European Communities, 1992.

¹⁶ Allan op.cit.

¹⁷ OECD, 1995.

¹⁸ Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States of America (OECD, 1995). At the time of the survey, Korea and Mexico were not yet OECD members.

¹⁹ See Michael Keating and David Rosalky, "Rolling Expenditure Plans: Australian Experience and Prognosis" in Premchand, "Government Financial Management Issues and Country Studies", IMF, 1990.

²⁰ Forward estimates in Australia do not include a reserve.

²¹ Descriptions of the MTEF presented in this section are extracted from the Public Expenditure Management Handbook, World Bank, pp. 31-52.

²² Public Expenditure Management Handbook, World Bank, 1998, pp. 46.

²³ ———, pp. 40.

²⁴ Allan, op.cit.

²⁵ The difficult experience of the United Kingdom in the wake of the 1973 oil crisis is relevant. See Thain and Wright, 1995.

²⁶ Chapter 15 explains a similar trade-off for accountability, whereby accountability for performance can be either strict but narrow, or broad but loose.

²⁷ Chapter 15 explains a similar trade-off for accountability, whereby accountability for performance can be either strict but narrow, or broad but loose. Hence, the feasibility of a multi-year expenditure programming approach is directly related to the predictability of future circumstances.

²⁸ E.g. Cameroon, Madagascar, etc.

**Chapter 14. INFORMATION AND COMMUNICATION TECHNOLOGY (ICT) IN
PUBLIC EXPENDITURE MANAGEMENT (PEM)
by Marilyn B. Pizarro***

This chapter is a summary of opportunities, issues, and concerns raised by ICT in public-sector management, including PEM. It is complemented by annex X which presents a detailed and sophisticated description of a fully integrated financial management information system. While such a system is not achievable or realistic in many developing countries and is highly technical (the reason why it is not included in the text), the annex demonstrates the possibilities and presents a likely ultimate objective in this area. It is important to begin by repeating the basic considerations made on the subject in chapter 1.

First, *ICT is a tool*, immensely powerful yet essentially no different from a photocopier or a car, in the sense that the user's needs and requirements must come first and dictate whether and how the ICT tool should be used. For certain functions, pencil and paper, or a telephone, or a face-to-face meeting, or a visit to the library is far more effective than computers or the Internet. This obvious point must be stressed because governments, consultants, or donor agencies frequently encourage computerizing anything in sight. The costs of a given ITC change must be assessed realistically and compared with the actual benefits expected from the change.

Second, *neither the ITC "techie" nor the public manager should work in isolation from each other*. As noted, improvements in effectiveness stem largely from better rules and procedures in the sector concerned. To apply more advanced ICT to obsolete or inefficient rules and processes means, in effect, to computerize inefficiency. To be inefficient faster is not progress. On the other hand, the absence of relevant ITC knowledge poses the risks of costly mistakes or missed opportunities for dramatic improvements in service.

Concerning PEM in particular, *ICT cannot substitute for good management and internal controls*. Indeed, the introduction of computers can give a false illusion of tighter

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expenditure control, in cases where a large part of the expenditure cycle occurs in parallel outside the computerized system.

Also, faster and integrated public financial management information systems carry correspondingly *greater potential risks* for the integrity of the data, and can even jeopardize the entire financial management system if developed carelessly and without sufficient checks, controls, security, and virus protection.¹

To sum up, the adoption of more advanced ICT should meet the following criteria: (i) it should always fit the user needs and the real objectives of the activity; (ii) it should aim at an integrated strategy and avoid a piecemeal approach (which can fit specific needs but add up to a ramshackle and even dangerous system);² and (iii) it should assure that the more advanced ICT goes hand in hand with improved rules and processes.

That said, ICT offers a wonderful potential for increasing government accountability, transparency, and participation; improving the efficiency and effectiveness of public-sector operations; widening access to public services; and disseminating information to the public and getting feedback from relevant stakeholders and service users. With specific reference to PEM, among other things, ICT can help solve the centralization/decentralization dilemma, by making relevant data easily available at all government levels; vastly facilitate budget analysis and programming; and improve the timeliness of budget information. It may appear from the following that these advances are relevant exclusively to developed countries. Although in large part the uses as well as the products of the technology are indeed associated with developed countries, the potential is enormous even for poor developing economies (see, for example, box 37). Thus, a single telephone line can bring a remote village into direct contact with a wealth of relevant information, as well as allow its inhabitants a “voice” in their government.

A. GOVERNANCE AND PUBLIC SERVICES IN THE INFORMATION AGE

1. Role of ICT in effective governance

Over the last five years or so, many national governments have published ambitious proposals for recasting government with the help of ICTs. Plans for Online Government have also featured prominently in proposals for the Information Society drawn up in such international forums as the European Information Society and the G7 Group of Industrial Nations.

While these initiatives differ considerably in scope and emphasis, they also reflect a broad consensus about the possibilities offered by ICTs. The growing synergy between information technology and telecommunications will enable governments to be much more flexible in the way they capture and exploit information. In turn, these new flexibilities will offer important new opportunities for designing business processes and configuring organizations, based on vastly expanded possibilities for human connectivity. In particular, such factors as time, geography, organizational boundaries, and national jurisdictions will become less significant in the conduct of human affairs.

New ways of handling and communicating information can allow governments to escape the (seemingly intractable) dilemma between cutting costs and increasing quality, creating government that “works better and costs less”. More importantly, new channels of interaction will open up between governments and citizens, enhancing transparency, increasing accountability, and making government more accessible to new forms of democratic participation.³

During the 1960s, the public sector led many private enterprises in the use of computers in support of basic administrative functions, including management information systems, payroll processing, and accounting applications. Subsequently, governments tended to fall behind private industry in Electronic Service Delivery (ESD) systems that give direct access to information and services.

Lately, however, many innovative local and national government agencies around the world have started applying ICTs to a growing range of public services. The objectives of ESD projects are two: implement major improvements in the speed of response, efficiency, and accessibility of public services; and bring government closer to the citizens.

The benefits of new information and communications capabilities for the services produced by public agencies are the following⁴:

- a. Lower administrative costs, releasing the savings for “front-line” support. ICTs allow for a significant reduction of information handling costs, and compliance costs. In particular, ICTs enable more data (e.g., dates of birth or changes of address) to be shared between different information systems, thereby reducing the number of times the data have to be collected.
- b. Faster and more appropriate responses to requests and queries, including the provision of services outside normal office hours. ICTs allow direct access to transaction or customer accounts held in different parts of government, especially for street-level public services. Thus, individual cases could also be processed more quickly.
- c. Access to all departments and levels of government from any location. ICTs support the development of more flexible, convenient ways for citizens to access public services. For example, governments are developing direct online round-the-clock facilities for transacting business such as welfare claims, tax assessment, visa applications, and license renewals. The use of smart cards is also being developed to allow access to an increasing range of government services---a kind of electronic one-stop shop. These could prevent fraud or misuse of public services and benefits, resulting in increased public confidence in welfare and taxation services.
- d. Better governance capability. ICTs enable governments to harvest more data from operational systems, thus increasing the quality of feedback to managerial and policy levels. Governments are also able to make more information available to citizens and support new kinds of online communication between policymakers, elected representatives, individual citizens, or organized lobbies. In these ways, ICTs could enhance the steering capability of modern governance.

- e. Assistance to local and national economies by facilitating the government-to-business interface. This could result in improved services to remote rural areas and enhanced emergency-support services.

Box 37
Information Technology in the Pacific Islands

In the Pacific Islands, new capabilities associated with ICTs could help to:

- *Simplify government bureaucracy.* For example, a United Nations virtual meeting last January linked governments and NGOs in 10 countries with a listserv. A productive exchange took place, saving over US\$25,000 in travel costs, and cutting out wasted travel time by busy officials.
- *Break down barriers between functional domains.* The Fiji Public Service Commission is introducing a personnel management system to facilitate, among many things, more effective training and monitoring of the performance of participants in the newly established Senior Executive Service.
- *Allow public services to be reoriented to solving problems for clients.* The Federated States of Micronesia uses a Web-based system linked with Hawaii for medical advice on difficult cases. A listserv links over 100 doctors in the Pacific Islands, serving as an early-warning system on outbreaks of disease.
- *Open up government, making it more transparent and accountable.* The Solomon Islands recently used the Web to help it assess the prior experience of an international contractor bidding on a government contract to do preshipment inspection of logging exports. Previously, contracts with unqualified firms were approved. In Vanuatu, the Ombudsman's Office set up a listserv to get legal advice on how to defend itself before the High Court against a suit by the Council of Ministers (many of whom were accused in the Ombudsman's reports of misconduct) seeking to abolish the office. The Ombudsman's Office succeeded in its legal defense, although the Ombudsman Act was subsequently repealed by Parliament.
- *Develop new forms of citizen participation.* Web-based chat sites such as the Tonga Kava Bowl and Niugini.com facilitate freewheeling political discussion difficult to sustain in regulated print media. They also allow the diaspora in the U.S.A., Australia, and New Zealand to participate in the political debates in their countries.

Source: Clay Wescott, Personal Communication, 1998.

2. Information Trading as a Public Service

Inevitably, governments are the biggest single collector and producer of information. Within the government, the way in which the information is managed has wide-ranging consequences. The relationship between the government and the people can be enhanced through wide dissemination of government information. To the

commercial sector, the efficient availability of government information can enhance the growth of information-related business activities.

The use of information communication technology (ICT) in government may enable government departments to integrate their information between them. The departments can thus harvest more data from operational systems at significantly reduced information handling cost. As governments realize that the information collected is a valuable asset, they may wish to use it commercially and turn it into a traded commodity. In this case, ICTs will act as the medium for transferring the information from the sources to the users or to the marketplace (Neil McBride 1999).

Richard Heeks⁵ has outlined opposing views taken by different governments about the nature of information (and, hence, its tradability):

- *Information is a public asset.* Public-sector information is owned by everyone since it has been gathered about and from everyone, often compulsorily. Therefore, information should, in general, be made freely available as it can assist both democratic and economic development. Information should either be made available freely or at a charge that reflects merely the cost of information output and transmission. With certain exceptions, individuals have a right to see the information that the government holds about them.
- *Information is a private asset.* Public-sector information is owned by the department that owns (or pays for) the computer on which that information resides. Since the public sector has invested money in producing information that often has considerable commercial value, it may sell information at whatever price the market will bear to earn valuable revenue. Individuals may see the information about themselves so long as they pay.
- *Information is not an asset.* It is not seen as important enough to warrant open consideration of issues of ownership, value, and charging. Where used, information is virtually a personal asset of particular public-sector staff. Information is not generally made available and individuals do not have rights of access, except perhaps through “under the counter” payments.

Recent research⁶ suggests that increasingly, government departments are commercializing information and seeking to sell it to generate revenue. There is also an increase in private-sector participation in government information marketing programs that can be considered as an alternative to the government department promoting the growth of the information industry. This issue of government information trading may be a new perspective in government information management.

How does government information trading work? The study suggests that government departments have treated information as a valuable and tradable commodity. Information is evaluated for its commercial value, extracted, and offered to the commercial market. Government departments may trade the information directly with users or through marketing agents or information brokers.

In the UK, guidelines are being implemented to streamline the involvement of government departments in supplying information to private companies. Government departments are encouraged to supply raw information to information brokers who will process and resell it to the users. Some departments have a contract with information brokers to sell information to the market. The contract stipulates that the brokers regularly receive packaged information to which they add value and with which they may provide good service to the end-users. The information brokers will pay the government departments according to the agreed payment schedule or rates which may depend on the volume of information and the total value of the sale.

The increasing willingness of governments to use ICTs to sell information to the users has raised a number of questions. The issue of ownership of data once it is sold requires clear guidelines from the government. Since some parties may misuse widely disseminated government information, there must be controls to regulate the use of this information. As governments become key information suppliers in the market, the extent to which they should compete with private companies and the manner in which information should be traded in the market must be governed by well-defined guidelines. Clear government policy is therefore important for the development of a good government information trading service.

3. Barriers to ICT Innovations

Failures in government policies are often one of the reasons why public-service benefits from ICTs are wasted. The U.S. Office of Technology Assessment (OTA) identified the following main problems: inadequate attention to the human element in systems development; insufficient priority given to the need for affordable, accessible, user-friendly applications; widening gap between the educated, technically proficient citizens, and the less advantaged; and failure to forge effective partnerships between government agencies and the private sector. Among the barriers to innovation in the provision of public services are the following:⁷

- a. Defense of functional organizational boundaries by agency “barons”;
- b. Fragmentation caused when departments or agencies develop systems exclusively for their own clients, although integrative multifunctional and cross-departmental “one-stop-shop” applications have greater long-term potential;
- c. Constraints and demotivation faced by champions of innovation in the risk-averse bureaucratic cultures that typify many public agencies;
- d. Overcentralization of government, leading to the weakening of local government and fewer opportunities for local innovation;
- e. Anxieties among staff members caused by fears of employment cuts, job reorganization, and geographic redistribution;
- f. Perception among many staff members and citizens that costcutting is the overriding objective of ICT initiatives and that claims about improving services fulfill a primarily rhetorical role;
- g. A narrowly focused “business case” for ICT investment that fails to identify as key priorities the kinds of benefits that will build a broad constituency to support the continuing introduction and use of new applications;

- h. Negative reactions from citizens who do not want to be treated purely as “customers” or “clients” and who might see ICT as a wedge for the introduction of inappropriate business methods into public services;
- i. Experiences of past ICT failures, making users reluctant to be involved in new ventures;
- j. Difficulties in scaling up to larger operational systems from small pilot projects;
- k. Practical incompatibilities when communicating between systems in different departments, local authorities, levels of government, and private enterprises.
- l. Prevention of flexible, multifunctional uses of data by the introduction of privacy regulations to allay public fears about the use of personal information held within ESD systems.

Many of the barriers to the development of public expenditure management ICTs are organizational in character. Overcoming these barriers requires awareness among all concerned that new methods of service delivery cannot be successfully implemented unless the organizations that support those services also take on new forms.

It must be recognized that optimizing technology-intensive innovations like ESD requires organizational changes to support, sustain, and successfully carry out those service innovations. This is a more holistic concept of change, founded on the intrinsic interrelatedness of organizational outputs---the services provided---and the organization itself. As service innovations are designed and prepared for implementation, so organizational change must occur to support them.

In many Pacific Island countries, the main constraints holding up advances in ICTs are the high cost of ICT and the lack of ICT skills in the region. Costs are particularly high for Internet access. In Fiji, a 64K Internet circuit costs US\$10,100 per month, over nine times the cost of a comparable circuit in Jamaica. One reason is that

the local ISP has a monopoly, although the government has promised to open up to competition next year. Other regional telecommunications companies, worried about their monopoly positions, have prohibited the University of the South Pacific from installing links to its Intranet in their countries. This prevents extension students from using the USP's online library and other learning tools (Clay Wescott 1998).

In response to the need to develop ICT skills among technicians, policymakers, and users, the Asia-Pacific Development Information Programme (APDIP) has been conducting highly specialized seminars to suit specific needs and address important issues such as: IT-related policies, infrastructure building, funding and sectoral issues such as IT in health, education, environment, security, e-government, and teleworking. A series of seminars to government officials in developing countries will be held in Kuala Lumpur, Malaysia. The seminars are designed to assist in formulating comprehensive IT frameworks and enabling policies to harness the potential of IT and support national development in line with their social, economic, and political objectives. This will provide a catalyst to achieve optimal national IT growth while maximizing available resources and decreasing expenditures.

Box 38
Asia-Pacific Development Information Program (APDIP)

APDIP, the Asia-Pacific Development Information Program, is an initiative developed and funded by the United Nations Development Program (UNDP). Based in Kuala Lumpur, Malaysia, it covers 42 countries in the region through 24 UNDP country offices and is implemented by the UN Office for Project Services. APDIP aims at assisting member countries in the use of Information Technology (IT) to foster social and economic development. The program has several interrelated objectives:

- Train and inform government officials, NGOs, and regional counterparts on the benefits of IT and policy and legislation relative to the development of sound IT infrastructure in developing countries;
- Backstopping and support for IT initiatives in participating countries;
- Assist in the assessment, design, and implementation of IT systems at regional level.

APDIP is rapidly establishing itself as a reliable provider of sustainable technical solutions for IT needs based on distributed systems and Internet/Intranet strategies. At the regional level, APDIP provides technical expertise to organizations, UN agencies, and Programs as well as other regional or subregional entities. Major organizations supported are the Association of Southeast Asian Nations (ASEAN) and the Economic Cooperation Organization (ECO) with connectivity and/or Intranet development to foster knowledge sharing among members.

Other activities also include the Regional Information Server Programme, which provides hosting services to regional programs, enabling them to use Internet services such as Web, e-mail and newsgroups in support of their activities.

APDIP national assistance focuses on:

- Training seminars for government officials, decision-makers and potential users of IT. These seminars provide an introduction to the benefits of IT in support of a wide range of development activities. Specifically, the participants are given insights into the use of IT on three distinct levels: within the organization (Intranet), within the country (CountryNet), and Internationally (Internet). Other seminars are tailored to specific issues at the national or regional level;
- Assistance with the formulation of IT proposals. APDIP assists decision makers and major partners not only in conceptualizing the potential use of IT as an enabling tool for development activities in their own countries, but to also in formulating and planning IT proposals through access to best practices and advice on financial requirements and resource mobilization;
- Technical backstopping. APDIP assists in the implementation of specific IT initiatives, especially in countries where data communication and infrastructure are limited or serve only major centers;
- Assistance with legislation and policy formulation. A number of governments are now confronted with new issues to be addressed in their effort to determine IT policies and implementation.

Source: APDIP Web site, 1998.

4. ICT and Corruption⁸

It is increasingly assumed that the introduction of more advanced ICTs reduces opportunities for corruption. The reality is more complex. While IT sometimes detects and removes corruption, it can also have no effect, or even provide for new corruption opportunities. Computerization creates changes in one or more of the following related aspects:

- *Skills.* Computerization is often associated with an “upskilling” of corruption, providing new corruption opportunities for those with IT skills, and removing opportunities from those without IT skills.
- *Confidence.* With computer systems being regarded as an objective, all-seeing, and all-knowing, corrupt staff members lose confidence and refrain from corrupt practices.
- *Access.* Computerization of records often closes down access to some staff members but opens up access to others who operate the IT systems. Depending on relative integrity, corruption may increase or decrease.
- *Control.* Data quality and computer omnipotence make some managers assume that IT removes the opportunities for corruption. They may therefore fail to institute controls on computerized systems. And this last is probably the most dangerous tendency, for the lack of controls will be evident to precisely those in a position to take advantage of it.

In all cases, corruption comes from a combination of two sets of factors: the microlevel, the individual, his/her circumstances, needs, skills, access, confidence, and autonomy, and the macrolevel, organization and national management systems, politics, and culture. Management decisions about computerized information systems may affect skills, access, confidence, and autonomy. However, they are most unlikely to affect the personal or environmental drivers behind corruption.

IT-based systems affect symptoms of a corrupt system rather than its causes. Corruption is a phenomenon rooted in the cultural, political, and economic circumstances of those involved. IT does little to affect these root causes, remains in its surveillance potential, and so cannot eliminate corruption in public expenditure management. IT has a potential role, but one that is limited and that forms only a part of a much larger picture.

B. ELECTRONIC SERVICES DELIVERY (ESD)

In the 1990s, several ESD applications started to be widely implemented, as shown below:

ICT Task	Sample Applications	Possible Systems
Narrowcasting	Public expenditure meetings; education; up-to-date information (including multilingual)	Cable and satellite networks The Internet; multi-media kiosks; CD-ROM; bulletin boards; videotext
Transactions	Welfare benefits advice; electronic benefits transfer; payments for services, licenses, transport, etc. Voting; referenda; public opinion polling; criminal parole checking Electronic tax returns Road charging systems	Multimedia kiosks; expert systems; smartcards; automatic tellers; electronic funds transfers
Information retrieval	Access to government information Response to routine queries Support for public officials and professionals in service delivery	The Internet; online databases Voice response; electronic mail Executive information services; expert systems; electronic mail
Remote communication	Forums on public expenditure issues; help for voluntary and professional groups Citizens' complaints, requests; emergency support Intercommunity meetings; consultation with voters Parent-teacher interaction	The Internet; computer conferencing; bulletin boards Low-cost access to ICT networks; the Internet; kiosks; voice mail Video and audio conferencing; videophones; local cable networks Voice mail

Source: William Dutton, *Information and communication technologies*, 1996.

The use of ESD innovations is already beginning to change the way government operates in response to these constituent mandates.⁹ As stated earlier, these innovations are not only suitable for developed countries. On the contrary, they can be relevant even in developing countries. A single phone line can make the Internet

accessible to rural people so that they can access information on innovations in expertise, local varieties of crops, trees, fruits and vegetables, etc. Solar-powered or battery-operated systems can democratize the access to knowledge.

The government's use of the Internet can help it to provide better government service. As reported in the *PIPER Letter*, "when government delivers information, in many cases it is delivering the government service itself. This new interactive medium, with its built-in measurements and feedback loops, allows government to relate to individual constituents with a new depth and frequency. It can add an entirely new dimension to government relationship to its stakeholders" (Lydia de Conti 1998).

The Internet can be used as a public space for citizens to take greater control of their own agenda for deliberation. Examples are the U.K. Communities Online, the North Brabant land use consultation of the Dutch government, and the prelegislative online public consultation by the U.K. Cabinet on its Freedom of Information ("Right to Know") White Paper.¹⁰

This can overcome the barriers of language, literacy, and localism. Farmers do not have to learn only from local people, nor do they have to learn in textual form and from those who speak their language. Multimedia technology can help people get closer to each other. Databases of innovations with the names and addresses of the innovators and communicators can be kept and shared. Among the many other possibilities, discussion groups may be set up in the local language so that specific innovations or grievances may be taken up for collective improvements in design and scope, given the willingness of innovators as well as their peers to engage in such collaborative learning exercises. Such a system can also be used to provide organized feedback on the quality of government services and investment projects.

C. ILLUSTRATIONS OF GOVERNMENT ICT PROGRAMS

1. The G7 Government On-Line (GOL) Project¹¹

The G7 GOL project is one of eleven Information Society Pilot Projects launched by ministers from the G7 countries in February 1995. The project is jointly chaired by the

UK CCTA and the Treasury Board of Canada and aims to encourage the uptake of telematics within government. It seeks to encourage the exchange of experiences and best practice on the changing emphasis within government towards online business, to improve the accessibility of public information and service. Through collaborative projects, G7 member countries have the significant opportunity to share the effort and experience. By establishing the theme “government on-line,” participating countries can use existing technology and know-how to achieve the following: (i) widely available public information; (ii) better public service; (iii) reduced paper transactions in government operations; and (iv) free-flowing information exchange among governments. The project is expected to reduce the cost of producing government services, thereby reducing the burden on the taxpayer. Involvement of private-sector IT suppliers and service providers will be needed to provide the infrastructure to facilitate delivery of electronic services.

2. Country Illustrations

The following are some of the ICT programs initiated by different countries:

a. *India’s information-age reform*¹²

The computerization of the Indian Railways’ Passenger Reservation System may be considered a success (Heeks 1996). Not only did it significantly increase the efficiency of the reservation process, but it also reduced corruption (though it did not eliminate it), increased staff morale, and improved the quality of customer service. Moreover, it also gave Indian Railways (and India more widely) a more modern image, and it built information age capabilities within the country. Sadly however, this case stands out as a solitary example of success in India (Bhatnagar, 1997).

In India, there are almost as many explanations for failure as there are information systems. Public officials are central to information age reform and they can take different approaches in trying to realize the potential of information and IT. A key factor that has emerged is the attitude of senior public officials in India, both politicians and managers.¹³ India’s information reform program can be represented by the following “Four Is” model:

- *Ignore.* Public officials are ignorant about IT and information systems and do not include them in their plans for reform. This is found in many Indian public sector organizations where computers remain unused and merely act as costly executive paperweights.
- *Isolate.* Public officials remain computer-illiterate and lack an understanding the role of information in governance. IT investment is included in reform plans but it is seen as a separate responsibility of “computer experts”. The early years of The Indian Income Tax project in its early years is an example of the “isolate” approach. The introduction of computers was seen as the responsibility of technical staff rather than mainstream managers. Hence, huge investments made very little, if any, contribution to reform agenda in Indian public-sector organizations.
- *Idolize.* Public officials become semiliterate and believe that IT can transform the business of government if they initiate a high-profile IT project. In 1997, Andhra Pradesh state launched a high-profile project, the LEAP21 initiative, which aims to use IT as a main lever in the creation of better government in Andhra Pradesh.
- *Integrate.* Public officials recognize information as a key resource that is central to all government functions. IT is fully integrated into the process of organizational change, driven by reform objectives. The successful computerization of passenger reservations on Indian Railways can be seen to have followed this route. However, other examples of the integrated approach hardly exist in India. Approaches and chronologies remain unevenly distributed in India, but Bhatnagar (1997) sees much of the public sector still struggling to move away from the “ignore” stage.

Despite the potentials of information-age reform, substantial problems remain for Indian public expenditure management to enter the information-age reform era. While there is no magic recipe for ensuring widespread use of the integrated approach, education and training surely form a substantial part of the package. Indian public

managers will also need to adopt a more strategic approach to change that could derive technology needs from information needs, and information needs from reform objectives. Perhaps more realistic is a “core-periphery” approach that balances strategic and tactical, central and local needs (Heeks 1997).

b. Website of Philippine budget releases¹⁴

In the Philippines, the Department of Budget and Management (DBM) has started posting on the Internet its major budgetary releases to government agencies in a bid to make transactions more transparent to the public. The Web site includes information on the government’s accounts payable and the amount released by the DBM as payment for these accounts. Through this scheme, private contractors can check the veracity of the department officials’ pronouncements against the DBM budgetary releases. The details of all accounts payable and releases for each government agency are posted on the Web site each month, along with the names of the contractors and the amount of payment they are supposed to receive monthly.

The DBM also plans to post the 1999 budget on the Internet as soon as it is passed by Congress and approved by the President. The Web site is among the reform measures being instituted by the DBM.

c. New initiative in information society policy in Finland

The progress of the information society is among the most important goals of the Finnish government. The public sector will open its services massively on the Internet in the coming years. One important element is an easy-to-use service interface that resembles the use of television today. Many government agencies have already opened their services on the information network. The goal is to provide front-office services from one window. The target is to provide document distribution and information services in electronic form, such as tax reports. The goal in the long term is to promote teleworking.

The current initiatives in Finnish information society policy seek to achieve computer literacy for all citizens through education. To this end, the government has already started investing in information society training programs and schools. There is a risk of polarizing society into A and B citizens, but when the network services become widely available in libraries and public facilities, most people can benefit from the networks. The new interesting services and easy user interfaces create demand for networks.¹⁵

d. Digital documentation in the Italian administration network

The Italian Parliament is considering legislation that establishes principles and procedures for the authentication of electronic documents. The proposal, which originates from the work of the Authority for Informatics in the Public Administration (AIPA), contains new rules for private transactions, notarial deeds, and electronic signatures with asymmetric keys. These rules will have a big impact not only on the restructuring of the Italian public administration to regain efficiency and transparency, but will also act as a “laboratory” for the other European countries in the construction of the Trans-European Public Administration Network.

e. Information Society 2000: A Danish Strategy for the Information Society

A strategy that can bring Denmark to the forefront of development toward the information society will be based on the Danish model, which involves market forces. This strategy must secure the following special values:

- Provide free access to information and interchange of information;
- Support democracy and individual access to influence;

- Contribute to personal development, e.g., by supporting the individual work and in the spare time;
- Open up the public sector, make it more transparent, and facilitate the delivery of better service;
- Support the weaker sectors of society;
- Strengthen the international competitiveness of Danish companies as the basis for the Danish welfare system.

f. The United States access initiatives

The National Information Infrastructure, or Information Super Highway project launched in 1996 envisages a large-scale effort, where federal authorities become the leading force in the use of IT in legislation and special projects. For example, Internet users can now find electronic Social Security Administration (SSA) forms and transmit directly to the SSA. A printed statement is mailed back to the user. Passport applications can be downloaded at the same site. Visitors to the site can also apply for government jobs. The Electronic Benefits Transfer (EBT), on the other hand, aims at the delivery of government benefits electronically. With a single plastic card, cash and food benefits can be accessed at automated teller machine and a point-of-sale terminals. In addition to increased convenience and preserving the dignity of beneficiaries, EBT will dramatically reduce theft, fraud, and abuse in the delivery of benefits because there are fewer steps in the process, and patterns of abuse can be detected electronically.

In 1995, the U.S. Government Printing Office announced the free use of its award-winning GPO Access online service. All Internet and dial-in users can now receive electronically, at no charge, the *Congressional Record*, the *Federal Register*, congressional bills, and a growing list of other important government documents on the same day they are published.

D. Policies to Promote Successful Innovations¹⁶

1. A political climate that supports risk-taking

For any innovation to be successful there must be willingness to take risks. However, traditional public-service cultures are “risk-averse,” in part because scarce public funds are at stake. While various ICT experiments in the 1990s show that there are many entrepreneurs and innovators in public agencies, change is likely to evolve only incrementally unless a political climate that promotes and rewards risk-taking is created.

Top-level encouragement is important in creating this environment and in giving legitimacy to innovative ideas. In 1993, for instance, the U.S. launched the development of a standard nationwide system to deliver government benefits electronically.

2. Encouraging local initiatives

Risk taking also has to be supported at the local levels. Local agencies can more easily nourish innovations related to their communities because they are closer to the public, community groups, and businesses. Likewise, the large number and diversity of local governments in many countries can greatly facilitate the emergence of innovative ideas, provided a political climate and organizational arrangements are established to nurture them. Moreover, reorganizations of local government structures can offer a “window of opportunity” for authorities to rethink and change the way they do things, including how to deploy ICTs.

A problem that commonly hampers local innovation is budgetary constraint; that is, available resources are too small to support investment in long-term innovation programs. One way around this problem is to develop joint ventures and multiple funding sources involving a mix of public agencies at the local, national, and international levels (such as the EU), and private investments. It could also be feasible to establish a set of common funds for the promotion of innovations in the development of applications.

3. Making a public-service business case

Although financial goals for public services must be set to demonstrate that care is being taken with taxpayers' money, the focus of appraisals of public-sector ESD applications should be broadened so that genuine priority is given to identifying and meeting the needs of users and stakeholders. This vision should be reinforced by the trend in the public sector to shift the focus of ICT projects from "backroom" administrative support to direct improvements in the quality of front-line services offered to customers and clients.

A new approach to justifying public-sector investment is to combine traditional, financially-oriented, appraisal criteria with the need to take account of enhancing service quality, including the provision of tangible solutions to citizens' problems. For instance, an electronic support for one-stop services in welfare benefits administration should not only be appraised for its capacity to produce savings on the internal management costs associated with maintaining clients' files, but also in terms of qualitative intangibles related to improvements in customer service.

4. Institutional development

Changes in public expenditure management systems are more likely to succeed if transformations are seen as long-term processes. ICTs should be used to create a readiness for organizational innovation, through the development of information and knowledge resources, in ways that are sensitive to the needs of knowledge workers. In turn, public-service staff should be trained to understand and communicate the nature of the new services they are providing and of the logic of the organizational changes made to support them. Box 39 presents Mongolia's initial move towards the use of IT in the public sector.

Box 39
IT Seminar for Mongolia

The Asia-Pacific Development Information Programme (APDIP) held its seminar on IT Policies and Infrastructure Development for Mongolia in Kuala Lumpur on March 23-26, 1998. The curriculum was tailored to the specific needs of government officials from Mongolia to provide professional expertise in the development of IT policies for their country.

The seminar introduced broad issues that need to be addressed in determining IT policies and implementation. The focus was on specific global IT frameworks, the establishment of infrastructure, national information and services, quality of service, financial mechanisms,

taxation, Internet regulation, and legislation. Practical applications of the Internet such as electronic government, electronic commerce, telemedicine, distance education and teleworking were emphasized to foster development activities.

The government Intranet was demonstrated as a means to extend the administrative reach and distribution of information across the organization. Concrete examples were provided of how useful information for country advancement can be disseminated through a CountryNet. A CountryNet joins the public face of activities and organizations within a country. An application facilitating electrocardiogram (ECG) readings over the information systems network was also presented as an example to illustrate the significance of using telemedicine to extend specialist medical care (usually concentrated in urban areas) to less developed areas. Gabriel Accascina, APDIP Programme Manager discussed several applications to improve governance. He showed how citizens can be empowered with on-demand information such as current laws on women's rights and on alimony rights for women in Fiji. Accassina described the benefits of providing relevant and timely information more efficiently to business trade, then gave an example of how to promote tourism for Mongolia over the Internet.

The seminar resulted in two proposed actions for Mongolia: a national IT agenda for Mongolia should be formed and chaired by the Prime Minister, and a vision to strengthen awareness and benefits of IT for the nation should be set.

Source: APDIP Web site, 1998.

5. Gaining private sector support

The private sector is a crucial influence on the electronic delivery of public services, as it acts to create a familiarity with similar capabilities in daily life. These everyday experiences with electronic services establish benchmarks against which citizens may judge public-sector ESD. Furthermore, the introduction to public services of competitive tendering, privatization, and "outsourcing" has meant that business ICT know-how is being applied directly to public services.

6. Strategic public policies

To ensure that diverse ICT capabilities are effectively harnessed, there is a need to establish a coherent strategy. This strategic framework would coordinate ITC policies with closely related areas such as regionalism, industrial development, employment, privacy, data protection, and regulation of the mass media. For instance, policies that will enable citizens to gain access to vital facilities are crucial to gaining widespread commitment to ICT innovations. The framework would also seek to develop user charges policy and provision for subsidized services. In addition, appropriate legislation and regulations are needed in areas such as editorial control over networked

information, public access to information, privacy and data protection, and intellectual property rights. Finally, an ITC strategy should make a clear distinction between the provider of ICT infrastructure and the suppliers of information and services.

Box 40
IT Boost in Malaysia

In a move to boost IT literacy in Malaysia, the Education Ministry has revealed its proposed plans to ensure that all Malaysian schools will be fully equipped with computers, Malaysia thus hopes to catch up with the rest of the world in the area of computer ownership and the usage of multimedia applications.

Although the budget for this proposal has yet to be set, Minister Datuk Seri Najib Tun Razak stressed that this huge task had to be accomplished by the end of the Seventh Malaysia Plan (which began in April 1998).

He also challenged local computer companies to build quality machines at “rock-bottom prices” so that the target of at least one PC for every 13 students could be achieved. If this is achieved, Malaysia is likely to experience a tremendous jump in the number of PCs purchased for domestic use.

Datuk Najib also attached importance to the availability of appropriate and adequate software support in the form of computer-assisted learning packages of mathematics, Bahasa Malaysia and English. Malaysian primary schools will be the first to use such packages when the entire network is fully established.

Currently, one secondary school per state is equipped with network facilities that link them to the ministry’s technology education division. Both E-mail and Internet services are also available on this network which was set up by Telekom Malaysia at a cost of M\$3.8 million.

This proposal should serve as the starting point for the many opportunities to customize educational tools for use within the framework and for the individual schools. It will be a toss up as to which area will present the biggest opportunity—the development of software or the production of cheaper machines.

Source: The Ethos Home page, Internet, December 1998.

7. Grassroots partnerships

A key element in effective public expenditure management of ICT projects is the establishment of working partnerships among citizens, community groups, business enterprises, ICT vendors, and public agencies at all levels and across all functions. This has been particularly evident in the U.S.A., where local agencies have taken a strong role in leading innovation. The OTA has identified the following important guidelines¹⁷ based on experiences that have helped establish an understanding of how to build a political climate that motivates effective grassroots partnerships:

- a. Involve the grassroots: local citizens; community groups and other nonprofit organizations; national and local government agencies; business enterprises; and all others that are significantly affected by ICT innovation.
- b. Develop community infrastructure to facilitate the use of new electronic facilities, including the provision of adequate training, education and implementation support, for example, through schools, libraries, community centers, and town halls.
- c. Set up a planning task force and explore ideas and alternative possibilities using techniques like community workshops and technology demonstrations.
- d. In the preoperation phase, ensure cooperation and resolve key issues, such as how costs and risks are to be shared. Pilot projects and demonstrations can also be valuable at this point.
- e. At the operational stage, scale up resources and clarify the roles and responsibilities of lead agencies and participants.
- f. Establish directories and other information about relevant public agency and electronic democracy services.
- g. Ensure that budgets are allocated specifically to support the above activities.

In practice, however, the forging of level partnerships along these lines can be difficult. Some ideas generated at the grassroots may not coincide with the aims of senior policy makers, and vice versa. If original intentions are not satisfied, problems may likely ensue. Thus, it is important that senior management communicate openly with all constituencies to ensure that goals and commitments to achieving successful outcomes for public expenditure ICT developments are well represented.

E. KEY POINTS

Governments are becoming more aware of the potential benefits that ICTs can offer to public-sector management. ICT offers a unique opportunity to improve financial management information and reporting, streamline the delivery of government services, enhance communication with the citizenry, and serve as a catalyst for empowering citizens to interact with the government.

An important aspect of the current innovations is the sharing of information about the progress being made in renewing government activities. In time, and as appropriate in the local context, successful initiatives will revolutionize the way governments operate and provide services.

With the growing demand for information and its increasing recognition by governments as a valuable resource, information trading has been gaining ground in public expenditure management. Clear government policy must be established for the development of good practices in government information trading.

Despite the wide range of benefits ICT can offer, it must not be viewed as an end in itself. It cannot substitute for good management and internal controls. Likewise, faster and integrated public financial management information systems carry correspondingly greater potential risks for the integrity of the data. ICT therefore must: (i) fit the user requirements and objectives of the activity; (ii) aim at an integrated strategy; and (iii) assure that the more advanced techniques go hand in hand with improved rules and processes.

While IT can detect and remove some forms of corruption, it can also provide new avenues for corruption for those public servants who are adept at manipulating the new technology. Essentially, the ultimate impact of IT corruption is shaped by management decisions about information.

¹ Indeed, the first advice to a government moving from a manual public accounting and recording system to a computerized one should be to keep the manual ledgers going alongside the new system until it is certain that the new system is working well, and is secure and free of risk.

² Note that an integrated approach requires compatibility and coordination, but not necessarily a single system, nor simultaneous action on all fronts.

³ Taken from the opening remarks of Chris Bellamy during the E-conference on Governance and Public Services In the Information Age, Internet, 1998.

⁴ Drawn from William H. Dutton, ed., 1996.

⁵ Senior Lecturer in Informatics. Institute of Development Policy and Management, University of Manchester, 1999.

⁶ Undertaken by Neil McBride, Department of Information Systems, De Montfort University, The Gateway, Leicester, LE1 9BH, 1999.

⁷ As outlined by Dutton, 1996.

⁸ See Heeks, September 1998.

⁹ Taken from issues of *Honey Bee Newsletter*, June-September 1998.

¹⁰ Coleman, 1998.

¹¹ Source: The Government On-Line (GOL) Web site, 1998.

¹² Taken from Richard Heeks, Information Age Reform of the Public Sector: The Potential and Problems of IT for India, Working Paper No. 6, 1998.

¹³ Gupta, 1996; Bhatnagar, 1997; and Peterson, 1998 in Dutton, 1996.

¹⁴ Taken from Philippine newspapers, November 1998.

¹⁵ The following innovations were taken from the Ethos home page, 1998.

¹⁶ This is discussed further by Dutton, 1996.

¹⁷ Derived from OTA (1993a: 105-32), as published in chapter 5 of Dutton et. al.

Chapter 15. STRENGTHENING “PERFORMANCE” IN PUBLIC EXPENDITURE MANAGEMENT

“A man kept searching for his wallet under the street lamp because, he said, it was too dark in the back alley where he had lost it.”

A. THE GENERAL ISSUE

1. Why measure performance in the public sector?

Mechanically transposing private sector practices and methodologies to the public sector is analytically incorrect and inappropriate in practice. For private production in a competitive market, and for the enterprise as a whole, the worth of the activity is most easily measured by the price the buyer is willing to pay; the net social utility of the producer is well approximated by his profits during a given period, the “bottom line”; and persistent losses will drive companies out of business.¹ This is so, however, only when the buyer gets all the benefits of the product and (indirectly) pays all the costs. When indivisibilities and external effects exist (positive, or negative such as water pollution), or where there cannot be a competitive market as for public goods, the “bottom line” is not as easy to define, the activity is assigned to the public sector, and the measurement of the impact of public sector activity therefore becomes a major and complex issue.²

On the other hand, to limit the notion of public “performance” *only* to compliance with budgetary appropriations, or to literal observance of rules and regulations, leads over time to forgetting the real purpose of spending monies obtained from the public at large. Eventually, this generates a “culture” of means rather than ends, disregard for the public, and the legendary bureaucratic mentality that considers it a success to formulate tight and internally consistent controls, regardless of whether they are necessary or even helpful in executing the functions assigned to the state by the people.³

Thus, partly from mounting frustration with the unresponsiveness of large bureaucracies, and partly from the logic of the “New Public Management” that has emerged in advanced Anglo-Saxon economies in the last decade (see annex V), several developed countries and some developing countries have made increasing use of

“performance” concepts and “results” indicators, both in their managerial practices and in the formulation and execution of public expenditure programs.⁴ In some cases, the real difficulties of measuring performance in the public sector have been recognized and the resulting ambiguities tolerated and adjusted to. In other cases, as the man and his wallet, partial or misleading notions of performance have been adopted simply because they are easier to measure.

It is particularly necessary to present the full complexity of the performance issue both because greater performance orientation is very important and because its introduction is sometimes advocated as a very simple and self-evident matter. Earlier chapters have noted the confusion and policy mistakes caused by unclear or conflicting terminology. This is especially true of the terms “performance” and “results”. The formal systems of “performance budgeting” were examined in chapter 3. This chapter begins by examining the meaning of performance, and then reviews in turn the methodological problems of measurement and monitoring; and alternative approaches to improving the performance orientation of the budget process. As elsewhere in this volume, the accent is on benefits as well as costs, risks, and implementation requirements, with reference to both international practice and its applicability in developing countries.

2. The semantics of “performance”

It is essential to start by underlining the difference between “performance orientation”; “performance indicators”; “performance appraisal” (of personnel); and “performance (or program) budgeting”. None of these necessarily implies the others; yet, they are very often confused in practice, with wasteful or counterproductive results.

It is important, too, to underline the difference between “precise” and “quantitative”. Vague indicators of performance are, of course, problematic. But indicators do not have to be quantitative to be precise. First, qualitative measures can be transformed into quantitative ones by surveys, systematic feedback, and other ways of assessing the opinion of the users. The statistical problems are tricky, but in principle the possibilities exist. (For example, the quality of education can be in part quantified by measuring the percentage of parents who are “fully satisfied” with their children’s school.) Second, as lawmaking demonstrates, one can achieve a great degree of

precision by the use of clear language. The objective is not quantification. The objective is accountability—and that can be achieved by indicators that have unambiguous meanings for the assessor and the person or group assessed.

a. *Performance is a relative concept*

Dictionary definitions of “performance” include such alternative terms as “accomplishment”, “achievement”, “realization”, and “fulfillment”. Most of these terms have to do with the *objective* effect of public actions; but some relate to the *subjective* sense of satisfaction experienced as a result of one’s action. Naturally, the economic and public management literature emphasizes the former meaning, not only because of its direct implications for the population, but because subjective satisfaction is extremely difficult to measure and impossible to aggregate.

Accordingly, performance may be defined in terms of *effort* or in terms of *results*. It is a mistake to completely neglect the subjective dimension of “performance”, for it is one important determinant of external effectiveness. Consider what happens if the “effort” dimension is neglected, and incentives are tied *exclusively* to objective results. The more capable underachiever will be rewarded, and the less capable but harder worker will not. The former will therefore receive the message that underachieving carries no negative consequences; the latter that working hard carries no rewards. Both being rational individuals, the level of effort will decline for both and hence for the entire organization.

Recognizing (even if not rewarding) genuine individual effort can do much for morale and serve as a demonstrator for others, thus fostering the effectiveness of the organizational unit. More fundamentally, most individuals consider “a sense of accomplishment” as a strong motivator of their action (independent of salaries, penalties or other material incentives). Thus, if public sector reform programs inadvertently remove that motivation, other things being equal the efficiency of public personnel is likely to decline, and the effectiveness of public action along with it.⁵ But this is true only in countries where the public sector and public employees are guided by an ethos of public *service*—a key asset which, no less than physical assets, requires proper “maintenance” on its own terms. Where instead satisfaction is derived from the exercise

of public *control*, emphasis on external results can lessen unwarranted government interference with economic activity, at the same time as it spurs public sector efficiency. It remains true that the normal human drive to do something right⁶ should be harnessed, and not disregarded or depreciated. (It is certainly recognized in the more efficient private corporations.)

All of that being said, our recommendation is only to keep these factors in mind. To introduce stronger performance orientation, including in public expenditure management, in most cases *it is advisable to rely on **results**, among many reasons because “effort” is not measurable and is an excellent alibi for lack of results.*

In any event, it is critical to realize that the concept of “performance” is instrumental and not an end in itself, as well as relative: relative to the economic system, to the size of the country, to the role of the state, to the quality of governance, to the prevailing culture, and, of course, to the specific economic sector. What one does with this realization is a different matter; but merely transposing concepts and definition of performance to a different economic and social milieu is most unlikely to produce the desired effects. Indeed, a realistic understanding of local institutions (informal as well as formal) is a prerequisite for the effective introduction of performance considerations into a “nonperforming” public sector.

b. “Results”: Output, process, outcome, impact

The measurement of “objective” performance rests on inputs; and/or on one or more of the following results.⁷ Using the example of children health services:

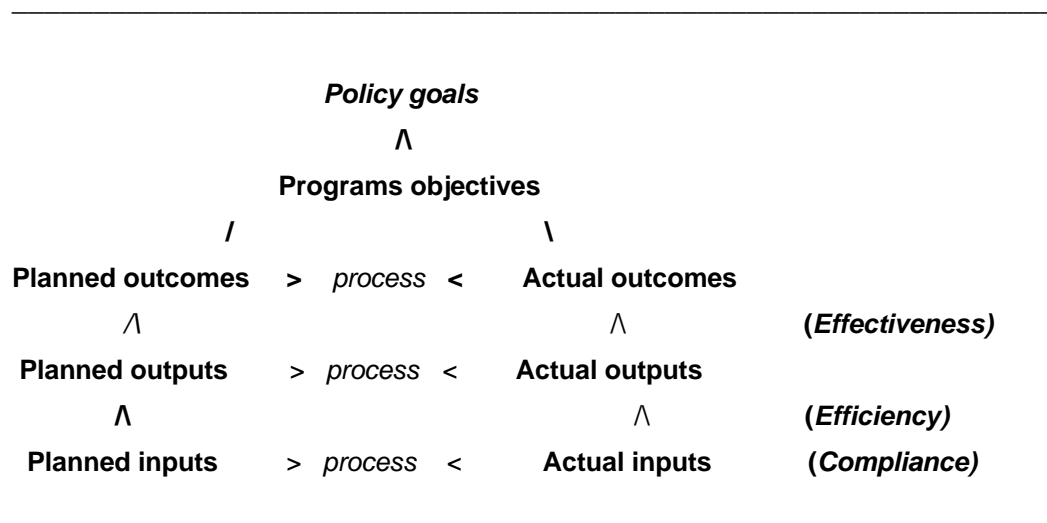
- *inputs* are the resources used to produce the service—e.g., doctors, nurses, hospital equipment, medicines. The social value of inputs is measured by their cost. The budgeting performance criterion corresponding to inputs is *compliance*, i.e., defined as close adherence to budgetary ceilings and ex-ante allocation, as well as a proper but agile procurement process.⁸
- *Output* is the service itself—e.g., number of child vaccinations. The social value of outputs is approximated by the market price for the same or the

closest equivalent service (or, in its absence, by total unit cost). The performance criterion corresponding to outputs is *efficiency*, i.e., minimizing total input cost per unit of output (or maximizing the quantity of output in relation to a given total cost of inputs).

- *Outcome* is the purpose that is achieved by producing the service—e.g., reduction in child mortality and morbidity. The social value of outcomes is subjective and arbitrary, except as revealed by public reaction in the political arena. The performance criterion corresponding to outcomes is *effectiveness*, i.e., maximizing outcomes in relation to the outputs produced;
- *Impact*, often used as a synonym for outcome, is more properly defined as the *value added* from the activity, i.e., the “gross” outcome minus the contribution from other entities or activities. The notion is important in that it takes some account of favorable or unfavorable circumstances beyond the control of those responsible—e.g., a poorer child population. However, impact (in this sense of value added) is nearly impossible to measure, and is not discussed further in this chapter.
- *Process* is the *manner* in which inputs are procured, outputs produced, or outcomes achieved. The value of “good” process is undetermined. For inputs, good process consists of intelligent compliance with input acquisition and utilization rules and, of course, integrity. In some areas of public activity, such as law or politics, “due process” has its own independent validity and is a key element of good governance. (For example, an increase in arrests achieved by violating civil rights would not constitute “good performance”.) In other areas, process indicators are a useful proxy for performance when outputs or (more often) outcomes cannot be defined with clarity. (“Bedside manner” in health services, “rules for free debate” in policy formulation, etc., are examples of process indicators.) Process indicators can be quantitative (e.g., percentage of class time dedicated to student questions) but are usually qualitative. Even then, however, as noted earlier, they can frequently be transformed into quantitative indicators by feedback from users: hospital patient satisfaction can be numerically assessed through a patient survey.⁹

Section B provides examples of input, output, outcome and process indicators in various sectors. Figure 15,¹⁰ is a simple illustration of the relationships among indicators, also useful for their application to the budget process discussed later in this chapter.

Figure 15
Hierarchy of Performance Criteria and Indicators



3. The link to accountability

The hierarchy of definitions in paragraph 10 suggests a sort of complex production function of public services, whereby the *outcome* of one stage is an *output* of the next stage. Accordingly, in “downstream” activities close to the ultimate user (e.g., urban transport) the output-outcome link is clear and immediate enough to permit using output indicators as a good proxy for outcomes. In “upstream” activities this is not so (e.g., in rulemaking, where “maximizing” public rules is hardly a desirable measure of public performance).

The “accountability tradeoff” noted in chapter 1 states that clearer and more immediate accountability is by definition narrower accountability; and conversely, the link

between action and results becomes more ambiguous the broader and the more meaningful the results. Hence, control through outputs is least workable for complex tasks, (e.g., mental health) and more appropriate for simple processes (e.g., trash collection).¹¹

The above implies an “accountability chain”—with accountability clearest and most immediate by the narrowest performance criterion (i.e., compliance with input allocations), and most ambiguous and diffuse by the broadest performance criterion (i.e., net impact).¹² For example, it is fairly easy to hold a village nurse strictly accountable for the output of vaccinations, and to reward or penalize him accordingly; it is difficult to hold him responsible for the outcome of improving the health of village children. Yet, his affirmative involvement in household sanitary conditions, or nutrition, or other health factors, may have more influence on the outcome of improving children’s health than a greater number of vaccinations—*but such involvement will not be motivated by an incentive system that focuses only on the outputs.*

Moreover, in the absence of close supervision, it is difficult to prevent immunizations from being performed with less than the recommended quantity of vaccine (the remaining vaccine “leaking” out of the health delivery system). Therefore, abandoning input and quality controls in favor of output indicators may carry substantial practical risks. (Easy “insurance” could be provided by retaining input and quality controls alongside the output indicators, for as long as may be needed to shake the bugs out of the results-oriented system.)

These considerations are not meant to suggest that outcome indicators are “better” than output indicators, or vice versa. Other things being equal, output indicators are closer to the desired outcomes, and hence more realistic, the closer the activity is to the final user. However, it is certain that accountability can be broad, or strict—but not both. The greater specificity associated with output indicators comes with a loss of relevance; and conversely, it would be difficult to hold public servants strictly accountable for outcomes.

The selection of output or outcome indicators (in cases when the introduction of non-input-based performance indicators is appropriate to begin with) is also heavily

influenced by data availability and information technology. First, good data and good monitoring permit better definition of outputs and thus justify greater reliance on them as a measure of performance. Conversely, when data are lacking or unreliable (or monitoring is weak), measuring performance by outputs generates only game playing and self-delusion. In such cases, the priority must be to place compliance on a firm footing and improve both the relevant data and the monitoring capability—before considering the introduction of results-based performance elements.¹³

Moreover, data collection costs, and more generally the transaction costs of introducing performance indicators in a systematic manner can be enormous. These costs must be assessed realistically and weighed against the benefits expected. It is simply wrong to limit a debate on whether to introduce performance indicators only to the benefits expected from doing so. The introduction of performance indicators is no exception to the basic rule of economics that “there is no free lunch”.

Thus, first, one must never confuse means with ends, and should keep a clear distinction between the objective of introducing greater performance *orientation* in PEM and any particular method for doing so. Greater attention to performance may be stimulated by a variety of means other than the use of actual performance indicators—“moral suasion”, periodic questioning, exposure to the public, peer pressure etc. Second, as noted earlier, the appropriate choice of performance indicators differs for different countries, times, and sectors. Accordingly, the only valid general rule is: *when performance measurement is appropriate and cost-effective, performance should be assessed according to that **mix** of output, outcome and process indicators that is realistic and suitable for the specific activity, sector, and country.*

4. Beware the “law of unintended consequences”

Introducing new ways of evaluating the results of human action always leads to changes in behavior. Of course, it is precisely the change in public servants behavior—toward ends rather than means—which performance indicators are intended to generate. However, the well-known “law of unintended consequences” states that attempts at modifying behavior may produce unintended behavior, which may be at odds with the objective or even defeat it altogether and make the initial situation worse. The

risk of unforeseen consequences is higher, the greater the ignorance of the informal rules that govern actual behavior in the host society (private and public sectors alike). And, to return to our metaphor, informal rules lie mostly under the surface, like the iceberg which sank the Titanic.¹⁴

Some examples, all from real life, follow:

- When police performance is measured by the number of police officers “on the beat”, important statistical and analytical functions will be neglected, with adverse consequences on law and order. If the measure is the overall crime rate, the implicit incentive is for policemen to under-report all crimes. If performance is assessed on the basis of a specific crime category, underreporting of that crime and neglect of crime prevention in general are likely;
- If hospital subsidies are based on the length of patients waiting lists, hospital managers and doctors will keep noncritical cases waiting as long as possible and will spend inordinate amounts of time on other cases (higher-quality care for some, none for others); if performance is assessed instead by number of patients treated, the quality of care may suffer (Williams, 1996).
- When an aboriginal tribe in Australia was informed that its sanitation and other subsidies would depend on their performance in keeping sanitary facilities clean, they did so most effectively by thoroughly cleaning the toilets, and then closing them to the public.

The point is to illustrate the care, common sense, and direct sectoral knowledge needed to introduce performance indicators successfully. Indeed, the careless introduction of performance indicators has often generated unintended consequences so serious as to provoke a general backlash against all performance measurement. (This explains the apparent paradox of why those who stand to lose from a new and robust focus on performance rarely object to the introduction of simplistic performance indicators.) The next section discusses in detail problems of definition and measurement for the various types of performance indicators in various sectors.

B. FORMULATING PERFORMANCE INDICATORS

As a memory “fix”, the nature of the problem can be illustrated by reference to the well-known management consulting rule that: “what gets measured, gets done”. There are three conditions for this rule to be valid: (i) the right thing must be measured; (ii) the thing must be measured right; and (iii) there must be consequences if it does not get done. None of these three conditions is easy to meet. Even more of a complication is the obvious corollary of the rule: “what does *not* get measured, does *not* get done”. In the public sector, the least measurable activities may be the most important ones. Finally, as noted, one must keep in mind that rule changes entail behavioral changes: in the long-term, these may be beneficial or dysfunctional depending on the modalities and fairness of the performance assessment system. It is never enough to assess the short-term consequences of changes in organization or in incentives (nor, of course, to limit attention to the benefits expected without consideration of the costs).

1. Illustrations of performance indicators¹⁵

The performance indicators in table 5 are only examples, but should make clear which particular indicators would make little sense as a measure of “performance” in the specific sector. Yet, the reader probably knows of instances when they are in fact used and may have led to career rewards for the civil servants involved. Fortunately, as noted earlier, whenever data availability and practical considerations permit, a much fuller understanding of performance can be gained by the use of a combination of indicators.

Table 5. Examples of Performance Indicators

<u>Sector</u>	<u>Type of indicator</u>			
	<i>Input</i>	<i>Output</i>	<i>Outcome</i>	<i>Process</i>
<i>Administration</i>	No.of staff	No. of policy papers	Better decisions	Openness of debate
<i>Education</i>	Student/teacher ratio	Retention rates	Higher literacy	Encouraging student expression
<i>Judicial system</i>	Budget	Cases heard	Low appeal rate	Assistance for indigent defendants
<i>Police</i>	No. of police cars	No. of arrests	Decline in crime rate	Respect for rights
<i>Corrections</i>	Cost/prisoner	No. of prisoners	Recidivism rate	Preventing abuse
<i>Health</i>	Nurses/population	No. of vaccinations	Lower morbidity	"Bedside manners"
<i>Social welfare</i>	Social workers	Persons assisted	Exits from system	Dignified treatment

2. The measurement problem

a. Backdrop

To some extent, every measure of performance is a proxy measure. For example, the performance of an economic system should be gauged in terms of human well-being.¹⁶ Since that is impossible, it is measured in terms of goods and services produced; and, because these cannot be physically aggregated, their market value is used as a measure of economic performance. "Real GDP" is therefore only a second-order proxy for the true outcome. The measurement problem becomes more complex as one proceeds up the scale from input measures through process indicators. Although the quality issue is ever present, there is no great methodological difficulty in defining and measuring outputs, and even less so, inputs; the issue is their relevance. Similarly, the interpretation of outcomes is rarely in doubt; the issue is their feasibility as a spur to better performance. Outcome indicators are almost always more meaningful, and output

indicators, almost always more feasible. Combining the two factors, performance indicators are most appropriate for sectors where there is a direct and immediate relationship between the government agency's outputs and the desired outcomes.

b. The CREAM of good performance

With the above caveat, a performance indicator must be:

- **C**lear—i.e., precise and unambiguous (not necessarily quantitative);
- **R**elevant—i.e., appropriate to the objective at hand (and not used simply because it is readily available);
- **E**conomic—the data required should be available at reasonable cost;
- **A**dequate—by itself or in combination with others, the measure must provide a *sufficient* basis for the assessment of performance;
- **M**onitorable—in addition to clarity and availability of information, the indicator must be amenable to independent scrutiny.¹⁷

If any one of these five criteria is not met, performance indicators should not be introduced and other ways of assessing and stimulating good performance are needed—including the old-fashioned method of open dialogue with competent and honest managers. At the same time, however, work should be done toward meeting the CREAM rule, to permit the introduction of good performance criteria in the future. In developing countries, circumstances are often inimical to the introduction of result-based performance indicators. However, it is still possible to assess performance in the delivery of basic social services, through opinion surveys and other means of feedback from those who know the situation best: the users of the services.

c. The measurement of outcomes

Smith (1996) defines outcome as “a personal valuation of quality-adjusted output”, expressed in the identity: *Outcome = Valuation (Output x Quality)*. The formulation is useful because it calls attention not only to the quality factor (often forgotten in the rush to quantify results), but also to the difficult issue of *whose* valuation should be used. Even when it is feasible to ask the beneficiaries' opinion, the

conceptual question remains of how to aggregate the subjective valuations of the same outcome by different persons, as well as the policy question of how to take into account the different distribution of benefits within the same “average” outcome. Finally, there are public services, such as medical care, for which valuing the outcome only by individuals’ ability to pay is unacceptable in most societies. A fuller discussion would take us too far afield¹⁸, but it should be clear that the appropriate measurement of outcomes is not a simple matter. Even less simple, of course, is their utilization for performance assessment, because of the variety of influences on outcomes that are outside the control of the civil servant or government organization.

d. Setting appropriate performance targets

Once the right indicators have been chosen, the specific levels to be achieved need to be set. The general principle for the setting of any performance target is that it must be challenging but achievable. Both overambitious and too easy targets lead to underachievement. “Benchmarking” and “league tables” are often used to assist in defining appropriate targets.

C. THE ROLE OF BENCHMARKING IN MEASURING PERFORMANCE¹⁹

Benchmarking and performance measurement are closely linked. Performance measurement can be the first step towards improving the performance of a public sector organization and, if backed by an appropriate incentive system, it can help shift organizational focus from inputs to outputs and outcomes and thus improve efficiency and effectiveness. However, the real benefits come from using the performance measures as the basis for internal or external comparisons with the objective of improving the performance of an organization. This is called Benchmarking, which can be defined as the technique of comparing *business practices* and *performance levels* between organizations to identify opportunities for making improvements in *economy, efficiency or effectiveness* of an organization’s activities.

There are two main approaches to benchmarking, i.e., metrics and process benchmarking. Metrics benchmarking focuses on the calculation of numerical performance indicators such as unit costs, response time and number of customer

complaints, which can then be compared with similar data from other organizations in the same field. Metrics benchmarking is a useful diagnostic tool, as it can help an organization to identify the less efficient areas and provide targets for it to aim at. Generally, most people associate benchmarking with the setting of targets to be achieved, but that is only one part of benchmarking as metrics do not tell you what improvements can be made and how. For that purpose one has to turn to process benchmarking, which focuses on the comparison of the processes and activities underlying the performance of a function. Thus metrics allows you to identify the problem areas, and process benchmarking helps you to find ways to deal with the problem.

The first steps in a process benchmarking exercise involve the preparation of process maps for the activities in the selected area of focus, collection of information on resources consumed by those activities and an analysis of the practices, working methods and policies that determine the performance of those activities. Generally, at this stage many obvious inefficiencies in the existing processes are revealed, the elimination of which can yield significant performance improvements. The next steps are to obtain comparator data, compare the processes, develop recommendations and implement change. After the changes have been introduced, the new values of the performance indicators provide a measure of the improvements achieved and the basis for starting the next round of benchmarking. Therefore, this technique is often referred to in the literature as benchmarking and continuous improvement.

For the purposes of benchmarking, comparators can be either internal or external. The former refers to a situation where comparisons are made between separate divisions of the same organization where similar processes are performed (e.g., multi-site organizations such as the tax, health, or education departments can compare the performance of their offices, hospitals, or schools in different cities). External comparators can be direct competitors, i.e., organizations providing the same product or service, e.g. the public sector could benchmark schools or hospitals run by it against those run by the private sector or NGOs in the same area; or other public sector bodies performing similar processes such as land registration and vehicle registration agencies; or the best organization around, public or private, in the case of similar business processes, such as in the areas of accounting, information systems, procurement, payroll, and customer service. However, It is often helpful to start with

internal benchmarking, i.e., comparing performance measures between different offices or sites, understanding the processes and methods that explain the differences in the measures and what is the best internal practice, before going to outside comparators.

Benchmarking can yield additional benefits in the public sector by introducing a form of competition into the sector. If the results are publicized and general recognition, promotions and career opportunities of public sector managers are linked to the relative performance of their offices, divisions or ministries as demonstrated by benchmarking, it can be a powerful force for improvement in the public sector. However, many people believe that the league table approach can be demotivating for those at the bottom of the league. It is argued that motivation is better fostered by focussing on the gap between the individual unit and the best, the level of improvement, and the moving up the percentiles. Benchmarking also enables meaningful and realistic performance targets to be set for public sector organizations and, if these measures are appropriately designed, it can help to increase the customer orientation of the organization. Finally, process benchmarking promotes team work and cross-functional learning and provides the basis for continuous improvement.

Some of the problems encountered in the application of the benchmarking technique are necessarily the same as those for performance measurement, i.e., capturing the important attributes of the product in question, agreeing on what is to be measured and how to measure it, and the comparability of performance between organizations. In addition, benchmarking is a resource intensive technique and there is the need to restrict the scope of any single benchmarking exercise to the key areas, which can be those that account for the largest component of costs and/or where there are the largest performance gaps. It is also important to avoid excessive detail in the collection of data or mapping of process as it could divert effort from the primary purpose of benchmarking, i.e., identifying better practices and implementing the lessons it teaches. Finally, a critical success factor in benchmarking is the commitment of the senior management to improvement in the performance of the organization.

Box 41

Benchmarking in Hong Kong: Mass Transit Railway Excels in Worldwide Industry Study

Mass Transit Railway Corporation (MTRC) carries 2.4 million customers daily throughout the Hong Kong area. The organization is consistently rated as one of the best in customer service and "best value for the money" among all public transportation in Hong Kong. However, for the past five years, MTRC used *performance and process benchmarking* to ensure that it is the most reliable transportation system in the world.

Performance Benchmarking at MTRC

MTRC conducts performance benchmarking annually through its 3-year-old benchmarking project, Community of Metros (CoMET). The benchmarking group spent considerable time defining the 18 Key Performance Indicators to better compare one metro with another. In half of the categories, MTRC was classified as "best in class" but weak in "staff efficiency" and "incident management." To improve these areas, MTRC set up special task forces that met regularly, and site-visited the best performers. However, it was seen that some industry challenges stand in the way of certain improvements, and factors like social system, culture, and purchasing power make it difficult to adapt learnings from the study.

Categories	Key Performance Indicators (KPIs)	Best Practice	MTRC's Score	MTRC's Ranking
Financial Performance (expressed in BCU)	1. Total cost/passenger	0.16	0.42	2
	2. Operations cost/passenger	0.09	0.24	2
	3. Maintenance cost/revenue car operation km	0.59	1.30	5
	4. Fare revenue/passenger	1.15	0.61	4
	5. Total commercial revenue/operations cost (including maintenance)	6.19	6.19	1
	6. Operations cost/revenue car operating km	0.20	1.05	3
	7. Total cost/revenue car operating km	0.77	4.12	2
Efficiency	8. Passenger journey/total staff + contractor hours	64	62	2
	9. Revenue capacity km/total staff + contractor hours	2,253	1,960	2
	10. Revenue car km/total staff hours	14	6	7
Asset Utilization	11. Passenger km/capacity km	34.07%	23.64%	3
	12. Capacity km/track km	596,583,750	596,583,750	1
Reliability	13. Revenue car operating hours between incidents	12,074	12,074	1
	14. Car operating hours/total hours delay	50,978	50,978	1
	15. Trains on time/total trains	99.79%	99.79%	1
	16. Revenue operating car km/total incidents	361,718	361,718	1
Service Quality	17. Total passenger hours delay/1000 passenger journeys	2.38 min	2.38 min	1
	18. Passenger journeys on time/total passenger journeys	99.80%	99.80%	1

Process Benchmarking in Action

In 1995, MTRC and nine founding organizations came together to discuss several essential, but generic, processes that would benefit most members and mutually agreed on the supplier/vendor process. Based on the benchmarking findings from the supplier study, MTRC redeveloped its suppliers' selection criteria and created a purchasing system by fully computerizing its purchasing orders. These changes reduced the material supplier base by 40 percent (from 10,000 to 6,000) since 1996 and achieved 30 percent cost savings in rail supply and 20 percent cost savings in uniform supply. MTRC also has reduced its damage/shortage/rejection rate by 49 percent in the past two years and received better pricing due to quantity discounts and better shipping arrangements.

Source: *Benchmarking in Practice, Issue 11, American Productivity and Quality Center, Internet Edition, 1998, by Vicki J. Powers*

D. CONTRACTING-OUT: A LOGICAL EXTENSION OF PERFORMANCE ORIENTATION?

The prospect of losing customers is a well-known and powerful stimulus for performance in a private enterprise, but—despite the absence of the profit motive—can also prod a public sector organization to perform better. In addition, contracting the delivery of social services to the private sector can, if done right and under certain circumstances, lead to efficiency savings in and of itself. Therefore, the possibility of contracting out certain public services or functions should rank near the top of the list of questions to be asked periodically in government organizations. However, contracting-out is only one market-related mechanism to improve efficiency and effectiveness. It is dealt here at length because of the need for a full understanding of the uses and limits of this mechanism in view of the increasing frequency of its introduction in developing countries.

1. What is “contracting out”?

Contracting-out is the transfer to the private sector of the implementation of activities financed and previously delivered by the government. The practice has experienced a recent resurgence (as part of the New Public Management; see annex V) but is common in history. For example, “tax farming” was prevalent in ancient China, Greece, Rome,²⁰ and, more recently, Thailand, which until 1875 did not have a governmental organization for tax collection.

Generally, under contracting-out arrangements, the activities transferred to the private sector remain financed by the government. Separating the financing from the delivery allows the governmental purchaser to choose from among different suppliers and to control costs and quality standards, without having to take into account particular interests of its staff. Contracting out aims at improving efficiency and curbing costs by promoting competition and/or clearer identification of costs. For example, in New Zealand the audit office contracts out a number of its activities,²¹ and in the U.K. “partnering” is used where the tendering process is not competitive owing to an undeveloped market for the services and special qualifications of the contractor.²² Integral to a possible decision to contract out is the “market-testing” approach, by which

government assesses whether the public service in question can be better delivered by the private sector.²³

Build-operate-transfer (BOT) or build-lease-transfer (BLT) schemes concern private financing of public investment. In BOT schemes the private sector finances the initial investment; recoups it through the profits from a concession to operate the project over a determined period; and, at the end of the concession, transfers the assets to the government. BOTs are seen as a means of attracting private and foreign capital.²⁴ BOT schemes have been adopted for years in some developed countries (the most publicized one being the Anglo-French Channel Tunnel).²⁵ Recently, these schemes have been introduced in developing countries. Asia has a variety of BOT projects, including bridges and the airport in Hong Kong, power and railways in China, highways and airports in Malaysia, telecommunications in Thailand, mass transit and power in the Philippines. The US\$1.8-billion Hub River thermal energy project in Pakistan involves BOT arrangements second in size and complexity only to the Channel Tunnel Project.²⁶

Some BOT contracts guarantee the contractor against losses in operating the project (in the example of a tollroad, if traffic is less than projected the government could ensure the servicing of debt contracted for the project). In other BOT contracts the contractor is formally responsible for the success or failure of the project. However, if the contractor goes bankrupt, in a majority of cases the government will have to continue operating the project and to subsidize it. (See the discussion on implicit contingent liabilities in chapter 2.)

2. Managing the contracting-out process

Government activities cannot be contracted out simply on the basis of standard contract management, but needs a special assessment.²⁷ To begin with, it is necessary to define clearly the business need and to identify specifically the activities to be contracted out. It is also important to evaluate likely changes in conditions (e.g., service increases and investment requirements); review issues of coordination between the activities to be contracted out and the other relevant governmental activities; and assess whether governmental activities in other agencies could be incorporated into the project to increase its efficiency. The contracting out needs to be organized on the basis of a

purchaser-provider relationship between the government agency and the contractor. Therefore, the quality of the contractor's management and the nature of the relationship are important. A variety of options should be considered regarding the type of agreement (lump-sum contracts, price-per-unit contracts, shared profits, etc.); the objective (e.g., cost saving only or service improvement); etc. Project costs should be assessed (when possible) based on the experience on similar projects or specific studies; performance standards should be clearly stipulated in the contract; and the contract should incorporate provisions regarding contractor nonperformance and dispute resolution mechanisms.

Box 42
Risks and Opportunities in Contracting Out

In *Malaysia*, the government signed a novel and ambitious 28-year concession with a private consortium to upgrade, rehabilitate, and extend the entire country's sewerage system. Although the estimated US\$2.8 billion contract was awarded in 1993, progress has been slow, primarily because of significant public and commercial backlash from tariff collection and tariff increases. Malaysia's experience points to the unique risk allocation issues raised by private provision of retail sanitation services in instances where these services have never been centrally provided before, the legal right to cut off service for nonpayment is absent, and sewerage and water services are billed separately.

In *Argentina*, the city of Buenos Aires delegated the management and investment responsibility for its water and sanitation systems to a private consortium. Under the terms of the 30-year concession, the consortium will invest US\$4 billion in upgrading, rehabilitating, and extending the systems. In three years, the consortium has brought dramatic operational and financial improvements through reduced UFW and higher bill collection rates. The success can be traced to the significant steps the Argentine government took to ensure the financial viability of the concession: raising tariffs prior to privatization, assuming the state water companies' liabilities, financing a voluntary retirement program, providing a guarantee that the concession company would cut off service to consumers for nonpayment, and creating an independent regulatory authority to prevent politicization of the concession. Soon after the award of the concession, however, tariffs had to be raised ahead of schedule because the government agreed with the operator's view that the physical state of the systems was worse than anticipated.

Source: *Finance and Development*, March 1997.

Contracting out an activity does not discharge the government agency from its responsibility for that service. The agency has the obligation to monitor the performance of the contractor to ensure that standards are met and the contract is fulfilled. Assessment and management of risks are important aspects of contract management. The agency needs to keep up its technical knowledge of the service, to be able to monitor the performance of the contractor and to audit performance information from the contractor.

Box 43
Why did the lights go out in New Zealand?

Following the deregulation of the New Zealand energy industry under the 1992 Energy Companies Act, Mercury Energy Limited was incorporated on October 1993 as the successor to the Auckland Electric Power Board (AEPB). The 1992 Energy Companies Act set the deregulation process in motion by requiring all power boards to come up with a plan to turn themselves into successful businesses. Mercury Energy's plan, which was accepted by the government, included creating shares and placing them in the hands of newly formed Auckland Energy Consumer Trust (AECT). That made the AECT principal shareholder of Mercury Energy. Each year, Mercury Energy pays the AECT a dividend of at least 50 percent of its after-tax profit. The AECT, after meeting its operating costs, distributes the surplus to customers of Mercury Energy.

Mercury Energy covers both electricity distribution and power distribution activities. The distribution or lines business involves the operation and maintenance of a regional network covering the city of Auckland. Currently, around 68 percent of Mercury Energy's distribution system uses underground cables. The company has about 250,000 customers, including 50 of the country's top 200 electricity consumers, and 217,000 residential customers.

On February 20, 1998, a power crisis hit Auckland when four major cables feeding the central business district crashed. International experts engaged by Mercury Energy have found possible causes for the cable failures: the exceptionally hot and dry weather, problems in the backfill and ground in which the cables were installed, steep slopes down which some sections of the cables were laid, vibrations from road and rail traffic, and the cutting of control cables by contractors.

Whether the causes of the power failure are under the control of Mercury Energy or not, the company's competence, standards and practices as Auckland's major provider of power, have been put into question. The ministerial inquiry into this incident distributed blame between Mercury Energy and its predecessor, the AEPB because both neglected the evidence of increasing unreliability of the cables supplying the Auckland CBD. Mercury Energy, however, gets a bigger part of the blame as it seems likely from the inquiry's conclusions that it did not properly evaluate the risk of supply interruptions which have been increasingly growing with the rising load on unreliable high-voltage cables.

Moreover, the inquiry report concluded that the indirect nature of the trust ownership of Mercury Energy may have had an effect through "absence of clear Board accountability through effective shareholder and/or market disciplines", a vital objective in a network industry with monopoly characteristics. Likewise, Mercury's contracts with its customers do not clearly define what supply risks are involved and unless exclusions and limitations were freely and equitably negotiated between supplier and customer, the supplier should bear the residual liability.

Sources: *The Age*, Melbourne Online, various issues, 1998; and Rob Laking, Director of Master of Public Management, Victoria University of Wellington, 1998.

3. The need for caution

As noted, contracting out can be an effective tool for promoting efficiency and improving the delivery of certain public services. Possibilities for contracting out must be taken into account when preparing the budget. When preparing and reviewing ministries' budget requests, it is always advisable to ask whether a more cost-effective private solution could exist, and move to contract out the service if the answer is yes. However, contracting-out cannot be a substitute for a sound restructuring of the public sector, or for privatization if the service in question does not properly belong in the public sector. Nor is contracting out a panacea; indeed, it carries fiscal, efficiency, and governance risk if it is not well designed and monitored. It is always necessary, therefore, to determine accurately the contractual and market conditions in which the possible private solution can be implemented.

Box 44
Why Sydney Siders Had to Boil Their Water

Until 1995, Sydney Water, a state-owned corporation, was responsible for Sydney's water. As water quality guidelines became stringent, Sydney's raw water came under increasing stress and the Sydney Water Board decided to contract for a privately built-owned-and operated (BOO) system for water treatment. Several factors persuaded the Board to adopt the BOO system for water treatment. It was facing major capital outlays to upgrade and expand wastewater treatment capacity, and was about to be corporatized, thereby involving the private sector and providing access to a full range of international technology. Moreover, the growing competition made the Board realize its relative inexperience in filtration systems. In 1993, two consortia were contracted for water treatment plants: the Australian Water Services and North-West Transfield. A year later, a third contract was awarded to another consortium, Wyuna Water. By the end of the century, the drinking water consumed in Sydney will be treated by the three plants.

On July 31, 1998, Sydney residents were warned to boil tap water following the discovery of a parasitic contamination affecting the entire metropolitan area. Sydney Water confirmed that the source of contamination was the Prospect water filtration plant, a plant operated by Australian Water Services. Sydney Water's contract with private treatment plants costing taxpayers US\$3 billion does not require the target of giardia cysts and cryptosporidium, the organisms that invaded the drinking water supply.

Several years ago, Sydney Water abandoned plans to clean its reticulation network, a move that could render the four contracted treatment plants ineffective. Moreover, Sydney Water took more than two years to finalize a memorandum of understanding (MoU) for the Department of Health to take over regulation of water health matters, despite having been directed to do so two years ago by the Ministry for Urban Affairs and Planning. Responsibility for the problem thus appears to be shared. The event demonstrates anew the need for thoroughness and attention to quality control when contracting out basic social services.

Source: *The Sydney Morning Herald*, *The Herald Sun*, and *The Courier*, various issues.

In any case, caution is needed. The experience in practice with lump-sum contracts and “partnering” is similar to that with management contracts for public enterprises adopted by many developing countries in the 1980s.²⁸ Generally, these contracts have not helped in rehabilitating ailing enterprises or improving their efficiency, and in many cases have led to asset stripping and “profit milking” by the management. (When managerial contracts were associated with substantial equity investment by the new management, these problems were significantly alleviated.)

A competitive environment is generally necessary to benefit from contracting out. After reviewing several surveys of contracting experiences in the U.S. that show uneven results, Donahue concludes:

*First, the profit-seeking private firm is potentially a far superior institution for efficient production. Second, that productive potential can be tapped only under certain circumstances. Public versus private matters, but competitive versus noncompetitive usually matters more... Half of a market system—profit drive without meaningful specifications or competitive discipline—can be worse than none.*²⁹

Particularly in developing and transition economies, benefits from contracting out depend from progress with reforms to build a competitive environment. Public enterprises to which contracts are granted should be corporatized, and the role of the state as “principal” separated from the functions of management as “agent”.³⁰ There should be an arm’s length relationship between the private or public contractors and the government. And an adequate market-oriented legal framework must be in place.

Contracting out is sometimes a way of slipping budgetary constraints rather than a deliberate choice on efficiency grounds. In theory, the financial risk should be transferred to the contractor, but contracts often include explicit or implicit government guarantees. Because of the importance of the service to the public, when the contractor fails to provide the service correctly or goes bankrupt, the government has no practical alternative but to intervene and give financial support to the activity previously contracted out. Some contractors therefore use contracting-out agreements to get the contract,

without intending to submit themselves to real market discipline afterwards. Contracting out may also diminish transparency, since it substitutes "commercial confidentiality" for accountability and thus escapes legislative controls.

When the government is obliged to support an ailing project implemented under a BOT contract, the fiscal cost may be particularly high, as shown by the Mexican experience described in box 46. This calls for a careful analysis of the legal and economic aspects of BOT arrangements. The usual cost-benefit analysis of projects undertaken under BOT schemes must be undertaken, but further assessments of risks, variants, etc., are required. The legal negotiations may need years. A BOT arrangement should never be an excuse to launch an unprofitable project. A genuine private solution must be considered. When the government cannot find a genuine private solution, the reason is often that the project is not viable in the first place. The corruption risk of BOT arrangements is of special concern. Compared with normal procurement, the complexity of BOT arrangements provides greater opportunities for corruption. For example, in a country such as France, where corruption within the civil service is nearly nonexistent, several recent judicial proceedings revealed corruption of local authorities through BOT contracts.

Box 45
Contracting Out Gone Wrong: Two Examples

In the 1980s, local authorities in the United Kingdom, faced with financial stringency, resorted to a range of private funding vehicles to evade public expenditure control. These unconventional means of finance involving private parties become known as "avoidance instruments". For example, many local authorities resorted to sale-and-leaseback arrangements with existing assets, in some cases reaching the extremes of realizing cash through sale and leaseback of street furniture such as lampposts or parking meters.

Mexico launched in 1987 an ambitious program for contracting out the construction and operation of roads under BOT arrangements. Initially, the arrangements appeared to be successful, and more than 5,100 km of new toll roads were built. However, resources were allocated poorly and were used before they were needed; construction periods turned out to be 55 percent longer than had been agreed with the contractors; vehicle traffic 37 percent lower than projected; and investment 29 percent higher than agreed. The profitability of the roads was naturally far lower than had been anticipated. The Mexico economic crisis of 1995 aggravated the financial situation of the toll roads under concession to private companies, forcing the government to implement a plan of emergency support of US\$2.2 billion. As a consequence, the participation of the public sector rose to 40 percent of the capital stock of companies holding the concessions, and the concession terms were extended to allow private investors a greater opportunity to recover their investment.

Sources: David Heald "Privately financed capital in public services", The Manchester School, 1997; and Robert Barrera, "Contracting-Out Highway Development and Operations in Mexico", in *Contracting out government services*, OECD, 1997.

E. KEY POINTS AND DIRECTIONS OF REFORM

1. Key Points

Greater performance orientation in public expenditure management is a goal, and must not be confused with any specific means of encouraging it. In particular, better performance in budgeting should never be confused with “performance budgeting”, which may lead to better or (more often) worse performance depending on circumstances. Performance is a relative concept, which can be defined in terms of effort or in terms of results. The subjective dimension of performance should never be neglected, and genuine effort should be recognized, or it will no longer be exerted. However, it is advisable in most cases to define performance in terms of objective measures.

Objective indicators of performance can relate to:

- input—the resources used to produce a service (e.g., doctors)
- output—the service itself (e.g., number of vaccinations)
- outcome—the purpose achieved by producing the service (e.g., lower morbidity)
- process—the manner in which inputs are procured, outputs produced, or outcomes achieved (e.g., good “bedside manners”).

The output of one stage is an outcome of the previous stage and input into the next. Thus, in activities close to the ultimate user, outputs are a good way of contracting with service providers. In upstream activities instead (e.g., medical research) the measurement of performance is much more ambiguous. There is an “accountability tradeoff”, by which accountability can be strong or broad but not both. In any case, the *quality* of the service requires explicit monitoring, or performance indicators may inadvertently lead to lower quality. The selection of appropriate performance indicators, therefore, depends on the nature of the service as well as the circumstances of the country in question. The only general rule is that—in those cases when performance measurement is demonstrated to be appropriate and cost-effective—performance

should be assessed according to that *mix* of input, output, outcome and process indicators which is realistic, cost-effective, and suitable for the specific activity, sector, and country.

Among the several cautions the risk of counterproductive behavior ranks high. It is essential to think carefully about the impact on actual behavior of using any specific indicator of “performance”. For example, when an aboriginal tribe in Australia was told that its subsidies would depend on keeping sanitary facilities clean, they did so most effectively by cleaning the toilets thoroughly and then closing them to the public. With these caveats, good performance indicators should meet the “CREAM” criterion: they should be Clear, Relevant, Economic, Adequate, and Monitorable. If any one of these requirements is not met, the indicator should not be used. When indicators are used, the next question is setting the appropriate target: the general rule is that a target should be challenging but achievable.

Contracting out—the transfer to the private sector of the implementation of activities previously performed by government is in a sense a logical extension of performance orientation (and belongs, as well, in the realm of the third PEM objective of good operational management). Contracting out is the transfer to the private sector of the delivery (not the financing) of government services. It offers the potential for efficiency increases both in the delivery of the service contracted out and, through the “market-testing” effect, in the government delivery of other services. However, contracting out calls for great caution, and requires, among other things:

- a competitive environment;
- definition of the business need and of the activity to be contracted out;
- coordination with other related governmental activities;
- careful consideration of the quality of private management;
- protection of transparency and of service quality;
- specification of performance standards (which meet the CREAM criterion) and of consequences for non-performance; and
- very close monitoring of contractor’s performance.

The risks associated with contracting out are particularly great in the case of Build-Operate-Transfer (BOT) arrangements, whereby a private entity finances and builds the facilities, then recoups its investment through an exclusive concession to operate them, and finally transfers them back to the government. First, the complexity of such arrangements provides greater opportunities for corruption; second, risk assessment is essential, for the government may well be obliged to foot the bill if the private contractor bankrupts or defaults.

It would be a gross oversimplification to attempt to summarize further the summaries of general reform recommendations shown in Chapter 17 to which the reader is referred. The general prescription for successful reform are, in fact, the same as the broad themes of this book": (i) never transpose into a different social and economic context reforms introduced elsewhere, without a realistic assessment of their impact and requirements and appropriate adaptation if necessary; (ii) never move beyond the basics until certain that the basics have been set right; (iii) never hope for a quick-and-easy technical solution to complex and long-standing budget process problems; and above all (iv) never assume that the "experts" are invariably right. Competition and contestability can be as effective in screening out bad ideas as they are in screening out bad products. Therefore: question, question, and question some more. If the advice is good and the experts are right, they will be able to answer to everyone's satisfaction. More importantly, local officials can then implement the reforms themselves, with external advice, certainly, but only in a supporting rather than a controlling role.

2. Directions of reform

Injecting new formal performance-related elements into the budget process requires extreme care, both because better performance orientation is critical for improving public expenditure management and because there are many wrong ways of pushing it and only a few ways of doing it right. The lessons of international experience for the reform process in this area are thus essentially the following:

- Never confuse the objective of better performance orientation with any one of the specific instruments for achieving it. There are many ways to foster performance, short of making formal changes in the budgeting system;

- If the public expenditure management system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. (Symmetrically, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.)
- Consider carefully the probable impact on individuals' behavior, especially in multi-ethnic societies or very small economies.
- Understand clearly the different uses and limitations of input, output, outcome and process indicators, and tailor the use of each to the specific sector and issue in question. Whenever possible, avoid using any single indicator to assess performance.
- Assure robust monitoring of performance, with swift and predictable consequences.
- Build-in provisions for the systematic assessment of *performance of the performance system itself*. It is inherent in the logic of the system that it, too, must be subject to a reality test, and to periodic proof that its concrete benefits have outweighed the cost.
- Beyond these caveats, it is important to continuously look for any possibility to expand the "service awareness" of government administration; raise the rewards for good performance (not necessarily monetary) and the sanctions for unsatisfactory performance; and keep under constant review the possibility of introducing the various tools for measuring and monitoring performance. In all these tasks, systematic feedback from the service users and the public at large is invaluable, and so is an informed and aggressive free media.
- The process can consist of first picking one or two government departments that provide services directly to the public; introduce simple performance measures at an acceptable cost (including transactions cost); monitor closely

the functioning an impact of the measures; debug the measures and adjust as needed; gradually expand the application of performance measures to other governmental areas as and when appropriate; and stop when reaching the point of diminishing returns. The performance indicators can be used right away in the dialogue during the budget preparation, but direct and mechanical links to budgetary appropriations should be avoided.

¹ However, for units within a private enterprise the problem of measuring performance may not be any easier than in the public sector. This is especially true in a large enterprise, suggesting that “size” may be as important a variable as the public or private nature of the activity.

² For a private corporation, success can be assessed by a variety of related quantitative measures: share price, profit, dividend distribution, turnover, market share, etc. None of these indicators are applicable to government activity. Hence, among other implications, private management techniques (“management by objectives”, etc.) might provide useful pointers, but cannot be transposed to the public sector.

³ As in Heller’s work of fiction, *Catch-22*, in which the commanding general insists on a “tight bombing pattern” whether or not the target is hit, and reprimands a pilot who destroyed the assigned target but whose bombs did not hit in the prescribed close pattern.

⁴ Primarily the U.S., the U.K., Australia, and New Zealand. New Zealand has gone farther in this direction than any other country (see OECD, 1997). In the U.S., which has the longest experience of disappointments with “performance” or “program” budgeting, performance orientation in the budget process is now being pursued less mechanically, through the 1996 Government Performance and Results Act (GPRA; see U.S. GAO 1996a and 1996b, and U.S. GAO 1997a and 1997b; on the general question of using performance measures in the U.S. budget, see U.S. CBO 1993).

⁵ In the ancient adage: “Man does not live by bread alone”. A reductionist view of human nature risks, in time, reducing sharply public sector effectiveness, and possibly increasing the risk of corruption.

⁶ What Thorstein Veblen called “the instinct of workmanship”.

⁷ These measures are discussed in a variety of sources, e.g., UK Audit Commission, 1986; Beeton, 1988; and Federation des Experts Comptables Europeens, 1991.

⁸ As noted in Chapter 1, “economy”, i.e., least-cost provision of inputs is frequently used as a performance indicator. Although it is an administratively convenient concept, as it linked to the procurement function, it is subsumed in efficiency and thus not independently useful for analysis or policy.

⁹ Note that not all useful data concerning a public service are necessarily performance indicators. For example, the percentage of arrests from citizens’ direct complaints is a useful statistic for law enforcement, but says little if anything about the performance of the law enforcement apparatus.

¹⁰ The illustration is our adaptation from David Shand (1998), who in turn derived it from Boyle (1989), Jackson (1991), and OECD (1994).

¹¹ Perrow, 1986 (quoted in Robert Laking’s “Don’t try this at home: A New Zealand approach to public management reform in Mongolia”, paper presented at an ADB training event, Nov. 1998).

¹² For process indicators, accountability can be stronger or weaker depending on the nature of the public activity.

¹³ Consistent with the need to “get the basics right”, this principle is analogous to the conclusions of the chapters on budgeting and on accounting: cash-based systems must be strong and well-rooted before considering a move toward program budgeting or accrual accounting.

¹⁴ For an elaboration of the distinction between formal and informal institutions, and the concept of “path dependence”, see North, 1991.

¹⁵ A large number of indicators for most sectors can be found in UK Audit Commission, 1986b, and 1993; Carter et al, 1992; and OECD, 1997. For education, see Johnes, 1992, and Reynolds, 1992; for health, Wilkin et al, 1992, and Williams, 1995; for law enforcement, Fowles, 1996 (in Smith, 1996); for public housing, Bines et al, 1993; for social security, Deleeck et al, 1991.

¹⁶ “Real income”, in Irving Fisher’s sense.

¹⁷ Shand, 1997, lists many more requirements for performance indicators. However, several are desirable but not mandatory, and others are in fact different dimensions of the five requirements listed above.

¹⁸ The reader is referred to Smith (1996) and, for the health sector, to the outstanding analysis in Williams (1996).

¹⁹ We are indebted to Naved Hamid and Gie Villareal for this section.

²⁰ See John Brewer, *The sinews of power: war, money and the English state*. Knopf, 1989 quoted in Premchand (1993).

²¹ *Contracting out government Services*. OECD, 1997.

²² "Strategic partnering in government". CPU guideline no 57. U.K. Treasury.

²³ The British Council, *Governance: Public sector reform*, Glossary of terms

²⁴ At least in developing countries. In developed countries with open financial markets, this advantage of BOT schemes is questionable. See Heald, 1997.

²⁵ For about 40 years in France for toll-roads and water supply under the name of "Public service concessions." See D. Heald. "An evaluation of French concession accounting" .*The European Accounting Review*. 1995.

²⁶ James Leigland "Privatization of Public Enterprise in Asia: Current patterns and emerging issues" in Naomi Caiden "Public Budgeting and Financial Administration in Developing countries". Jai Press. 1996.

²⁷ See U.K. Treasury, "Contract management"; Central Unit for Procurement. Guidelines no 61. 1998.

²⁸ A management contract is with a private contractor; a performance contract (pioneered by the French *contrat-plan*) is between the government and the public managers of the state enterprise.

²⁹ John D. Donahue. *The privatization decision*. Basic Books, 1989

³⁰ For a discussion of corporate governance in transition economies, see Dominique Pannier and Salvatore Schiavo-Campo, "Corporate governance of public enterprises", World Bank, 1995.

Chapter 16. BUDGETING REFORMS IN OECD MEMBER COUNTRIES

By Jim Brumby

A. INTRODUCTION

While OECD countries differ in the magnitude of their budgetary problems and the timing and comprehensiveness of their responses, there has been increased acceptance by governments that the structure of the budget process and institutions influence budgetary results. Institutional reform is now seen generally as a necessary condition for the achievement of durable budgetary conditions. This should come as no surprise as it is now well-recognized generally in economic and institutional analysis that the “rules of the game” do shape the nature of decisions taken. By managing the institutions of budgetary control and management, we shape the rules of the game and by implication, the outcome of the game. It is noteworthy that the most comprehensive budgetary reforms have been in countries that experienced serious budget deficits during the economic slowdown earlier in this decade. Those countries that moved early with reforms are reporting positive feedback, and more member countries are moving in this direction. Much of the modern reform in the nature of the budgetary systems has thus been concerned with changing “the rules of the game” to reduce the likelihood of systematic biases for poor fiscal outcomes. This paper starts with a brief examination of the generic problems associated with aggregate expenditure management and the management of the public sector in OECD countries.

The chapter then moves on to survey recent developments in budgetary management in OECD countries, and then surveys recent developments in budgetary management in OECD countries. In doing so, it will focus particularly on the following major developments:

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- Institutional requirements for fiscal responsibility;

- The shift to a more multiyear focus;
- Top-down budgeting techniques;
- The relaxation of input controls;
- The use of output based accountability regimes; and
- The introduction of accrual accounting and budgeting systems.

The paper concludes with a discussion of earlier budgeting reforms in OECD countries and how the current reforms relate to them. Two disclaimers are very important at the outset. First, reforms in OECD countries have been designed to deal with particular problems in these countries, and are unlikely to be applicable to problems of developing countries and transitional economies. Second, even when the problems are relevant, developing countries may not have the administrative capacity or other pre-requisites needed for the effective introduction of these reforms.

B. PROBLEMS OF AGGREGATE FISCAL MANAGEMENT

There is abundant literature on how various institutional features of decision making may give rise to what could be called an excessive level of government spending. These features can reasonably be summarized as “the tragedy of the common.” In this well-documented case the individual interest of the participants conspire to produce a loss to all which comes to light through time.¹ The problem is that no one gains individually by self-restraint. In expenditure management this suggests that sectoral or individual political or economic interests can be promoted with little concern for the aggregate position. Only the Finance Minister has an interest in the protection of the whole, and this may or may not be valued by the Prime Minister and the electorate, depending on their own views concerning their particular risk exposure to the aggregate budget. This creates room for opportunistic behavior.

There is some evidence to suggest that there is a kink in the way economic actors evaluate gains and losses: they dislike losing a certain amount more than they

¹ More formally, the model of “the common” relies on two noteworthy features: first, only those that use the common are affected in proportion to how much they use it; and second, the costs of using or overusing the common is in the same currency as the benefit (T. Schelling, *Micromotives and macrobehavior*, Norton, 1978, pp. 112—113).

would value a gain of the same amount. Thought of in terms of collective decision making, this suggests that there will be accretion or a bias for upward movement in the spending line, not necessarily matched by taxes. Participants will never agree to a reduction, but will always pursue an increase.²

The decision-making problem is not helped by some systemic features of traditional public management which also add to the likelihood of upward bias. These features include:

- Poorly developed product markets for public services, making the public sector a monopoly supplier, with tax-supported expenditure being a captive purchaser;
- Nonexistent control markets, making public-sector supply immune to market-based monitoring and pressure;
- Complex, incoherent, or unstated goals, making allocation to the highest value very hard to determine, with this difficulty often compounded by unclear accountability after the fact;
- Limited authority being passed down the line to where information is more complete; and
- Unequal access to information, placing higher decision making at a severe disadvantage relative to lower.

At various speeds, from different starting points, most OECD countries are considering introducing or have introduced large-scale reforms to deal with some or all of these problems. This has been a profound aspect of late-20th-century governance. And more and more, a transnational interest in these issues is being seen.

Global commercial liberalization and the free flow of capital are exerting new pressures on systems of public governance. Recent experience shows starkly that the quality of public institutions and the trust in which they are held by economic players

² In addition, expenditure increases typically benefit a specific group (significant enough to mobilize political support), while the implied tax increases are distributed imperceptibly across the whole population.

can have very demonstrable effects on the behavior of these markets. Public-sector governance systems that induce loss of market trust impose costs not only directly on their domestic economies, but more generally as they reduce global growth rates below potential.

While many of the features of the responses required to deal with the Asian crisis are outside the scope of this paper, they are operating in a way that is consistent with the direction of the changes in budgeting and management systems. These changes deal with the three tiers of efficiency associated with budgeting and management systems:

- The general call on resources made by the public sector (aggregate allocative efficiency);
- The ability to direct resources to where they will be most beneficial (allocative efficiency); and
- The technical efficiency associated with producing—or having produced on behalf of the public sector—specific goods and services (technical efficiency).

C. INSTITUTIONAL REQUIREMENTS FOR FISCAL RESPONSIBILITY

It is difficult for a government entity to commit credibly to a course of action, because it has the means to change its mind and to put this change into effect. A number of the new fiscal frameworks, whether legally based or relating to a political commitment to a rule of thumb, have been designed to increase the credibility of the commitment by government to a course of action. The basic idea here is to create rules and mechanisms that impose a cost on government for deviating—or at least, capriciously deviating—from a course of fiscal responsibility. Once the government can commit credibly, it means that it can strongly influence expectations through signaling and communication.

There have been two particularly noteworthy innovations in fiscal frameworks associated with building in credibility in commitment:

- Establishment of medium-term budget targets; and
- Requirements for transparency and timeliness in financial reporting.

The global fiscal targets incorporated in the Maastricht Treaty as convergence criteria for EMU are a clear example. These requirements have given targets both a multilateral character and a higher intensity of obligation by creating a peer group of countries with common objectives. Most EU countries now refer to the Maastricht criteria as their primary aggregate fiscal goal. It seems that these have served as a particular incentive for fiscal consolidation in countries with significantly higher deficit and debt levels than the Maastricht criteria. There can reasonably be debate about the durability of this mechanism and the aptness of the targets so far chosen. But what we have already witnessed is quite formidable. Fiscal rectitude has generally entered the objective functions of the EMU and potential EMU countries, to a degree not seen before. Especially for the smaller EMU countries, the Maastricht targets and the conditions of EMU continuation provide very compelling reasons for ongoing prudence. The common currency area brings forward the benefits of fiscal consolidation to these countries.

The U.S. has made legislative change over more than ten years in support of budget deficit reduction. The Gramm-Rudman Hollings Acts of 1985 and 1987, the Omnibus Budget Reconciliation Acts of 1990 and 1993, and the Balanced Budget Act of 1997 have been the main legislative frameworks.³ The latest budgetary rules have proved successful in controlling discretionary spending by setting caps on government investment and consumption. If the annual appropriation bills exceed the caps, the law invokes an automatic sequestration, which means across-the-board cuts in discretionary spending. While the caps have been amended annually, real discretionary spending has fallen every year since 1991.

The Swiss government has proposed that its fiscal consolidation target be enshrined in the Constitution. The new constitutional clause would set the authorized

³ Most observers consider the Gramm-Rudman Hollings Act ineffective. This view is supported by the vast increases in the central budget deficit until 1993, despite their existence.

deficits for coming years. Should these objectives not be achieved, a mandatory procedure would be set in train, requiring savings to be made based on financial priorities. It has still to be presented for approval by the Parliament, the cantons, and a public referendum.

New Zealand has adopted a different legal track for fiscal consolidation objectives through the Fiscal Responsibility Act of 1994. This law states principles of responsible fiscal management and transparency on key budget parameters and other aggregate fiscal reports. The important mechanism operating here is that governments have to explain the policy rationale behind five crucial fiscal indicators. The fact that they have to do this repeatedly builds in commitment. When they deviate from a policy that is consistent with the achievement of the indicators, the government is required to explain its track back to meet the objective.

The Australian Charter of Budget Honesty also aims to increase transparency in fiscal policy making and fiscal results. A notable feature it shares with the New Zealand approach is the requirement to publish a set of fiscal updates prior to all elections to prevent governments from withholding information on the true fiscal position. This produces a number of desirable features—including sharing a common economic and fiscal outlook in the election debate and preventing a newly elected government from being “shocked” at the state of finances. The U.K. has recently announced a Code for Fiscal Stability, which has a number of features that are quite similar to the New Zealand law. This code includes adherence to “the golden rule,” targeted debt, and real operating expenditure levels.

The golden rule in this context specifies that over the cycle the government will borrow only to invest and not to fund current expenses (including depreciation and maintenance). The German golden rule—which is embodied in article 115 of the Constitution—states that in any year, government lending must not exceed government investment expenditure, except in circumstances of a “macroeconomic disequilibrium.”⁴ The United Kingdom’s golden rule differs from the German one by allowing deficits to

⁴ The German golden rule refers to investment in budgetary terms that differs from the national accounts definition in a nontrivial way.

exceed investment in any specific year as long as the rule is fulfilled over the course of the economic cycle. On the other hand, it is stricter by referring explicitly to net instead of gross investment. The Japanese golden rule is institutionalized by the virtual separation of government “deficit bonds” from government “construction bonds” and the aim of limiting government borrowing to construction bonds only in the medium term.⁵

The advantages of a golden rule are twofold: it puts a limit on the scope for government lending, and it does not prevent beneficial government investment from being undertaken. The underlying idea of the rule is that government investment generates a future stream of income and/or services that justifies the allocation of some of the expenditure to the future. However, a golden rule does not rule out government borrowing to finance even investment projects with low economic or social returns. In any event, the golden rule appears to have some appeal to policymakers; since 1970 both the German and U.K. versions of the golden rule seem largely to have been fulfilled for many OECD countries on a national accounts basis, and indeed also for the OECD as a whole.⁶ Adherence to the golden rule, however, does not rule out fiscal stress unless governments also commit to a funding constraint—usually captured by a net or gross debt target. General government-sector capital expenditure may produce positively returns from projects from an economic perspective, but these returns are not necessarily captured by the government as a financial entity.

There can be a risk that high-profile capital and operating spending targets, and targets for deficits and debt can lead to an inappropriate recourse to nonspending interventions. There is evidence for some countries that during the 1990s parts of the social agenda have been shifted onto off-budget mandates—in particular, regulatory activities and targeted tax relief. The economic costs of such measures are often not as transparent as financial costs associated with budgetary mandates. Similarly, in the

⁵ The Fiscal Structural Reform Act of 1997 states that the current budget of central and local government should balance by FY 2003 (later amended to FY 2005).

⁶ This applies if borrowing were allowed to cover a broad range of capital expenditure. If based on a more narrow capital expenditure definition, i.e., government fixed investment only, net lending of most member countries would have surpassed their golden-rule level on the average during the past 25 years.

absence of a robust accounting system and method, hard targets for one sort of expenditure can lead to pressure on the classification system.

D. THE SHIFT TO A MULTIYEAR FOCUS

By their nature, the “rules of thumb” and legal frameworks referred to above include an intertemporal perspective. By bringing into play the “through-time” dimension, decision makers are forced to consider issues of sustainability, and rates of deterioration and consolidation. It also means that the policy implications for aggregate spending level have to be integrated with aggregate tax and debt planning.

It is hard to be credible when putting forward a fiscal policy that is not sustainable. This is not to say that it is not possible, just that the credibility will require very careful explanation. The medium-term focus, of itself, redresses some of the natural focus of politicians and tends to place a new test of credibility onto their reputation and functions. It brings into play today the relative harvesting or stewardship of the common referred to at the outset.

As discussed at length in chapter 4, multiyear planning and forecasting serves to increase the fiscal discipline by setting overall fiscal policy objectives, showing the minimum costs of continuing existing policies through baseline projections, and illuminating the full-year budget implications of decisions in following budgets.

As noted earlier in this book, a multiyear perspective in setting budgetary policy serves to restrain demands at the start of budget process. They serve notice to politicians, interest groups, bureaucrats, and other claimants for public funds that there are clearly set limits to the responsiveness of government to their demands. In most countries, political leadership and public support have been a critical factor in governing these global targets. To serve their intended purpose effectively, they are generally expressed in aggregated terms capturing either future fiscal trends or the direction the government plans to go. They are not detailed qualitative statements of intent. The global targets used in member countries can be grouped into three categories as follows:

- Ratios (usually expressed as a percentage of GDP). The ratio may relate to the level of the budget balance, revenue or expenditure, public debt, or government borrowing.
- Rates of change in revenue or expenditure.
- Absolute values for the target variable in nominal or real terms. These targets may be expressed as the future level of expenditure or the deficit, or as the amount of desired change from previous baseline projections.

The key tension in determining medium-term targets is to provide enough *stretch* so as to produce change, on the one hand, while being sufficiently attainable to be *credible*. Sweden applies the following four criteria in determining appropriate targets. The targets should:

- be difficult to manipulate;
- involve a political cost to deviating from them;
- be sufficiently flexible to allow the fiscal policy to deal with the cycle; and
- be easy to communicate to the public.

Yet these medium-term frameworks have also encountered a number of methodological problems, including the following:⁷

- A tendency to overestimate the growth potential of the economy. In some cases this has created the illusion that additional resources were available in the forecasting period and created an upward impetus for public expenditures.⁸ “Prudent” or “conservative” economic assumptions have now become the dominant feature in a number of countries so as to avoid this problem. It can be questioned whether a precommitted bias for underforecasting growth itself can deliver the benefits sought, as decision makers would be expected to undo the bias. A more durable practice would

⁷ “Multi-year budget forecast,” *Budgeting for the future*, OECD, PUMA/SBO (96)3.

⁸ Evidence is found in the experience of Canada, Finland, France, and the United States (see “Managing structural deficit reduction, OECD occasional paper no. 11, 1996).

involve the use of the best available or best professional forecasts, thereby separating the interests of the technicians from those of the politicians.

- Some ministries have viewed their numbers in the forecasting period as a commitment from the center to a certain level of resources. This has made changes in existing policies difficult and created a bias for their perpetuation, even in the event of a negative shock.
- The focus on medium-term fiscal objectives could contribute to postponing or undermining pressing short-term consolidation decisions. It is even possible that medium-term forecasts can give the illusion of more fiscal room when demographic conditions are expected to become more benign in the medium term prior to deterioration.⁹

For the EU countries a number of medium-term reporting requirements are embodied in the Maastricht Treaty and the Stability and Growth Pact.¹⁰ Since 1993, EU member states have been obliged to publish medium-term convergence programs regularly, with the programs being scrutinized by the ECOFIN council. Members of the EMU are obliged to submit every year a “stability program” containing medium-term projections for government deficits and debt covering at least the following three years, their main assumptions and a description of budgetary measures being taken—or proposed—to achieve the objectives set forth. In the case of major budgetary measures, an assessment of their quantitative effects on the budget position should be provided. Finally, sensitivity analyses of how changes in the main assumptions might affect the budgetary and debt position are required. The stability programs are key elements of the “early-warning” procedure of the Stability and Growth Pact in which the Council can make recommendations for member states to take corrective actions in the event of actual or expected significant deviation from the medium-term budgetary objective or the adjustment path toward it. Member states outside the euro area will continue to submit convergence programs, which—unlike the stability programs—

⁹ This was noted in the OECD's report *Maintaining Prosperity in an Aging Society*.

¹⁰ Some EU countries, for instance, the United Kingdom, Sweden, and Denmark, also publish medium- and long-term fiscal strategy reports on their own.

should contain medium-term monetary objectives and their relation to price and exchange rate stability.

Most countries outside the EU also publish medium-term fiscal strategy programs containing, to a varying extent, the same sort of information as the stability programs. For instance, New Zealand publishes an annual Fiscal Strategy Report, Australia a Fiscal Strategy Statement, and the United States an Economic and Budget Outlook. Some others prefer not to announce medium-term fiscal targets. In Canada, a two-year fiscal planning horizon has replaced previous medium-term plans, as authorities there concluded that a short-term focus would be more appropriate in dealing with consolidation. They argue that a medium-term view is not necessarily helpful in achieving the goals of visibility and public support. Furthermore, most OECD countries publish an extensive amount of information related to the current and coming year's budgets (prebudget reports, financial statements at the time of the budget, fiscal updates during the year, etc.). In the Netherlands, the independent Netherlands Bureau of Economic Policy Analysis publishes a pre-election analysis of the estimated effects of economic packages proposed by the different political parties. Perhaps this is a practice that may spread.

The use of long-term budget forecasting has not been as widespread nor as uniform as the medium-term planning and forecasting. Long-term forecasts covering 30—40 years have been prepared in countries such as the United States, Australia, New Zealand, and Denmark, mainly to capture the impact of changing demography on budgets—as the aging of populations is by far the greatest single influence on the expenditure trend facing government. By their nature, long-term forecasts tend to be indicative rather than predictive, with projections for future economic activity being susceptible to wide variation.

Several countries, including the United States, Norway, and New Zealand, have also prepared generational accounts to assess the long-term implications of current policies and their effect on the distribution of cost and benefits across generations. Such accounts, however, are subject to a number of severe measurement and

methodological problems which have raised some skepticism as to their informational content.

E. TOP-DOWN BUDGETING

Another important development has been to split up various components of budget decision making, and make more formal the interactions between these components. This is based on the view that separate consideration of budget aggregates from sectoral aggregates and then sectoral aggregates from program allocations can increase the hardness of the budget constraint. It means that the systematic bias for creating demands for additional spending can be constrained through cascading commitments to hard budget constraints. Again, this is essentially a commitment device, which can be used like a two- or three-level game, where the goals of coordinated action are ranked more highly than individual goals.¹¹

The fact that the visible costs of renegotiating any higher-level commitment are high means that they have credibility, and actors at lower levels will see this and accept the hardness of their constraints. Positive incentives for budget-reducing behavior can give this technique even more credibility—this would involve measures such as promoting bureaucrats and ministers who are seen to be budget reducers rather than budget maximizers.

Such top-down spending controls are being applied by a significant number of countries to varying degrees. They place an upper limit on the spending expectations of ministries. New expenditure demands are sometimes funded by a combination of across-the-board cuts or targeted cuts. Many countries have shown a preference for applying targeted cuts rather than across-the-board cuts. This approach should allow resources to flow from less-valued to more-valued areas and act to encourage ministries and agencies to establish their own spending priorities and seek out productivity gains. Evaluations have played a role at this level and within sectoral

¹¹ See, for example, Robert D. Putnam, "Diplomacy and domestic policy: the logic of two-level games," in P.B. Evans et al. *Double-edged diplomacy*, University of California, 1993, pp. 431—468.

allocations. But generally the higher-level allocations are about preference revelation and involve political signaling.

Canada, Sweden, Norway, Iceland, the Netherlands, Finland, and the U.K. have continued their top-down budgeting systems. The *frame budgeting system* in the Nordic countries, consisting of an initial policy decision by the Cabinet to lay down an expenditure frame for each ministry for the coming year, has done much to restrain demands for new expenditures and has helped to reduce the stock of existing expenditure programs to make way for new ones. France has also followed this new budgetary procedure, using a preparatory ministerial meeting for overall mandates to ministries to establish itemized budgets.

The reinvention of the budget determination process into split-level games has also involved the legislature. A number of countries involve the legislature in agreeing to the aggregates and accepting that consideration of the detailed estimates will be done on the basis of these aggregates. This makes the commitment even more credible at the executive level, and removes another potential avenue from ministries seeking increased resources.

There is a trend also for the legislature to split consideration of the budget—with the aggregates being considered by the economics/finance/budgeting committee, and the program allocation being considered by the sectoral committees. This appears to work well with the specific interests and specialties of the sectoral committees being able to challenge allocative decisions, but within the context of the hard constraint.

F. RELAXING INPUT CONTROLS

Of course, the central budget office is not all-knowing. It does not have the information available to make lower-level allocative decisions. Attempts to get the information can prove very costly. And a failure to provide managers with discretion over the use of their budget-constrained resources—while preventing some forms of

opportunism—may induce higher economic costs than necessary as blockages prevent funds from flowing to where they are most valued.

Many countries are responding to these problems by giving agencies greater freedom in operational decisions. Consolidation of appropriation line items into less detailed appropriations and the devolution of resource allocation decisions to ministries and agencies have been increasingly common. Many countries including Australia, New Zealand, Sweden, and the U.K. allow almost complete discretion in spending within aggregate limits on running costs. The devolution of central control on running costs is generally accompanied by strict restrictions to keep their rate of increase below the rate of inflation. The main restrictions on the use of flexibility still in place concern the number and remuneration of senior officials. France still maintains separate controls on personnel, but these may be eased as reform progresses. There are often restrictions on transfers between programs and running costs so as to ensure that focus is kept on managing the efficiency of running costs.

Shifts between fiscal years have been liberalized by permitting ministries and agencies to carry over unused funds to the following year and, in some cases, to prespend a portion of the next year's budget. These changes have been made to reduce incentives for end-of-year spending splurges and to limit poor resource use as a result of arbitrary time-lines.

An important aspect of the incentives regime is that future indicative funding levels are not reduced by underexpenditure in a previous year. Typically, the amount that may be carried forward or prespent is limited to a certain percentage of appropriated funds, or running-cost funds. Not surprisingly, the tests to carryover to the future or draw down from the future are asymmetrical—with tougher tests being employed to control drawdowns. In several countries, incentives are also increased by allowing agencies to earn interest on funds carried forward and charging interest on prespent funds.

Another arrangement providing greater flexibility is the introduction of net appropriations which allow ministries or agencies to retain all or some revenue raised

from user charges, even in tight budgetary situations. This is designed to reward successful organizational effort at revenue collection. Concerns have been raised about a weakening of spending control of the Parliament and the central budget office. In some countries, net appropriations also provide the means to give an incentive for the identification and sale of surplus assets. Agencies may be credited with all or a portion of the proceeds from asset sales, rather than these going entirely to the central budget. In such cases, it is important to be clear over which assets can be controlled fully by agencies and those over which the agency has only limited rights.

The OECD has recently commissioned a study on the relationship between increased managerial flexibility and aggregate fiscal outturn.¹² The argument here is that the more responsive the movement of resources at the line-management level, the less pressure is placed on spending caps and the more likely fiscal consolidation exercises that rely on reductions in spending will be successful.

This study investigates cases of fiscal consolidation from 1986 to 1997, across nine countries. According to a standard definition of success (broadly two successive years of deficit improvement or a debt reduction in the second year after the consolidation exercise), there were 22 successful cases and seven unsuccessful cases.

The study shows that consolidation efforts in countries with high managerial flexibility are less likely to fail than in countries with low flexibility. All stabilization efforts in countries with high managerial flexibility were persistent; seven of the 17 episodes in countries with low flexibility were short-lived. This is shown in table 1.

Table 1. Managerial Flexibility and Consolidation Success

	Low	High
Unsuccessful	7	0
Successful	10	11

¹² R. Strauch, *Managerial flexibility and fiscal performance*, OECD (forthcoming).

Note: The exact Fisher test allows rejecting the hypothesis of independence at a significance level $p < 0.05$

G. ACCOUNTABILITY FOR RESULTS

The quid pro quo for the relaxation of input controls and increased flexibility for managers is that they be held accountable for results. Instead of controlling inputs, the focus is now on outcomes and outputs. Most countries have put considerable emphasis on developing performance indicators, and many of their annual reports and budget documents contain an extensive range of performance information. Chapter 15 discusses these issues at length. This section presents some observations from the experience of OECD countries.

Contractual arrangements have been developed as a tool to specify expected results and to assign accountability as a way of increasing performance in the public sector. The traditional idea of the purchaser-provider contract is being broadened significantly to include budgetary agreements between the central budget office and spending ministries, and even within ministries between ministers and chief executives. The UK and New Zealand have made widespread use of contractual arrangements on performance between ministries and agencies. Australia has developed resource agreements between the Department of Finance and individual departments or agencies. Most resource agreements pertain to running costs, but some deal with program expenditures. Many agreements link resources provided including funding levels, additional money for investment, retained user charges, and outputs or outcomes.

There are two main issues to be confronted in developing performance indicators or performance orientation. These are the technical problems associated with developing indicators that are meaningful, and secondly the manner in which the performance orientation is integrated with the resource allocation process.

The mere name—“indicators”—suggests that such performance information is not seen as complete, but that it generally represents aspects of performance. It sounds partial and therefore subject to challenge. There are many illustrations of how a narrow range of measures can distort organizational behavior—a tax office that has costs per unit of tax collected may shy away from complex, costly tax evasion cases, thereby setting up a dynamic for evaders to need only to signal credibly that they have deep pockets for this purpose to scare away the tax collectors. Of course, these distortions can be expected to flow only if incentives are altered to reflect them, and this requires some degree of integration in either the resource allocation system or the personal performance management system, or both. In any event, just because such distortions may be visible does not mean they are greater than in a world with no indicators—it may be just that the previous distortions were less visible.

It is possible to become hung up on trying to develop performance measures at every step of the intervention process from the center. But the effort should concentrate on establishing information that is of use in decision making and that can assist the dynamic concern of efficient resource allocation. This means that the center should not expect to have an interest in numerous low-level or economy-type measures. Instead, it makes sense to focus on the performance of its main policy interests and allow dynamic institutional pressures to induce a cascading down of objectives and the natural alignment of lower-level performance information to these needs. For instance, contracting and costing on a competitively neutral basis, when there is a threat of changing suppliers, should induce the supplier to stay smart. Output-based performance information has the generally desirable characteristic that it relates to sets of direct personal or organizational responsibilities and resource allocation. An example is provided of the New Zealand system of output-based purchase agreements.

The ease of contractability for output performance is far from uniform. There can be a range of increasing complexity from tangible services (such as issuing licenses, passports: easy) to nontangible personal services (such as training and education: harder) to nontangible ideal services (such as policy advice: harder still).¹³

¹³ See C. Pollit, *Integrating financial and performance management*, OECD (forthcoming).

But the yearning for contracts means that more thought is going into the risk characteristics of these sorts of outputs, with ensuing benefits.

As explained further in chapter 15, the trend in assessing wider organizational performance is to move to a balanced scorecard approach, picking up on dimensions of performance that are not captured in one-period output contracts, such as the ethical fabric of the workforce and the institutional capability of continuing to do the things government wishes.

Benchmarking is also being increasingly recognized as a useful tool for improving value for money by establishing performance targets in reference to the best practices identified in comparable public or private organizations.

H. ACCRUAL ACCOUNTING AND BUDGETING

The increased focus on results and outputs has led authorities to question the basis of the financial information provided about these outputs and results. More countries are seeking full cost information so that they can represent to citizens the full cost of service provision. Accrual accounting was discussed at length in Chapter 7. This section is limited to summarizing the situation in OECD member countries.

There are four broad groups of OECD country practice in relation to accounting.

- Only *four* member countries have adopted both full accrual accounting and budgeting practices, or have firm plans to do so in the very near future. Iceland and New Zealand have already done so, and Australia and the United Kingdom plan to do so.
- Another *four* member countries have adopted—or are in the process of adopting—accrual accounting principles for their whole-of-government financial reporting, but not budgeting. These countries are Canada, Finland, Sweden, and the United States.

- *Three* member countries have adopted accrual accounting standards on a pilot basis in a limited number of individual agencies: Germany, Ireland, and the Netherlands (Korea, too, has announced that it will take this path).

The rest of the membership has not yet started the journey. But some countries, such as France, are considering it very actively.

The author of this chapter believes that the general transition to accrual accounting is virtually unstoppable. The shift will be accelerated if financial markets begin rewarding countries for making the commitment to accruals. There is evidence in the U.S.A. that states using accrual information borrow more favorably than those states using solely cash accounting. We could expect a similar discipline to emerge at the national level. But it is important to remember that the shift to accruals does confront institutions and individual interests with change. It can dispossess information monopolists and unleash dynamic processes. For instance, once countries commit to agency or departmental accrual reporting, they set themselves on a journey, which logically can only stop at accrual budgeting and whole-of-government accrual reporting. This is irrespective of whether this was the goal when they set out. The U.K., Australia, and Iceland are providing evidence of this. And while New Zealand shifted in one step to accrual budgeting and reporting, the shift to whole-of-government accrual representation of the fiscal position followed later because it represented the only logical framework available. One of the surprises in New Zealand came when the financial markets happily agreed to the dumping of the traditional-format cash aggregates (the so-called “table 2 reports”). Discussions with financial market operators showed that they never had much confidence in the old cash data. While the trend to accruals may be unstoppable, the time taken to make the journey may be long in some jurisdictions. Some countries have argued that on a cost-benefit basis, that there are higher-rewarding reforms to make. But in some cases, it appears to be as much the appetite for change as an assessment of the costs of change.

I. EARLIER BUDGETING REFORMS

The paper concludes with a discussion of earlier budgeting reforms in OECD countries and how the current reforms relate to them.

The first major attempt at modern budget reform was what is interchangeably termed “program budgeting” or “performance budgeting.”¹⁴ It was fashionable in the early 1950s.

The essential elements of this reform were to describe the various activities performed by each government organization, to allocate total costs to the various activities, and to establish performance measures for the activities performed. As such, it mirrors some of the reforms being undertaken today in OECD countries.

Much was achieved in terms of annotating budget documentation with information about the activities performed. However, the reforms largely failed in regard to cost allocation and performance measurement. First, these were very novel concepts at the time and were poorly understood by the government organizations that were to implement them. Second, there were few discernible benefits from implementing the reforms. Third, the reforms involved a very serious burden on government organizations as accounting systems and performance measurement systems were quite primitive by today’s standards. Although the objectives of these reforms and current reforms are largely aligned, today’s reforms benefit from an increased understanding of the reforms by government organizations, outputs have replaced inputs as a control mechanism rather than being an additional control, and information technology systems have reduced the cost of the reforms.

The second large-scale budgeting reform was the Planning, Programming, Budgeting System (PPBS) that a number of OECD countries adopted in the 1960s. This was a very ambitious reform that sought to create better linkages between goals and objectives, programs and activities, and financial resources. The essential element of PPBS was to create an analytical capability to examine in-depth the objectives of government intervention and to examine competing ways of achieving those objectives.

¹⁴ Usually associated with the Hoover Commission “Report to the Congress on budgeting and accounting,” 1949.

At the heart of PPBS was the use of cost-benefit and cost-effectiveness studies to compare the various programs and activities being considered as competing means of achieving a given objective. PPBS also sought to “ignore” organizational boundaries in the budget process and to extend the time horizon to five years rather than a single fiscal year.

PPBS proved to be difficult to implement. First, the role of politics in the budget process was not recognized. The political reality that government objectives and activities are compromises of differing value judgments was not sufficiently recognized in PPBS. Second, the usefulness and applicability of rational methods such as cost-benefit analysis and cost-effectiveness studies were exaggerated as government objectives and activities are so disparate and generally noncommercial in nature. Third, departmental boundaries, which PPBS sought to ignore, proved to be very resilient and a significant obstacle to the implementation of PPBS as originally envisaged. Fourth, PPBS required highly trained administrators to conduct the various analyses and studies, and they were in short supply.

PPBS made an important contribution to budgeting as it introduced various concepts from economics and the social sciences that had not been applied in budgeting previously. These concepts are used today, but on a case-to-case basis where applicable. PPBS was simply overambitious in trying to replace traditional budgeting with these techniques in bulk.

The last major budgeting reform prior to the current wave was Zero-Based Budgeting (ZBB), which was introduced in the late 1970s in OECD countries. ZBB required every cost item in a budget proposal to be justified and approved each year. Moreover, it required that all decisions be evaluated and ranked in order of importance based on systematic analysis.

ZBB proved to be short-lived. Many of the problems that confronted PPBS were also faced by ZBB. Moreover, annual review of all programs also proved to be too demanding. Considering the time constraint and the skills required to operate ZBB, this approach is useful for occasional expenditure reviews, but it would be impossible in

practical terms to undertake a complete ZBB exercise each year for the preparation of the annual budget.

In many ways, current budgeting reforms can be seen as a continuation and adaptation of previous reforms rather than being a rejection of prior reforms. Previous reforms have generally had the same objective as current ones and have been steps along the learning curve.

Chapter 17. HOW TO GET THERE FROM HERE: THE STRATEGY AND SEQUENCING OF BUDGETARY REFORM

As discussed in chapter 1, improvements in the budgetary system are largely a function of institutional change, in the contemporary sense of the basic rules that govern the behavior of organizations and individuals.¹ The distinction between “institution” and “organization”—and the interplay between the two—is key to understanding the challenge of improving the management of public expenditure in developing countries. Budgeting organizations can be improved—sometimes even created *ab nihilo*—but economic, social and political behavior will not change unless the rules and procedures change as well. For example, simply merging a Ministry of Finance with a Ministry of Planning will not, by itself, do much to integrate current and capital budgeting more thoroughly. However, the reverse is also true: rule modification is unlikely to produce results *in an operationally meaningful time frame* unless organizational improvements proceed apace. Thus, to follow the same example, an improvement of the budgetary rules for coordination and integration of current and capital budgets can be frustrated if the organization of the Ministry of Planning is not improved as well. Clearly, then, improving public expenditure management requires *both* institutional (regulatory and procedural) reform and organizational development.

In the light of the above considerations, this chapter first presents some general strategic considerations; then outlines the key priorities and sequencing of reform in each of the various aspects of public expenditure management discussed in this volume. In addition, Annex XI contains a questionnaire useful for the assessment of the effectiveness of budget systems. Our standard warnings should be repeated once more: (i) budgetary improvements should be assessed not only in terms of the benefits expected, but also of the probable cost and of likely sustainability; (ii) “best practice” is a dangerous term, when it is misinterpreted as importing budgetary models developed elsewhere and without hard-nosed consideration of local realities—particularly administrative capacity, data availability, and the informal rules that determine much of the behavior of local officials and their private sector counterparts in the specific country.

A. **STRATEGIC CONSIDERATIONS**

1. **General reform choices**

Aside from the extremes of a “quick and clean” reform strategy (optimal but entirely unrealistic) is optimal and a “slow and dirty” strategy (the worst possible approach), the practical strategic choice revolves around the intermediate options of a “slow and clean” reform strategy or a “quick and dirty” strategy.² As a general presumption, the former is preferable because *it is more likely to be sustainable*. Short-term efficiency of public financial resources must be balanced against the need to improve financial accountability in the long-term. This balancing act between flexibility and excessive discretion is probably the most difficult dimension of improving public expenditure management. The extremes are easy to define and to reject. Thus, reform that eliminates ex-ante financial controls altogether in the name of managerial flexibility, without paying any attention to accountability regimes, is a recipe for widespread corruption. At the other end, protecting the integrity of public resources by introducing a list of micromanagement controls is bound to reduce efficiency sharply. The right middle ground between these two extremes is difficult to find and must be country-, sector-, and time-specific.

2. **The “torto-hare” approach to institutional change**

Strategic attention should focus on identifying areas where it is feasible to move very fast (with only a slight cost in terms of “cleanliness” or deviations from the optimal long-term path), and areas where it is essential to build slowly and carefully the solid institutional foundation required for sustainable reform.

Thus, to the question of what the “optimal” pace of reform is, the reform-maximizing answer is “it depends”—unsatisfying and demanding as such an answer may be. This answer is especially valid in the fluid and opaque circumstances of the current transition. To use the metaphor of road traffic, optimal driving speed depends on traffic conditions—*subject to an overall speed limit and to the need to keep moving*. “Torto-hare” was the slogan (*tarta-lepre* in Italian, combining tortoise [*tartaruga*] and hare [*lepre*]) coined by the Italian highway authority in the 1960s to describe the optimal driver

behavior: drive fast or slow depending on the circumstances. To complete the metaphor, the worst approach to driving in heavy and erratic traffic and poor visibility is to go on cruise control, whether at high or at low speed.

In this perspective, there is an aura of unreality to the debate between “big bang” and “gradualism”. The underlying premise of the big-bang approach is that, in the absence of simultaneous rapid policy reforms in complementary areas, partial reform measures will have no effect.³ The underlying premise of the gradualist approach is that there is only so much change and upheaval a society can stand at any one time, and the attempt to do too much may end up in a failure to accomplish anything. The difficulty is that stretching these valid premises to their logical extremes leads to caricature and untenable prescriptions. Thus, the “fundamentalist” interpretation of the big bang is tantamount to advocating reform of everything at once. Aside from being utterly unrealistic, especially for developing countries, such a prescription could also cause extreme damage in a plural society riven by ethnic conflict. At the other extreme, the “fundamentalist” interpretation of gradualism becomes a prescription for total immobility. Hence, the actual operational choice is never between these two extremes, but between the *specific* policy areas where a “big bang” is possible, and those where gradualism is more effective. The obvious alternative to ideological approaches is *analysis*, on a case-to-case basis, of the benefits, costs, opportunities, and risk of specific budgetary reforms in a specific country. A budgetary reform should be pushed very fast wherever and whenever the circumstances warrant, but may need to be postponed in other areas or occasionally slowed down to allow accountability to catch up, absorptive capacity to grow, or public tolerance to be rebuilt. Such an obvious point would not deserve to mention if it were not so often disregarded in practice.

3. Some corollaries

a. The futility of “paper reforms”

A first corollary of the above considerations is that public budgeting improvements are hollow in the absence of effective monitoring and enforcement mechanisms. Organizational and human capacity is essential to administer and enforce the new framework. Administering, monitoring, and enforcing mechanisms take time,

resources and genuine commitment at several levels to become operational. Yet, two very different tendencies often converge in practice to sidestep these requirements. The first tendency is the temptation of politicians and foreign donors alike to declare a problem solved and move on to the next item on the agenda. Thus, the introduction of a new budgetary nomenclature can be considered as an isolated output without any attention to the other elements needed to improve the budget process. The other tendency is the ingrained habit of control-minded elites in the Ministry of Finance to try to effect behavioral change by decree. There is overwhelming evidence that such change, if any, is purely transitory.

b. Adopt, adapt, or create?

A second corollary concerns the question of whether it is possible to “import” foreign budgetary and/or accounting practices. The answer to the question is often phrased in dichotomous yes or no terms. The term “best practice” is itself an example, in its implication that a given practice is “best” in all circumstances. However, as is generally true in other instances of transfer of technology, once again the better answer is: “it depends”. Formal rules can be imported fairly easily, informal ones much less so. It follows that importing foreign institutional practices is a practical proposition only when these practices have a high component of formal rules. This is the case, for example, the more “technical” areas of public expenditure management. However, even the most “technical” procedures require an open-minded assessment that country conditions are amenable to the efficient introduction of the new procedures.

By contrast, when the nature of the institution entails a high component of informal rules, as in “social” and “governance” areas or personnel incentives, the institution will normally need to be homegrown or, if imported, will require substantial adaptation and changes over time. In such cases, process and form (“ownership”, “dissemination”, “consensus-building”, etc.) are as important as the eventual results. Indeed, it is sometimes true that (*pace* Frederic Molnar) “the play’s the thing”: the process *is* the reform.

c. *Design of assistance for PEM improvement*

The risks of giving the “wrong” advice (which, as noted, includes “good” advice that is not suited to local realities) are heightened by the reality of “path dependence”, i.e., that institutional reforms enacted today have inescapable but unpredictable long-term implications—particularly in the more fluid context of developing countries and transition economies. The penalty for mistakes, of course, falls almost exclusively on the people of the developing countries themselves. Thus, the moral hazard inherent in all forms of intervention from the outside—however benevolent the intention—is especially severe in the area of institutional change. Those who urge to “just do it” take on a particularly heavy moral burden.

These considerations should not be taken as counseling inaction or benign neglect—inaction, too, carries its own brand of moral hazard—but to stress the importance of identifying the risks and minimizing them to the extent possible. The risks can be generally minimized by flexible mechanisms of assistance adjusted periodically, with attention to financial accountability and governance implications, and by a focus on local capacity building. More concretely, the risks of intervention can be reduced by interaction with a variety of local interlocutors and optimum use of local expertise. (An example of successful intervention is the ADB loan of US\$250 million to the Indian state of Gujarat for public sector reform—see Box 46).

Box 46**ADB Loan of \$250 million for the Gujarat Public Sector Resource Management Program****Project Objectives**

- *The program supports the Government of Gujarat in improving public finances and augmenting domestic resource mobilization, improving the allocation and efficiency of the public sector, and reducing the role of the Government of Gujarat in commercial activities while promoting market-oriented policies to enhance private sector participation in the infrastructure sectors.*

Project Scope

- *The program focuses on (i) strengthening state public finances and their prudent management; (ii) divesting and restructuring state-owned enterprises (SOEs) to allow the private sector to take the lead in commercial activities while reducing the burden that SOEs put on the budget and the economy at large; and (iii) strengthening the policy, regulatory, legal and institutional frameworks for private sector participation in critical infrastructure sectors (power, ports, and roads) and evolving an enabling environment.*

Highlights of the Program

- *Reduction of overall fiscal deficit to sustainable levels.*
- *Sales tax reforms, including the introduction of value-added tax (VAT), the rationalization of key state taxes, and municipal tax reforms.*
- *Raising of user charges to improve cost recovery.*
- *Expenditure rationalization and improved fiscal policy management.*
- *SOE reform planning and associated institutional mechanisms.*
- *Privatization, partial divestment and restructuring, merger, leasing, or closure of SOEs.*
- *Social safety mechanism for the restructuring of SOEs.*
- *Initial steps to start power sector reforms.*
- *Revision of power tariffs to maintain a 3 percent rate of return on the assets of the Gujarat Electricity Board.*
- *Improved investment planning in power and creation of a framework for promoting private sector investment in roads and ports and initiating private sector investment in roads and bridges by 1997.*
- *Restructuring of the Gujarat Maritime Board.*
- *Strengthening of the capabilities of the Roads and Bridges Department to process private sector road projects.*

Source: India's Economic Survey, 1996-97.

4. Operational approaches

The search for operational approaches to improving public expenditure management in developing countries rests on the above strategic considerations, as well as on four premises. *First*, the information problem is massive. *Second*, specific entry points must be identified. On the one hand, it is evident that simultaneous budget system

reform across the board is not realistic; on the other hand, total inaction on the institutional front is a recipe for progressive deterioration of functions. Somewhere between those two extremes, intermediate possibilities for constructive action must be found. *Third*, path dependence is a reality. Institutional mistakes tend to become evident only years down the line, when they have become irreversible and the advisers or consultants are long gone, with potentially severe consequences for accountable governance and effective public resource allocation and use. *Fourth*, countries must, after all, work with what they have. The human resource endowment, the inertia of bureaucratic habits, the predictable resistance and backlash of the losers from change, etc.—all these factors can be altered, combated, utilized, perhaps even deliberately neglected, but cannot be *ignored* by those who would assist the institutional transformation. These four premises underpin two interrelated approaches to constructive intervention: (i) strengthening intrasystem linkages; and (ii) fostering the creation of “efficient nuclei”.

a. Strengthening internal linkages: The essence of “capacity building”

In many developing countries, and in most transition economies, the absence of systematic lines of interagency communication and the lack of incentives to share information (which is often viewed as a personal asset) result in fragmented policy formulation and atomized decision making. This presents a major problem for the implementation of reforms. The challenge is how to improve communications and reduce the cost of information within the public sector.

It is difficult to decide whether to strengthen one particular agency of government or another; the outcome of bureaucratic “turf” disputes is utterly uncertain, and the risks of losing an organizational bet are potentially severe. The guiding operational criterion of technical assistance for sustainable PEM improvement should therefore be to strengthen the linkages between the components of the overall budget formulation and execution system, not only among central ministries, but between them and subnational entities. Not enough is known to pick winners and losers—and today’s winners may well be tomorrow’s losers anyway. Strengthening the institutional and communication linkages within the system: (i) does not prejudice or preempt the appropriate transition path for

the system as a whole; (ii) entails a direct reduction in transaction costs; and (iii) is most likely to have positive implications for transparency and accountable financial management (except in countries with extreme and systemic governance problems). Even when supporting the reinforcement of one or another specific budgetary procedure, it is essential to encourage *positive* interaction with other government agencies. Such encouragement must not be limited to rhetoric, but should entail incorporating in the assistance specific incentives for greater information exchange, training and cooperation.⁴ This point leads to the second approach suggested here.

b. Efficient nuclei

Action to strengthen linkages and communication channels facilitates but does not in itself generate the spread of new rules and efficient organizational practices. There must also exist dynamic agents of change that can generate the positive “messages” to be transmitted throughout the system by the improved communication channels. These agents, these “efficient nuclei”, must be deliberately created to perform a few key selected public functions.

A guiding criterion for selecting these key functions (and this is where the interrelation with the previous approach emerges) is their contribution to maximizing the linkages within the public sector. By analogy with Albert Hirschman’s “unbalanced growth” approach of 30 years ago, *efficient nuclei should be created largely on the basis of their potential for spreading new institutions and organizational practices throughout the public financial management system.*

Beyond the general criterion of linkage maximization, an efficient nucleus should meet the following practical standards:

- Be small;
- Be fiercely meritocratic, in the initial selection and in the evaluation of staff performance;
- Have flexible and simple procedures;
- Provide adequate compensation for staff (this may require fixed-term contracts without fringe benefits, to permit adequate salaries without compromising

eventual decisions on a fiscally sustainable civil service structure and compensation);

- Have adequate material and financial resources;
- Use local talent, with external advisers only when demonstrably necessary;
- Be a transitional arrangement, with a clear sunset clause and advance specification of the procedures for reassignment of its staff throughout the relevant government agencies;
- Operate not only to perform specific tasks but also a teaching-by-doing function, in cooperation with other agencies.

An illustration can be given in the area of public investment. As discussed in chapter 12, realistic and affordable public investment programming based on economic project evaluation and real-cost financing, is key to efficient and effective allocation of bid resources. However, improving “core ministry” capacity (e.g., in a Ministry of Planning, or of Finance) accomplishes little without sufficient capacity at the sector level to screen out unsound ideas and formulate good projects. It will take a long transition for the sector ministries to build up their own capacity in this respect. In the interim, a mechanism is needed to assure results and speed up the transition as well. By the efficient-nucleus approach, such a mechanism could consist of creating a “visiting team” unit in the core ministry that is charged with public investment responsibility. The unit would comprise a small number of highly qualified, newly trained local analysts and an experienced external adviser, all with excellent communication skills in addition to economic competence. The unit would provide ad hoc assistance to sector ministries, at the right points in the budget cycle, by sending a visiting team “in residence” for a brief period of time. This would combine their technical knowledge with the sectoral familiarity of the ministries’ staff. The team would visit each sector ministry in turn, and interact with its staff to produce better-quality decisions as well as some “teaching by doing”. The relationship would be one of cooperation and mutual assistance—because decisions on actual approval of projects for funding would be entrusted to an entirely different core entity. Such a relationship would therefore encourage informal exchanges of information and advice as and when needed. When, helped by this mechanism (and, of course, their own specific training programs), sector ministries have acquired sufficient project preparation capacity, the visiting team unit would disband, and its personnel would be

reassigned to take care of PIP matters within the core ministry or to lead the work in sector ministries.

B. REFORM PRIORITIES AND SEQUENCING OF REFORMS

This section assembles the “directions of reform” recommendations from each of the previous chapters. The convenience to the reader of having a self-contained PEM reform and sequencing agenda justifies this duplication. (This section should be read in conjunction with the last section of chapter 1 which summarizes the key points in the expenditure management cycle.)

1. The budget and its preparation

a. Budget coverage

Priority actions should consist of laying the foundations required for any sound budgeting and policy formulation system, which include:

- A reasonably comprehensive coverage of the budget;
- Assessment, disclosure, and review of all policy decisions that have an immediate or future fiscal impact, such as contingent liabilities, lending, tax expenditures, and quasi-fiscal expenditures;
- An expenditure classification system that fits the needs of both policy analysis and management, and covers all government expenditures.

These actions should be carried out jointly with the priority actions listed below to improve budget preparation, execution, and accounting procedures. They are a prerequisite for further improvements in the budget system.

Among these further improvements, the following can be considered:

- Developing instruments for better assessment of liabilities, contingent liabilities, and policy commitments. These instruments can include a modified accrual accounting system or multi-year expenditure programming.
- Developing special management arrangements for some expenditure programs (e.g., user charges, service delivery agencies) that can improve their operational efficiency without reducing the comprehensiveness of the budget or weakening expenditure control and accountability to the legislature.
- Setting up a classification of expenditure by activity and program, to allow defining the right performance indicators at an appropriate level.

b. Budget systems and expenditure

The main considerations here relate to the absolute need to take into account the lessons of experience and the specific country circumstances. Introducing sophisticated and demanding performance budgeting systems (and particularly their culmination in detailed output budgeting) has been shown by the experience of the last 50 years to be badly counterproductive when local capacity and “ownership” are not conducive to their introduction. In developing countries, this oversight has led to wasted resources and, in some cases, loss of fiscal discipline. The reform lessons are that: (i) line-item budgeting and expenditure control must be firmly established before moving beyond; and (ii) complex reforms in a limited-capacity environment succeed only in disempowering the limited local capacity itself and reinforcing dependence on external advisory. It should be recalled, however, that there are various ways to strengthen the performance orientation of the budget system short of introducing formal variants of performance budgeting.

c. Budget preparation

As noted, weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility favor questionable

approaches to budgeting. Improving budget preparation is not sufficient to address all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires (in addition to the scrutiny of all decisions with a fiscal impact) improvements in the following:

- Financial constraints must be built into the start of the budget formulation process, deriving from the preparation of a macroeconomic framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policy coordination mechanisms that fit the country context are needed, with particular attention to the policy-budget link.
- It is necessary to develop appropriate policy coordination mechanisms that fit the institutional, constitutional, and political context. Participation of civil society through consultation mechanisms should be sought.
- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority to design these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.
- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting).

d. *Moving to a multi-year perspective*

Every country should prepare its budget within a medium-term macroeconomic framework, covering three to five years, to be able to assess fiscal sustainability. The degree of sophistication of projections depends on technical capacities within the country, and could be progressively improved by the development of econometric models. However, the development of these tools should not be a prerequisite for preparing a macroeconomic framework. The macroeconomic framework should be supplemented by projections of aggregate expenditures by function and broad economic category, to assess its realism and to identify policy requirements and constraints in achieving the fiscal objectives.

To improve budget preparation, the first priority is to set sectoral spending limits and announce them early in the budget preparation calendar. Also, close coordination in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from funds, etc;) is required, whatever the government organizational arrangements. In countries where responsibilities for the capital budget are separated from responsibilities for the current budget, the priority measure is to require joint reviews of the two components of the budget at *each stage* of budget preparation and at each administrative level.

Budget preparation should systematically adopt into *a multi-year perspective*. This requires:

- *At least*, preparing aggregate expenditures estimates by function and broad economic category, and estimating and reviewing the forward costs of programs when preparing the budget;
- *At a further stage*, preparing multi-year expenditure programs, within a macroeconomic framework, linked with the budget preparation, and including only programs/projects for which financing is certain (multi-year programs should focus only on ongoing policies, and new policies should be decided only during the preparation of the annual budget);

- *As a final stage*, preparing a formal medium-term expenditure framework with the same coverage and in the same degree of detail as the budget. To achieve this objective effectively a progressive approach can be considered. As a first step, aid-dependent countries should prepare a strong PIP and detail the forward costs of investment projects financed by external sources. Other countries could focus on the more costly items, e.g. entitlements, large investment projects/programs, or major specific sectors). It is also possible to gain experience by preparing a full sector expenditure program for one of two key sectors. These partial programs, as noted, must be supported by projections of aggregate expenditures, by function and broad economic category.

e. *Organizational issues and the budget approval process*

The legislature is the appropriate locus of overall financial accountability:

- The obvious first step is to give adequate means to the legislature to review policies and the budget;
- The budget should be presented to the legislature on time, to allow its proper scrutiny and budgetary debates to be completed before the start of the fiscal year;
- Aggregate revenue, expenditures, and fiscal targets should be reviewed together.

To contain pressures to increase expenditures, limits may have to be set on the powers of the legislature to amend the budget (e.g., any amendment that increases expenditures or decreases revenues should be accompanied by a counterbalancing measure to maintain the initial deficit target). The legal framework should stipulate that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or its supplementary acts.

2. Budget execution

Budget execution generally needs to be improved along two lines: enhancing expenditure control, and creating the conditions for increased efficiency in public spending. An adequate balance between these two different requirements should be found. In addition, certain priorities for improving cash management can be suggested.

a. *First stage: Ensuring basic expenditure control*

In a number of countries, the first stage should be both to reinforce expenditure control and to ensure better conformity in budget execution with budget policies. In this respect, special attention needs to be paid to the following:

- Timely release of funds;
- Cash planning in conformity with budget authorization and taking into account ongoing commitments (of course, a sound budget is a prerequisite to begin with).
- Effective controls at each stage of expenditure (whatever the organization of controls, internal to the spending ministry or ex ante/external);
- Adequate monitoring at each stage of the expenditure cycle (commitment, verification, and payment);
- Clearly defined procedures for registering transactions (notably for commitments).
- Adequate cash management;
- Transparent procedures for procurement.

b. *Second stage: Improving the efficiency of the system*

For more efficient public spending, the following actions are generally needed:

- Flexible rules for virement and regulated carry-over provision, especially for capital expenditure;
- Progressive decentralization of controls (*in parallel* with a reinforcement of procedures for auditing and reporting); and eventually;
- Development of market testing and consideration of possibilities for contracting out.

c. Cash management and the Treasury function

In most countries priority actions should concern the following areas:

- The centralization of cash balances should be ensured (together with a centralization of the monitoring of transactions). In countries where the payments system has broken down, this may call for implementing a centralized Treasury system from scratch. In other countries, banking arrangements and procedures for transferring funds should be reviewed to better control cash and avoid idle balances. Factors to be taken into account include: (i) constraints due to the localization of local agencies and the infrastructure of the country; and (ii) the possibilities offered by modern information technologies.
- Sound cash planning should be established, together with other measures such as improving revenue forecasts and commitment accounting.
- Debt management, especially the timely tracking of borrowings and repayments, should be strengthened.

Once the centralization of cash flows is ensured, incentives for managing and forecasting cash flows more efficiently could be considered, but in practice this concerns only a limited number of developing countries.

d. Management control, audit and evaluation

The several elements that can contribute to the integrity, efficiency and effectiveness of government organizations and programs, must be instituted by government. They do not come into existence because one wishes them to. Some of the key considerations involved in developing effective management controls, auditing and program evaluation are as follows.

A government that is convinced of the need to build or strengthen its control and analysis capabilities needs to define a strategy for accomplishing these goals and establish responsibility for doing so. In most countries, there are two institutions that should play critical roles in this process, the Ministry of Finance and the Supreme Audit Institution. Ideally, the strategy should be the outgrowth of consultation and cooperation between these two institutions. Implementation of the strategy, involving the actions that must be taken by the line ministries, should be the responsibility of the ministers and senior civil servants in the line ministries, under the leadership of the MOF and external oversight by the SAI.

It is not possible to develop all the needed institutions and procedures at one time. In almost all countries, and especially in developing and transition states, the highest priority should be placed on assuring the reliability of the financial systems and the integrity and security of the controls over transactions. This translates into placing first emphasis on building reliable management control structures and effective internal audit units in the ministries and on assuring the effectiveness of the SAI as the external auditor. Only when these are in reasonably satisfactory condition is it worthwhile to focus on the efficiency and effectiveness of operations.

Countries need not depend exclusively on their own knowledge and experience in developing effective management controls, auditing and program evaluation. Technical assistance is available in all these areas from multilateral institutions, donor

nations and professional organizations. SAIs and MOFs in developed countries are often willing to provide technical advice and assistance to their counterparts in developing and transition countries because of their professional commitment to sound financial management in all countries.

3. The technical infrastructure

a. Accounting and reporting

In a majority of developing countries, it is necessary first to focus on the following:

- In countries that monitor only payments, a commitment register and an ancillary book for outstanding payments should be implemented. More generally, a comprehensive budgetary accounting system and register expenditure should be implemented at each stage of the expenditure cycle. Budget execution reports must show expenditures at each stage of the expenditure cycle.
- Develop a debt accrual accounting system should be developed if none exists, and comprehensive reports on debt should be prepared.
- Operations of extrabudgetary funds (if any), should be consolidated, and all government entities should be made to follow the same classification in their reporting.
- Contingent liabilities should be recorded and statements of these liabilities must be prepared and published.
- Publication of financial statements.

Further steps should include:

- Implementing modified accrual accounting to provide a comprehensive framework for reporting on liabilities, and systematic registration of contingent liabilities;
- Implementing asset registers, at least for the categories of assets that need to be carefully monitored.

When (and only when) the previous actions have been implemented, and are on a solid basis, can a move toward full accrual accounting and the accompanying financial reporting be considered.⁵ Taking into account the heavy implementation requirements, accrual accounting could be implemented gradually, beginning with agencies with a more urgent need to assess full costs.

b. Public investment programming and aid management

The broad goals of public investment programming are to: (i) raise investment efficiency by improving project quality; (ii) bring investment allocation in line with country policies and priorities; (iii) assure consistency between investment programs and available financing at favorable terms; and (iv) lead in time to a more comprehensive multi-year expenditure framework.

All these goals require sufficient control by the recipient government over project selection and strategic allocation of aid moneys—assuming a reasonable degree of integrity and efficiency in the country’s governance and public management.⁶ Conversely, a good public investment programming process is most often the best practical way in which the recipient country’s government can get into the driver’s seat and stay there.

The directions and sequencing of reforms in public investment programming and aid management stem directly from those four goals. For better project quality and investment efficiency:

- The first priority is to design ironclad procedures against the birth of “white elephant” projects. Once a project of large size is on the drawing board, the

bureaucratic dynamics from both donor and recipient sides make it very difficult to stop it. Among these procedures, involvement of high-level policy makers (and, for very large projects, the Cabinet) must be built in at a very early stage.

- Also essential is the capability for economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable, and selectivity is needed. Only projects of significant size should be analyzed in detail, with smaller projects “bundled” and the bundle evaluated only for its general correspondence with sectoral policies and common sense.
- Third, an agile procurement process that minimizes the opportunities for corruption, and effective physical monitoring of project implementation and completion are a must. Strengthening the audit function and obtaining systematic feedback from local entities can be extremely useful.

For the other three objectives of public investment programming:

- It is important to have a procedure for early decision of whether the investment allocation corresponds to aggregate and sectoral policies, and the ensuing preliminary definition of the sectoral expenditure envelopes.
- Also, through good aid management and coordination among donors, regulations are needed for assessment of the probability of financing for various projects, and strong regulation should be in place to assure that only projects with certain financing are included in the investment program.
- Finally, a realistic procedure and minimum capacity for estimating the total cost of investment projects and their recurrent costs is a must. This is always preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process. Conversely, the experience gained

through these forward estimates can be invaluable for the eventual move to a comprehensive multi-year expenditure approach.

c. *Performance orientation and contracting out*

Injecting new formal performance-related elements into the budget process requires extreme care, both because better performance orientation is critical for improving public expenditure management and because there are many wrong ways of pushing it and only a few ways of doing it right. The lessons of international experience for the reform process in this area are thus essentially the following:

- Never confuse the objective of better performance orientation with any one of the specific instruments for achieving it. There are many ways to foster performance, short of making formal changes in the budgeting system;
- If the public expenditure management system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. (Symmetrically, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.)
- Consider carefully the probable impact on individuals' behavior, especially in multi-ethnic societies or very small economies.
- Understand clearly the different uses and limitations of input, output, outcome and process indicators, and tailor the use of each to the specific sector and issue in question. Whenever possible, avoid using any single indicator to assess performance.
- Assure robust monitoring of performance, with swift and predictable consequences.
- Build-in provisions for the systematic assessment of *performance of the performance system itself*. It is inherent in the logic of the system that it, too,

must be subject to a reality test, and to periodic proof that its concrete benefits have outweighed the cost.

- Beyond these caveats, it is important to continuously look for any possibility to expand the “service awareness” of government administration; raise the rewards for good performance (not necessarily monetary) and the sanctions for unsatisfactory performance; and keep under constant review the possibility of introducing the various tools for measuring and monitoring performance. In all these tasks, systematic feedback from the service users and the public at large is invaluable, and so is an informed and aggressive free media.
- The process of introducing performance indicators can consist of first picking one or two government departments that provide services directly to the public; introduce simple performance measures at an acceptable cost (including transactions cost); monitor closely the functioning and impact of the measures; debug the measures and adjust as needed; gradually expand the application of performance measures to other governmental areas as and when appropriate; and stop when reaching the point of diminishing returns. The performance indicators can be used right away in the dialogue during the budget preparation, but direct and mechanical links to budgetary appropriations should be postponed to a later stage.

C. A Concluding Word

The approach of this book has been resolutely pragmatic, providing a menu of options rather than single “best-practice” models, and highlighting the need to consider carefully the specific country context. However, pragmatism degenerates into ad-hockery and shortsightedness if it isn’t guided by coherent and universal principles. Among these, the following are fundamental and applicable everywhere:

- Strengthening the “four pillars” of governance (accountability, transparency, predictability, and participation).

- Reinforcing their foundation in civil society, through such means as efficient and responsible fiscal decentralization, and encouragement of citizens' "voice".
- Using improvements in public expenditure management partly to reduce opportunities for corruption, both home-grown and imported.
- Following the beacon provided by the PEM objectives—fiscal discipline, strategic resource allocation, good operational management and due process.
- Stretching the horizon of budgeting beyond the immediate future—through a concrete multi-year approach, when feasible, but at a minimum at the level of systematic reflection and dialogue.

In addition to these universal principles, we suggest from experience four practical rules for assessing the merits of recommendations to improve expenditure management in the specific country context:

- *Put first things first.* "Getting the basics right" is a must for the process of spending the people's money, especially in poor countries where the people can least afford costly experiments. Other areas of economics and technology may offer realistic opportunities for "leapfrogging" over the immediate problems into a more advanced state of affairs. In public expenditure management, such opportunities are very limited, the costs of mistakes are very high, and these are rarely borne by the advocates of the experiment. In the words of the Press Communique of the Conference on Fiscal Policy and Reform (February 2-4, 1999, Apia, Samoa): "...fundamental elements of budgeting preparation; implementation; and monitoring that permit effective control, promote transparency, foster accountability, and ensure legitimacy need to be firmly in place before highly sophisticated concepts of budget management...[are] introduced."

- *Don't make the same mistakes.* Mistakes are inevitable; but repeating the mistakes of others can be avoided, by a realistic assessment of the concrete experience of a variety of other countries with the same mechanism or process.
- *Put the right driver in the driver's seat.* Any measure to improve public expenditure management in developing countries must raise the country's own capacity to manage its public expenditure. An "improvement" in public expenditure management designed and implemented primarily by expatriate specialists is no improvement at all, quite the contrary. Nor can improvements last if they are imposed top-down by the central agency with little involvement or implementation capacity of the sector ministries.
- *Finally, be open-minded but questioning.* The history of development assistance is littered with the bones of imported institutional failures. If the recommendation is sound, it will withstand critical challenges; if it is not, only critical challenge will reveal that fact.

¹ See Schiavo-Campo, 1994, for a summary of the main issues. Section A of this chapter is based on parts of that publication.

² This may be considered by some as an obvious choice, given that there is no credible alternative to some sort of step-by-step process. In actual practice, however, the attempts at “shock therapy” are all too frequent and have caused considerable problems.

³ A macroeconomic example of such a mistake would be an attempt to reduce the fiscal deficit by improving the tax effort without concomitantly strengthening expenditure control mechanisms. A microeconomic example would be the liberalization of public enterprise pricing without the complementary measures to place the enterprise on a commercial footing.

⁴ Furthermore, interdonor cooperation is important to prevent tunnel-vision actions by individual donors.

⁵ Because almost all developing countries still need to complete the improvements listed above, full accrual accounting is a realistic option only for developed countries, although many of these have not even begun to introduce it.

⁶ Because aid is fungible, if the government would implement a particular project in any case, aid earmarked for it releases governmental resources to finance a “marginal” project of which the donor knows nothing. The aid in effect finances the latter project, and the earmarking is an illusion. Hence, if the quality of governance or of public management is seriously deficient, donor control over the investment program as a whole may be the only way for aid moneys to have a positive development impact. (A far stronger impact, however, would result from assistance or insistence to improve governance in the first place.) In most developing countries, instead, donor financing for a project which the government does not consider a priority can distort resource allocation and create other adverse incentive problems and moral hazards which more than offset the direct positive impact of the assistance itself. Hence, strong coordination and direction by the recipient country’s government are essential to the development impact of the assistance. The implications of aid fungibility for the investment program under different assumptions have been examined long ago (see Schiavo-Campo and Singer, 1970) and have been recently rediscovered.

ANNEXES

Annex I

Code of Good Practices on Fiscal Transparency

CLARITY OF ROLES AND RESPONSIBILITIES

1. The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

- The boundary between the government sector and the rest of the economy should be clearly defined and widely understood. The government sector should correspond to the general government, which comprises the central government and lower levels of government, including extrabudgetary operations.
- Government involvement in the rest of the economy (e.g., through regulation and equity ownership) should be conducted in an open and public manner on the basis of clear rules and procedures, which are applied in a nondiscriminatory way.
- The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.
- Clear mechanisms for the coordination and management of budgetary and extra-budgetary activities should be established, and well-defined arrangements vis-à-vis other government entities (e.g., the central bank, and state-controlled financial and nonfinancial enterprises) should be specified.

2. There should be a clear legal and administrative framework for fiscal management.

- Fiscal management should be governed by comprehensive laws and administrative rules applying to budgetary and extrabudgetary activities. Any commitment or expenditure of government funds should have a legal authority.
- Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.
- Ethical standards of behavior for public servants should be clear and well publicized.

From International Monetary Fund, *Draft Manual on Fiscal Transparency*, October 1998.

PUBLIC AVAILABILITY OF INFORMATION

1. The public should be provided with full information on the past, current, and projected fiscal activity of government.

- The annual budget should cover all central government operations in detail and should also provide information on central government extrabudgetary operations. In addition, sufficient information should be provided on the revenue and expenditure of lower levels of government to allow a consolidated financial position for the general government should be presented.
- Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.
- Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditures, and quasi-fiscal activities.
- The central government should regularly publish information on the level and composition of its debt and financial assets.

2. A public commitment should be made to the timely publication of fiscal information.

- Specific commitments should be made to the publication of fiscal information (e.g., in a budget law).
- Advance release date calendars for fiscal reporting to the public should be announced.

OPEN BUDGET PREPARATION, EXECUTION, AND REPORTING

1. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

- A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.
- Any fiscal rules that have been adopted (e.g., a balanced budget requirement and borrowing limits for lower levels of government) should be clearly specified.
- The annual budget should be presented within a comprehensive and consistent quantitative macroeconomic framework, and the economic assumptions and key parameters (e.g., effective tax rates) underlying budget estimates should be provided.
- Existing commitments should be distinguished from new policies included in the annual budget.
- Major risks to the annual budget should be identified and quantified where possible, including variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g., financial restructuring).

2. Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.

- Government transactions should be on a gross basis, distinguishing revenue, expenditure, and financing, and classifying expenditures on an economic and functional basis. In addition, expenditure should be classified by administrative category. Data on extrabudgetary operations should be similarly classified. Budget data should be presented in a way that allows international comparisons.
- A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.
- The overall balance of the general government should be a standard summary indicator of the government's financial position. It should be supplemented by other fiscal indicators (e.g., operational balance, structural balance, and primary balance) when economic circumstances make it inappropriate to base judgments about fiscal policy stance on the overall deficit alone.
- The annual budget and final accounts should include a statement of the accounting basis (i.e., cash or accrual) and standards used in the preparation and presentation of budget data.

3. Procedures for the execution and monitoring of approved expenditures should be clearly specified.

- A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.
- Procedures for procurement and employment should be standardized and accessible to all interested parties.
- Budget execution should be internally audited, and audit procedures should be open to review.

4. Fiscal reporting should be timely, comprehensive, and reliable, and should identify deviations from the budget.

- During the year, there should be regular, timely reporting of budget and extrabudgetary outturns, which should be compared with original estimates. In the absence of detailed information on lower levels of government, available indicators of their financial position (e.g., bank borrowing and bond issues) should be provided.
- Timely, comprehensive, and audited final accounts of budget operations, together with full information on extrabudgetary accounts, should be presented to the legislature.
- Results achieved relative to the objectives of major budget programs should be reported to the legislature.

INDEPENDENT ASSURANCES OF INTEGRITY

1. The integrity of fiscal information should be subject to public and independent scrutiny.

- A national audit body, or equivalent organization, should be appointed by the legislature, with the responsibility to provide timely reports to the legislature and public on the financial integrity of government accounts.
- Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.
- The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.

Annex II

The “New Public Management”

As mentioned in box 12 (chapter 3), the set of public administration and budgeting practices collectively known as the “New Public Management,” has figured prominently, for over a decade, in the debate on improving public-sector efficiency and effectiveness. Although the New Public Management is hardly “new” anymore, and many of the NPM innovations have become commonplace in several developed countries (and is sometimes, and inaccurately, identified with “the New Zealand Model”), NPM is still a “new” thing in many developing countries and in some developed countries of continental Europe and East Asia. Because of its far-reaching implications for public expenditure management, it is useful to summarize here its core components as well as the major arguments in favor of and against the introduction of NPM.

NPM has alternately been sanctified or demonized. Its strongest proponents argue that NPM is fully applicable everywhere. Indeed, some even argue that it is applicable everywhere only if it is applied in *all* of its elements—and that the only implementation requirement is to “just do it” (in the well-known slogan of an apparel company). This position can be explained by the fact that the NPM construct possesses extraordinary internal consistency; each element is logically related to the others. At the opposite end of the debate, some critics argue that *none* of the NPM elements has any relevance to developing-country conditions, and that even in developed countries its applicability is partial and limited to countries with an “Anglo-Saxon” tradition. (The NPM has been primarily developed and implemented in Australia, Canada, New Zealand, the U.K., and—partly—the U.S. and Singapore.) In keeping with the pragmatic approach of this book, we believe that a more constructive assessment of NPM should be somewhere between those two extremes. Some elements of the approach are *likely* to work well everywhere; others are suitable mainly to developed countries; still others are appropriate only in countries with an Anglo-Saxon tradition; and, finally, some elements of NPM (e.g., a rigid “firewall” between service policy and service delivery) are unlikely to work well anywhere. Regrettably, the “all-or-nothing” insistence of some of the more ardent proponents of the approach has understandably led countries to rejecting the approach in its entirety—thereby losing the efficiency and effectiveness benefits which some of the innovations can make possible. Hence, the need for this summary.

Table AII.1 summarizes the key components of NPM,¹ and is followed by verbatim excerpts from two articulate views, one critical and the other positive, by Donald J. Savoie and Sandford Borins, respectively.² Readers will judge for themselves. But recall that, in considering whether or not to adopt a specific budgetary innovation, there is no substitute for a thorough and realistic assessment of its costs and benefits in the light of the objectives and realities of the specific country.

Table AII.1 Doctrinal Components of New Public Management

No.	Doctrine	Meaning	Typical justification
1	<i>"Hands-on professional management" in the public sector</i>	Active, visible, discretionary control of organizations from named persons at the top, "free to manage"	Accountability requires clear assignment of responsibility for action, not diffusion of power
2	<i>Explicit standards and measures of performance</i>	Definition of goals, targets, indicators of success, preferably expressed in quantitative terms, especially for professional services (cf. Day and Klein 1987; Carter 1989)	Accountability requires clear statement of goals; efficiency requires "hard look" at objectives
3	Greater emphasis on <i>output controls</i>	Resource allocation and rewards linked to measured performance; breakup of centralized bureaucracy-wide personnel management	Need to stress <i>results</i> rather than <i>procedures</i>
4	Shift to <i>disaggregation</i> of units in the public sector	Break up of formerly "monolithic" units, unbundling of U-form management systems into corporatized units, around products, operating on decentralized "on-line" budgets and dealing with one another on an "arm's-length" basis	Need to cite "manageable" units, separate <i>provision</i> and <i>production</i> interests, gain efficiency advantages of use of contract or franchise arrangements <i>inside</i> as well as outside the public sector
5	Shift to greater <i>competition</i> in the public sector	Move to term contracts and public tendering procedures	<i>Rivalry</i> is the key to lower costs and better standards
6	Stress on <i>private-sector styles of management practices</i>	Move away from military-style "public service ethic"; greater flexibility in hiring and rewards; greater use of PR techniques	Need to use "proven" private sector management tools in the public sector
7	Stress on greater <i>discipline</i> and <i>parsimony</i> in resource use	Cutting direct costs, raising labor discipline, resisting union demands, limiting "compliance costs" to business	Need to check resource demands of public sector and "do more with less"

Our own view is as follows. Stewart and Ranson (1988) consider the essence of the "new public management" to be a shift from the traditional model of "probity and propriety" to a new paradigm of "policy and performance." In these terms, we see the challenge not as one of choosing between these two paradigms, but of finding ways to combine "policy" with "propriety" and "probity" with "performance." For example, in law enforcement, the probity model corresponds loosely to "due process"; the performance model corresponds loosely to crime control. There is a natural tension between these two objectives, and continuing public debate, but the analytical and policy issue is not to jettison one in favor of the other, but to find ways of reconciling them in practice. It is the same with the "traditional" and the "new" paradigms of public sector management. Indeed, as we have stressed throughout this volume, all good policy rests on the reconciliation of multiple objectives.

"Con" (Donald J. Savoie)

- "The new public management philosophy . . . is rooted in the conviction that private sector management is superior to public administration. The solution, therefore, is to transfer government activities to the private sector through privatization and contracting out. Given that all government activities can hardly be transferred to the private sector, the next best solution is to transfer business management practices to government operations. . . . The very word 'management' implies decisiveness, a dynamic mindset and a bias for action. . .
- The new public management is basically flawed. By its very nature, the public administration field does not lend itself to Big Answers because private sector management practices very rarely apply to government operations. . . . Public administration operates in a political environment that is always on the lookout for 'errors' and that exhibits an extremely low tolerance for mistakes . . . in business it does not matter if you get it wrong 10 percent of the time as long as you turn a profit at the end of the year. In government, it does not much matter if you get it right 90 percent of the time because the focus will be on the 10 percent of the time you get it wrong. . .
- The new public management has yet to deal head on with accountability in government. . . . There is also a world of difference between citizens and clients. . . . Clients can turn to the market to depend their interests or walk away. . . . Citizens on the other hand, . . . hold politicians accountable through the requirements of political institutions and through exposure via the media. Politicians, meanwhile, hold public servants accountable through the application of centrally prescribed rules and regulations. . .
- The success of the business executive is much easier to assess than that of the government manager. There is also much less fuss over due process in the private sector than in government. . . . The new public management gives short shrift to these considerations: it simply ignores them. Rather than tangle with these fundamental issues, the disciples of the new public management employ a new highly value-laden lexicon to disarm would-be questioners. . . . reinventing, reengineering, empowering. . .
- If the problem with bureaucracy is one of insensitivity . . . we all too often forget that

one person's red tape is another's due process. The solution lies in fixing our political institutions. . . .

- The new public management has been with us for over ten years and it has very little to show for itself. To be sure, management consultants have profited extensively. . . .
- The basic premise is that private sector management practices are superior to those found in government. . . . The implication is that public service has no intrinsic value. It also belittles the noble side of the public service profession: public servants became public servants because they wanted to serve their country. If they had wanted to become entrepreneurs, they would have joined the private sector or started their own businesses. . . . But the real damage . . . is that . . . we have been diverted from confronting substantial issues of governance and public administration. . . .
- The new public management has also overlooked important problems. . . . The policy side of government and the ability of bureaucracy to be innovative and self-questioning needed more fixing than did the machine or production-like agencies. The new public management has very little to offer on policy. Instead, . . . it speaks to the need for more 'doers' and fewer 'thinkers'. . . .
- The new public management . . . may well be making matters worse, given its call for decentralized and empowered machinery of government. . . . [that] will make it more difficult to promote coherence in government policy and . . . for the political leadership to secure the necessary information to focus on the broad picture. Improvements in administration are also necessary. The solution, however, lies not in searching for the Big Answer: government will not be reinvented nor are we finally about to get it right. . . . Improvements in the administration of government will be made: . . . full use of new information technology to strengthen their capacity to provide services, . . . new partnership with other government departments to coordinate services. . . .
- Innovative thinking in government did not start with the new public management movement. Yet, one senses that anything significant taking place to strengthen the public sector tends to be attributed to the new public management by its advocates. . . . However, improvements are the results of new circumstances whether it is a tighter budget, new development in computer technology or old-fashioned common sense. The point to bear in mind is that the solutions that work are practical, rooted in the political and legal realities of government. They should not be expected to represent anything more than gradual and incremental improvements to public administration."

"Pro" (Sandford Borins)

- "The new public management is not a simplistic Big Answer. Rather, it is a normative reconceptualization of public administration consisting of several inter-related components. . . .
- The new public management came about in response to a number of environmental forces. . . . First, large and expensive public sectors were created during earlier periods of strong economic growth . . . [such that it became imperative to get] the debt problem under control. . . . Second, [there was] rapid development of information technology. Third, the ready availability of information . . . is destroying the tradi-

tional 'economies of scale' rationale for concentration of production in large organizations. Fourth, people . . . are demanding quality and service from both public and private sector producers. . . . Fifth, employees [look for] opportunities for personal growth and fulfillment. . . .

- The new public management is not slavishly following private sector ideas. . . . Rather, it acknowledges that both the public and private sectors are confronting similar forces, and it is receptive to learning about how the private sector has responded and, where appropriate, adapting private sector learning to the public sector.
- A second influence of private sector ideas is that the new public management is suspicious of all monopolies. Two mutually reinforcing remedies for monopoly are introducing competition and providing performance information to service recipients. The new public management advocates schemes such as Britain's market testing, which opens up the provision of some services to the public or within government to private sector competition. . . . There are impressive savings. . . .
- The new public management starts with the assumption that the world is at least partially decomposable. . . . For those functions that can stand alone, the obvious prescription is greater managerial autonomy. . . .
- The new public management has thought about the question of accountability. . . . In the past, when public servants acted as policy advisers, it was . . . similar to the privileged relationship between solicitor and client. The new public management has not ignored the role of public servants in policy development; rather it presents a new model. Increasingly, policy development is being done in open consultation among the general public, policy communities, and the public service. . . .
- The new public management does speak in normative tones, and it does use active verbs. The enthusiasm and the active verbs are an attempt to challenge the accountability-concealing passive voice and the overall greyness and grimness of tone. . . .
- One of the arguments often made is that the political context of the public sector has an extremely low tolerance for 'errors'. . . . The new public management's emphasis on continuous improvement is aimed at eliminating such errors. Of course this is similar to the use of TQM methods in the private sector to achieve goal like six sigma quality (that is, no more than one error per million). . . .
- There is a 'disbelief culture' found in government concerning management reforms. Part of the reason for the disbelief culture is that the proponents of these reforms, particularly the consultants, have tended to oversell their products. Academics, too, have often played a role in the disbelief culture, namely that of debunking the excessive claims of the proponents. . . . Some of us sense that the current wave of innovation and ferment in the public service is different in both scope and significance from the reform efforts of the past. . . . The public management community is characterized by strong initial beliefs but there is little agreement on what constitutes evidence. . . . [It] does not seem to have given enough thought to how we could determine if public management reforms are successful. . . .
- Ultimately, public management scholars should be contributing to the development of good governance. We will do that more effectively if we tone down our rhetoric, take off the shelf the social scientific research skills that we learned in graduate school, and concentrate on the challenging but *essential* task of evaluating the new public management."

NOTES

- ¹ From Christopher Hood, "A public management for all seasons," *Public Administration*, vol. 69, Spring 1991, p. 3. Reproduced by permission.
- ² "What Is Wrong with the New Public Management?" and "The New Public Management Is Here to Stay," both in *Canadian Public Administration*, vol. 38, no.1, Spring 1995. Reproduced by permission.

Annex III

Anti-Corruption Policy of the Asian Development Bank

The problem of corruption, here defined as the misuse of public or private office for personal gain, is an ancient one that can be found in every government. It can also be found in the private sector, and in the interactions between the public and private sectors. A balanced approach to combating corruption must address both sides of the equation, and make it more difficult and risky for those who would give bribes as well as those who would receive them.

Recently, a powerful combination of factors has emerged in donor and recipient countries that is providing momentum to the global anticorruption effort. At the same time, the latest empirical analysis is demonstrating that although the effects of corruption are complex and varied, it clearly exerts a negative impact upon development. As a result, the environment in which multilateral development banks (MDBs) operate has changed. Pressure for more active measures against bribery and graft is no longer likely to be isolated and sporadic, but will remain an important element of the broader debate over good governance and sound development management.

As a major multilateral development institution and one of the leading sources of development funding in the Asian and Pacific Region, the Asian Development Bank (ADB) welcomes this emphasis on anticorruption initiatives as part of its broader work on governance issues. The Bank's Board paper, "Governance: Sound Development Management," recognizes the importance of accountability for public officials, and transparency and predictability in government operations—critical principles in the fight against corruption.¹

At the broadest level, the Bank's anticorruption policy is intended to reduce the burden that widespread, systemic corruption imposes upon the governments and economies of the region. More specifically, the Bank's policy is centered upon three objectives:

- Supporting competitive markets, and efficient, effective, accountable, and transparent public administration as part of the Bank's broader work in governance and capacity building;
- Supporting promising anticorruption efforts on a case-to-case basis and improving the quality of the Bank's dialogue with its developing member countries (DMCs) on a range of governance issues, including corruption; and
- Ensuring that the Bank's projects and staff adhere to the highest ethical standards.

ADB, R89-98: "Anticorruption Policy," 11 June 1998 (Executive Summary).

The bulk of the Bank's effort will be directed toward broader measures to improve the quality of governance in the DMCs. This effort will have two components. The first will seek to reduce the scope of direct government intervention in the economy, in the belief that markets should be efficient and competitive, and have as few barriers to entry and exit as possible. This will reduce the opportunity for firms or officials to take advantage of artificially restricted markets or suboptimal pricing to demand monopoly rents.

The second component will focus upon supporting improvements in public administration and public sector management. Efforts to strengthen management information systems, for example, should enhance transparency and accountability, and strengthen the capacity of governments to monitor their expenditures. Measures to strengthen audit functions or to ensure adequate control over disbursements can play the dual role of helping to improve performance while making theft and embezzlement more easily detected. Procurement reform, which the Bank is already pursuing in a number of the DMCs, can reduce costs while making fraud and abuse more difficult to perpetrate. Steps to strengthen civil service establishment management will help to eliminate "ghost employees," and efforts to decompress pay scales and improve employment conditions will lower the incentive for illicit behavior. Measures to improve procedures for recruitment and promotion should help avoid abuse of patronage, nepotism, and favoritism, and help foster the creation of an independent, meritocratic civil service. The reengineering and streamlining of business processes can improve the efficiency and effectiveness of the public sector while simultaneously reducing opportunities for corruption.

In advancing such initiatives, the Bank affirms its desire to adopt a proactive and not a reactive stance. Most priority governance initiatives will have significant positive externalities that will make corrupt behavior more difficult to engage in and more readily detected once it occurs. Over the longer term, the Bank is likely to be much more effective if it focuses its anticorruption efforts upon measures for prevention and not on short-term efforts aimed at prosecution.

The Bank may also be called upon to assist the DMCs in pursuing an explicit anticorruption program. Bank assistance will be guided by three considerations: (i) the extent to which Bank assistance is requested by the DMC; (ii) the degree to which the request is consistent with the Bank's broader country operational strategy and ongoing efforts in the field of governance and capacity building; and (iii) the extent to which the request falls in an area where the Bank has expertise. Under this element of the policy, the Bank may also support regional anticorruption initiatives or anticorruption-related research.

ADB staff should exercise caution in addressing several sets of initiatives that will typically remain beyond the Bank's scope of involvement. They include efforts to influence the domestic debate within the DMCs regarding an anticorruption strategy or set of anticorruption initiatives; anticorruption programs that are highly politicized in nature and targeted at a particular individual or political party; and initiatives that are largely cosmetic and designed to foster the illusion of progress without the substance. To ensure consistency with the Bank's Charter, any anticorruption initiatives supported by the Bank must be apolitical in nature and motivated solely by essential economic considerations or concerns about the probity of Bank operations.

The Bank has several mechanisms for engaging in dialogue with the DMCs on issues of governance (including corruption), ranging from the country operational strategy and

the country assistance program discussions, to country portfolio review missions, to project appraisal, implementation, and review missions. Bank staff charged with country strategy and program formulation, including the drafting of the country operational strategy and country assistance program documents, as well as staff responsible for loan or TA projects, should address corruption in the context of broader governance and capacity-building issues. They should be knowledgeable about issues of corruption and its impact within their particular geographic and/or sectoral sphere of operations. They will use these mechanisms to discuss and recommend ways in which the Bank can help advance the principles of sound development management, including measures that would help to combat corruption, in any country where corruption affects Bank projects and the country's general prospects for economic growth.

Country portfolio review missions and project review missions may provide a useful venue for discussing the policies and practices that impede the efficient implementation of Bank projects. Under most circumstances, staff who suspect that corruption may have occurred or may be occurring within a given Bank project should follow the procedures outlined in paragraph 64 of this document and report the matter to the Office of the General Auditor, who will determine the optimal course of action. In rare cases where rapid follow-up actions may be needed, staff can address such issues explicitly with the relevant company, executing agency, or appropriate investigative agencies after clearance from their director and, the Office of the General Counsel (OGC). Any discussion with a given firm or government agencies should, however, be limited to a specific Bank operation or set of operations.

If the Bank's efforts to reduce illicit behavior among its DMCs are to be credible, it is essential that Bank staff be beyond reproach and the Bank's internal regulations and procedures support the highest ethical standards. Toward this end, the third pillar of the Bank's anticorruption policy calls for more robust internal measures to enhance the integrity of Bank operations along five dimensions: (i) maintaining the integrity of Bank lending and TA operations; (ii) strengthening the Bank's procurement policy; (iii) updating the Bank's Code of Conduct and creating independent internal reporting mechanisms to address allegations of corruption among Bank staff or within Bank operations; (iv) improving the quality of oversight for Bank loans and TA grants; and (v) ensuring that all Bank staff are familiar with the anticorruption policy and act in a manner consistent with both the letter and the spirit of the policy.

If there is credible evidence of corruption in a Bank-financed loan or TA grant, the Bank will address the issue in a dialogue with the DMC. Breaches of specific loan regulations or covenants could result in a decision by Management to blacklist the firm involved, suspend disbursements, or cancel the loan.

In keeping with the evolving practice of IMF and the World Bank, Management and staff will consider issues of corruption more explicitly in the formulation of the country operational strategy and the country assistance program. Cases may occur in which corruption has reached such proportions that it poses a significant impediment to the probity of Bank operations or the attainment of a country's fundamental development objectives. Under such circumstances, Management could elect to lower or suspend Bank lending and TA operations to that country after consultation with the country and the Board.

Conversely, situations may also exist where a given country has made significant progress in improving the efficiency, effectiveness and integrity of its public and private

sectors. Under such circumstances, Management may elect to accelerate the lending program or provide additional TA resources to ensure sustainability for the reforms.

In the light of the complex and highly differentiated nature of corruption, it is important that Bank Management and staff be granted some degree of flexibility in dealing with individual cases within the parameters laid out in this policy. While acknowledging the need for fairness and consistency in its operations, and strongly affirming the importance of a "zero-tolerance" policy when credible evidence of corruption exists among Bank staff or projects, the Bank notes that different types of corruption will require different responses. There is a need for careful judgment based on accurate information and the specifics of the situation. The Bank's anticorruption effort will place particular emphasis upon the implementation of practical and cost-effective prevention control measures, in a fashion consistent with the Charter principle of "economy and efficiency."

An Anticorruption Task Force under the leadership of the Project Coordination and Procurement Division was recently convened to examine Bank procurement policy. Having taken into account the advantages of harmonizing the anticorruption effort among the MDBs with regard to procurement and the engagement of consultants, the Bank will introduce anticorruption provisions effectively identical to those adopted by the World Bank in respect of rejection of proposals, loan cancellation, declaration of ineligibility, and inspection rights. The Bank will also introduce an optional "no-bribery pledge" in the bid form that will be similar to that of the World Bank. It will also introduce a mandatory clause that, when the contract is to be financed wholly or partly by the Bank, the contract documents shall include an undertaking by the contractor that no fees, gratuities, rebates, gifts, commissions, or other payments, other than those shown in the bid, have been given or received in connection with the procurement process or in the contract execution. Following the adoption of the anticorruption policy paper by the Board, provisions to this effect will be incorporated in the Bank's "Guidelines for Procurement" and the "Guidelines on the Use of Consultants by the Asian Development Bank and its Borrowers" and submitted to the Board for approval. The "Guidelines" will be supplemented by provisions in the Bank's loan regulations allowing the Bank to cancel loans where there is evidence of corruption or fraud in connection with the award of a contract being financed by the Bank.²

With regard to the Bank's internal policies and procedures, several measures are necessary to ensure that they are consistent with those of other MDBs and evolving best practice. Currently, there are no independent channels whereby Bank staff can report possible incidents of corruption and have them investigated. Under this policy, OGA will serve as the initial point of contact for allegations of fraud and corruption among Bank projects or staff. In consultation with the Strategy and Policy Office (SPO), OGC, the Budget, Personnel, and Management Systems Department (BPMSD), Central Operations Services Office (COSO), and other relevant departments, OGA will consider appropriate measures to be adopted under this policy to ensure that all Bank staff and projects adhere to the highest standards of ethical conduct.

In May 1998, Management approved revisions to Administrative Order No. 2.02, Section 4, which contains the Code of Conduct outlining staff ethical duties, rights, and responsibilities in greater detail than was previously the case.

The Bank will undertake a number of measures to improve the quality of project monitoring and audit. The capacity of OGA will be strengthened to enable it to address

anticorruption issues effectively. Specialized training in forensic accounting and other investigative techniques will be provided, which will also be extended to select financial analysts and project implementation officers. Ongoing OGA efforts to streamline internal work procedures to free up greater resources for audits of high-risk and high-impact areas will continue. OGA will devote more time to conducting audits of project procurement—related activities, which will help prevent and detect corruption or other forms of fraud. OGA will strengthen its exchange of information with supreme audit institutions in the DMCs, and—working in collaboration with other Bank departments—it will play an active role in assessing the need to upgrade the audit capability of such institutions.

The relevant sections in the “Project Administration Instructions” and the *Loan Disbursement Handbook* will be revised to require that qualified accountant(s) be recruited by the executing or implementing agency, and that robust internal control systems and accounting systems be in place for a project before loan disbursement can be made. Greater resources will be made available for upgrading the quality of project monitoring and implementation missions. Consideration will be given to the design of appropriate efficiency indicators, which will be utilized in monitoring financial and physical progress on a quarterly basis. The quality of the Bank’s management information systems will be enhanced to provide managers with more timely information for monitoring project processing, loan administration, and the status of mission budget utilization.

These measures will be ineffective if Bank staff are unfamiliar with the provisions of the Bank’s anticorruption policy and Code of Conduct or fail to exercise due diligence in the performance of their duties. While it is not the intention of this policy to turn Bank staff into “police officers”, or to make the objective of reducing corruption paramount over other development goals, all departments and staff have a strong obligation to ensure the integrity of Bank operations within their respective areas of responsibility. Bank staff should familiarize themselves with the content of this policy and staff guidelines, and be prepared to respond appropriately as required.

In conclusion, this paper recommends a number of concrete actions to establish the Bank’s anticorruption policy. These measures can be broken down along three lines: recommended revisions of Bank policy and staff guidelines, new programming initiatives, and administrative changes.

NOTES

¹ ADB, R151-95: “Governance: Sound Development Management,” 17 August 1995.

² Office of the General Counsel, ADB, “Ordinary Operations Loan Regulations,” 1986.

³ Office of the General Counsel, ADB, “Special Operations Loan Regulations,” 1982.

Annex IV

Principles for Managing Ethics in the Public Service

On 23 April 1998, the Council of the OECD adopted a set of principles and recommended that Member countries take action to ensure well-functioning institutions and systems to promote ethical conduct in the public service.

High standards of conduct in the public service have become a critical issue for governments in OECD Member countries. Public management reforms involving greater devolution of responsibility and discretion for public servants, budgetary pressures and new forms of delivery of public services have challenged traditional values in the public service. Globalization and the further development of international economic relations, including trade and investment, demand high recognizable standards of conduct in the public service. Preventing misconduct is as complex as the phenomenon of misconduct itself, and a range of integrated mechanisms are needed for success, including sound ethics management systems. Increased concern about decline of confidence in government and corruption has prompted governments to review their approaches to ethical conduct.

In response to the above-mentioned challenges, the attached principles have been developed by the Member countries. The twelve principles are designed to help countries review the institutions, systems and mechanisms they have for promoting public service ethics. They identify the functions of guidance, management or control against which public ethics management systems may be checked. These principles distil the experience of OECD countries, and reflect shared views of sound ethics management. Member countries will find their own ways of balancing the various aspirational and compliance elements to arrive at an effective framework to suit their own circumstances.

The following principles may be used by management across national and sub-national levels of government. Political leaders may use them to review ethics management regimes and evaluate the extent to which ethics is operationalized throughout government. The principles are intended to be an instrument for countries to adapt to national conditions. They are not sufficient in themselves—they should be seen as a way of integrating ethics management with the broader public management environment.

1. Ethical standards for public service should be clear.

Public servants need to know the basic principles and standards they are expected to apply to their work and where the boundaries of acceptable behavior lie. A concise, well-

Source: Policy Brief No. 4, Public Management Service, OECD, May 1998.

publicized statement of core ethical standards and principles that guide public service, for example in the form of a code of conduct, can accomplish this by creating a shared understanding across government and within the broader community.

2. Ethical standards should be reflected in the legal framework.

The legal framework is the basis for communicating the minimum obligatory standards and principles of behavior for every public servant. Laws and regulations could state the fundamental values of public service and should provide the framework for guidance, investigation, disciplinary action and prosecution.

3. Ethical guidance should be available to public servants.

Professional socialization should contribute to the development of the necessary judgement and skills enabling public servants to apply ethical principles in concrete circumstances. Training facilitates ethics awareness and can develop essential skills for ethical analysis and moral reasoning. Impartial advice can help create an environment in which public servants are more willing to confront and resolve ethical tensions and problems. Guidance and internal consultation mechanisms should be made available to help public servants apply basic ethical standards in the workplace.

4. Public servants should know their rights and obligations when exposing wrongdoing.

Public servants need to know what their rights and obligations are in terms of exposing actual or suspected wrongdoing within the public service. These should include clear rules and procedures for officials to follow, and a formal chain of responsibility. Public servants also need to know what protection will be available to them in cases of exposing wrongdoing.

5. Political commitment to ethics should reinforce the ethical conduct of public servants.

Political leaders are responsible for maintaining a high standard of propriety in the discharge of their official duties. Their commitment is demonstrated by example and by taking action that is only available at the political level, for instance by creating legislative and institutional arrangements that reinforce ethical behavior and create sanctions against wrongdoing, by providing adequate support and resources for ethics-related activities throughout government and by avoiding the exploitation of ethics rules and laws for political purposes.

6. The decision-making process should be transparent and open to scrutiny.

The public has a right to know how public institutions apply the power and resources entrusted to them. Public scrutiny should be facilitated by transparent and democratic processes, oversight by the legislature and access to public information. Transparency should be further enhanced by measures such as disclosure systems and recognition of the role of an active and independent media.

7. There should be clear guidelines for interaction between the public and private sectors.

Clear rules defining ethical standards should guide the behavior of public servants in dealing with the private sector, for example regarding public procurement, outsourcing or public employment conditions. Increasing interaction between the public and private sectors demands that more attention should be placed on public service values and requiring external partners to respect those same values.

8. Managers should demonstrate and promote ethical conduct.

An organizational environment where high standards of conduct are encouraged by providing appropriate incentives for ethical behavior, such as adequate working conditions and effective performance assessment, has a direct impact on the daily practice of public service values and ethical standards. Managers have an important role in this regard by providing consistent leadership and serving as role models in terms of ethics and conduct in their professional relationship with political leaders, other public servants and citizens.

9. Management policies, procedures and practices should promote ethical conduct.

Management policies and practices should demonstrate an organization's commitment to ethical standards. It is not sufficient for governments to have only rule-based or compliance-based structures. Compliance systems alone can inadvertently encourage some public servants simply to function on the edge of misconduct, arguing that if they are not violating the law they are acting ethically. Government policy should not only delineate the minimal standards below which a government official's actions will not be tolerated, but also clearly articulate a set of public service values that employees should aspire to.

10. Public service conditions and management of human resources should promote ethical conduct.

Public service employment conditions, such as career prospects, personal development, adequate remuneration and human resource management policies should create an environment conducive to ethical behavior. Using basic principles, such as merit, consistently in the daily process of recruitment and promotion helps operationalize integrity in the public service.

11. Adequate accountability mechanisms should be in place within the public service.

Public servants should be accountable for their actions to their superiors and, more broadly, to the public. Accountability should focus both on compliance with rules and ethical principles and on achievement of results. Accountability mechanisms can be internal to an agency as well as government-wide, or can be provided by civil society. Mechanisms promoting accountability can be designed to provide adequate controls while allowing for appropriately flexible management.

12. Appropriate procedures and sanctions should exist to deal with misconduct.

Mechanisms for the detection and independent investigation of wrongdoing such as corruption are a necessary part of an ethics infrastructure. It is necessary to have reliable procedures and resources for monitoring, reporting and investigating breaches of public service rules, as well as commensurate administrative or disciplinary sanctions to discourage misconduct. Managers should exercise appropriate judgement in using these mechanisms when actions need to be taken.

Annex V

The IMF Monetary Model: A Hardy Perennial

Jacques J. Polak

From the day in 1947 when the International Monetary Fund opened its doors for business and member countries came to it seeking credit to help them meet deficits in their balances of payments, the IMF had to have an understanding of the causes of such deficits and, both qualitatively and quantitatively, of the policy measures necessary to overcome them. Only then could it come to a judgment on whether a country's policies would be sufficient to restore balance and, if they were not, to insist on a strengthened policy package as a condition for IMF credit.

The model that the IMF introduced in the 1950s to meet this need is still very much alive today. IMF Stand-By Arrangements and other financial support continue to be designed around monetary targets serving as "performance criteria" for the release of successive amounts of financial assistance or as "benchmarks" that play a major role in the reviews of such arrangements.

The Case for a Simple Model

One key characteristic of the model is its simplicity. There were two good reasons for this. First, at the analytical level, simplicity was inevitable in view of the paucity of basic economic data such as national income in the early postwar years for many of the Fund's member countries, the total absence of econometric models to describe their economies, and indeed, the probability that this situation would not be remedied for decades ahead. Hence the choice of a model that needed as inputs only two sets of statistics that were generally available—banking data and trade data. Second, and even more important, simplicity kept the model focused on the key variable that governments could control domestic credit creation—that was seen as crucial to the correction of the balance of payments problems for which IMF assistance had been invoked.

The limitations on statistical data have to a considerable extent subsided, but there are still many IMF customers, both in the developing world and among the transition econo-

Finance and Development, December 1997. Reproduced by permission. This article draws on the author's paper, *The IMF Monetary Model at Forty*, IMF Working Paper 97/49 (Washington, April 1997). Jacques Polak was Director of the IMF's Research Department from 1958 to 1979. He is considered to be the "founding father" of the IMF monetary model. Both within and outside the IMF, the model is usually referred to as the "Polak model."

mies, for which constructing an empirical model suitable for inferences about policy choices and outcomes would be a questionable undertaking. For program design as well as control, the IMF has continued to need a simple model, with a very limited number of standard variables, subject to elaboration on an ad hoc basis.

The Model

The model was designed to study the effects on both income formation and the balance of payments of the two most important exogenous variables (variables determined outside the model) operating on the economies of the great majority of countries in the early postwar period: autonomous changes in exports and the creation of domestic bank credit; or, in monetary terms, foreign and domestic autonomous additions to a country's money supply. To handle the effects of these two variables required a model that explicitly recognized a demand-for-money function. The evidence from many countries suggested that the simplest form of such a function—namely, assuming that the demand for money is proportional to income—would be a reasonable approximation. As a second behavioral equation, the model contained a function for the demand for imports. The full model appears, in its simplest form, in the box.

The dynamic character of this model derives from the fact that it contains both income and the change in income. Solving the model gives us values for the variables that are determined by the model, such as income and the change in foreign reserves, as weighted averages of the values for the current and past years of exports, capital inflows of the nonbank sector, and the change in the domestic credit of the banking system.

We made a large effort to test the validity of this proposition. For those interested in the never-ending debate between Keynesians and monetarists, it may come as a surprise that the simple assumptions of the model make it both Keynesian (a multiplier model with a marginal propensity to spend of 1) and monetary (based on a constant velocity of circulation). The dynamic nature of the IMF model, in contrast to most of the academic monetary models of the balance of payments, yields not only the final equilibrium value of the endogenous variables but also the time path toward these values. It was essential to be able to derive these short-term effects if the model was to be used in analyzing current policy problems and finding their solutions.

The set of four equations in the model constitutes the logical core of the IMF's programming exercise, which is known as "financial programming". Since the early 1950s, it has been the centerpiece of the analysis leading to IMF conditionality—the policy actions that a borrowing country must take to have access to IMF credit.

The Model over Time

Although the IMF has continued to use essentially the same model as the foundation of its credit arrangements, these arrangements themselves have continued to broaden and deepen over the years. Thus, the analytically neutral variable "credit creation" was split into credit to the private sector (usually to be encouraged) and credit to the government sector

(usually to be discouraged). In a further specification, the IMF moved toward advice on specific types of taxes (with some taxes judged more acceptable than others) and on various types of expenditure, endorsing social safety nets and education (especially primary, but not necessarily tertiary, education) and frowning on military and other nonproductive expenditures.

Beyond filling in with ever-increasing precision the credit creation component of its conditionality, it also added further specifics of a nonmonetary character, relying on a wide spectrum of policy instruments, many of them in fields where the World Bank was also active.

Many IMF-supported programs in recent years have contained major policy understandings on structural adjustment, price and trade liberalization, and many other policies. But, since none of these could conveniently be captured in econometric equations, no attempt was made to build them into the model. Thus, while financial programming and the simple model underlying it continued to provide the packaging for the IMF's lending arrangements, the contents of the packages became increasingly complex over the years. Over time, a number of changes to the model have been considered, in particular with respect to the exchange rate, medium-term growth, and control over inflation.

The Exchange Rate

The design of the model in the early postwar years reflected two characteristics of the world economy at that time: the par value regime of fixed exchange rates and a dominant upward trend in world demand. Balance of payments problems that brought countries to seek the assistance of the IMF were typically due to bursts of excessive domestic expansion and could usually be cured by the introduction of financial restraint. If the expansion has festered long enough to raise the domestic price level above that of the rest of the world, there would be a need for a compensating change in the par value. And, in the limited number of countries subject to chronic inflation, it might even be necessary to include a regular dose of compensating depreciation in IMF-supported programs. In an age when the world was broadly on a full-employment path, there was, unlike the situation in the 1930s, little incentive for countries to resort to currency depreciation to raise their real incomes, quite apart from the fact that the IMF's founding charter, its Articles of Agreement, banned competitive depreciation.

As the par value system unraveled, provisions about the exchange rate became a frequent

The IMF Monetary Model

$$\Delta MO = k\Delta Y \quad (1)$$

The change in a country's money supply (ΔMO) is proportional to the change in its income (ΔY) by the factor k , which is the inverse of the velocity of circulation of money (Y/MO); thus, $k = MO/Y$.

$$M = mY \quad (2)$$

The demand for imports (M) is a function of a country's income (Y), where m is the country's marginal propensity to import.

$$\Delta MO = \Delta R + \Delta D \quad (3)$$

The change in money supply (ΔMO) is by definition equal to the change in a country's foreign reserves (ΔR) plus the change in a country's foreign reserves (ΔR) plus the change in the domestic credit of the banking system (ΔD).

$$\Delta R = X - M + K \quad (4)$$

The change in foreign reserves (ΔR) is by definition equal to exports (X) minus imports, plus net capital inflows of the non bank sector (K).

component of IMF Stand-By Arrangements. But this did not require a radical change in the model. Exports already entered the model as an exogenous variable, and forecasting them, with or without the exchange rate as one of the determining variables, was in any event performed outside the model. To the import equation (determined within the model) an exchange rate term could readily be added. Effects on prices, output, government finance, and (if they could be ascertained) on capital movements, had, of course, also to be taken into account. Since, as noted, it is in any event not feasible to design a complete set of structural equations for most of the economies with which the IMF works, the addition of the exchange rate as a variable merely had the effect of making the process of iteration more laborious rather than changing it in a fundamental way. It also made it possible to address explicitly two policy objectives: maintaining a healthy balance of payments and the pursuit of full use of the country's productive capacity.

To ensure that a country's exchange rate would remain sufficiently competitive during the period of a Stand-By Arrangement, the IMF normally includes in such an arrangement a provision that a country must hold a minimum level of net international assets to be able to draw successive installments of its stand-by credit, the idea being that the instrument by which countries would ensure the observation of this limit would be the exchange rate. The standard IMF conditionality thus evolved toward the inclusion of a double monetary prescription: setting a ceiling on the expansion of the domestic assets of the central bank to achieve an acceptable balance of payments result (a flow concept) and a floor under the central bank's holdings of net foreign assets (a stock concept) to bring about a satisfactory level of foreign reserves, and to ensure that the central bank would not use excessive intervention to counter market pressures for a more depreciated exchange rate.

Medium-Term Growth

As the strongly expansionary trends that had characterized the world economy in the third quarter of the twentieth century came to an end, the IMF and its members became increasingly concerned about the impact of IMF programs on the growth prospects of the countries that needed to borrow under them. Growth, in this context, meant two different things, which were not always sufficiently distinguished in the policy discussions, namely: (i) the increase in real GDP especially after a country had experienced a negative shock—that could be achieved with the country's existing productive capacity; and (ii) the increase in output over the medium or long term that could be achieved through the growth of productive capacity.

I mentioned earlier the potential impact of a change in the real exchange rate on capacity utilization. With respect to the second dimension, it is curious that for their medium-term macroeconomic projections both the IMF and the World Bank continue to rely on highly mechanical growth models of the Harrod-Domar family, first developed in the late 1940s. In these models there is no place for what the two institutions themselves consider the most important factors determining the growth of developing countries, such as outward orientation, realistic prices, privatization, reform of the financial sector, and, in general, government attitudes toward the economy.

Rather than expanding its model, the IMF has pursued the double objective of stabilization with growth by appraising the different items entering its existing model on the basis of their potential contributions to growth. The first step in this direction, the introduction of a sub-ceiling on credit to the government, served the purpose of ensuring an adequate supply of credit to the private sector. The further refinement of the entries on both the taxation and the expenditure sides of “net credit to the government,” referred to earlier, reflected an increasing desire on the part of the IMF that the understandings reached with member countries on short-term stabilization would, at the same time, contribute to medium-term growth.

Inflation Concerns

Limits on credit creation can ensure a minimum balance of payments outturn, but they do not provide protection against deviations from the program in the opposite direction. Exceeding the foreign reserve target is often followed by a larger increase in the money supply than had been assumed in the program. It is probably fair to say that up to the 1970s, this possible outcome did not cause much concern; it might rather be seen as a welcome development that might lead to early repayment of IMF credit. But developments in the 1980s, and even more strikingly in the 1990s, have shown how such overperformance might also lead to shockingly high inflation, both in countries that had been afflicted by the 1980s debt crisis and in many of the IMF’s new members in Eastern Europe, the Baltics, and the Commonwealth of Independent States (CIS). In all these countries, controlling inflation became the first order of business, often ahead of dealing with potential balance of payments problems. The IMF thus had to face the question of how this objective was to be integrated into its model. Changes in three directions seemed to be necessary:

- The flexibility of international capital movements makes the treatment of that variable as exogenous no longer tenable; their dependence, at least in part, on both the domestic interest rate and exchange rate expectations would need to be allowed for. Bearing in mind that an important component of international capital flows nowadays may be the outflow or the return flow of domestic flight capital, this change in the model alone would present a major challenge.
- Allowance would have to be made for the fact that the domestic interest rate, which does not even appear in the simple model, may be strongly affected by the size of the government deficit, whether that deficit is financed from the banking system or in a nascent domestic capital market.
- The exchange rate would need to find a place in the model, not only in terms of its effect on trade flows but also with respect to inflation expectations, since governments have to face the choice between two possible exchange rate policies: a floating rate to block the inflationary impact of an oversupply of “money of foreign origin”; or a fixed (or crawling) exchange rate to provide a psychological anchor to the price level, even though that might cause a competitive disadvantage if there remained some inertial inflation in the economy.

In a formal sense, it would not be particularly difficult to introduce these three extensions into the model. But that would be essentially useless unless it were also possible to obtain some order of magnitude of the coefficients for the variables in the newly introduced equations. And that, unfortunately, is not possible. In this setting, the IMF has had to forgo the comfort of its old model and base its conditionality on a set of ad hoc instruments that seemed plausible in the circumstances.

With respect to government finance, the IMF has found it necessary in recent years to go behind ceilings on bank credit to the government and introduce direct restrictions on government deficits. Even if financed in a noninflationary way in the domestic capital market, such deficits crowd out investment by the private sector. Indeed, in the IMF's relations with many countries (Argentina, Pakistan, and Russia, to name a few), agreed limits on the budget deficit as a percent of GDP have become the most prominent feature of adjustment programs.

To stave off imported inflation caused by an expansion in the money supply owing to higher foreign inflows, the IMF has favored a free (upward) float in many of the CIS countries, taking comfort from the fact that the currencies of many of these countries were so deeply undervalued that a measure of appreciation would not undermine their competitiveness, in particular since they were also experiencing a rapid increase in labor productivity.

While the prevention of excessive domestic credit creation and the targeting of a desired increase in foreign reserves are relatively straightforward, the avoidance of an excessive increase in the money supply raises more questions. In the first place, the normal effect of a successful stabilization after a period of high inflation is an increase in the demand for money. An inflow of money from abroad to meet this demand—and the corresponding overshooting of the foreign reserve target—are entirely desirable, and to frustrate this demand by either floating the exchange rate or (with a fixed exchange rate) putting a ceiling on the money supply would needlessly depress the economy, as Brazil found out in 1994. Putting a ceiling on base money (currency held outside banks plus banks' claims on the central bank) would imply that the central bank would have to engage in open-market sales of government paper at high domestic interest rates, which could be extremely costly. In addition, the resulting rise in domestic interest rates could attract more money from abroad, thus setting up a vicious circle.

Finding itself without much of a model to go by, the IMF has in recent years tended to adopt an "all risk" policy, furnishing its arrangements with CIS countries and with the Baltic states with a triple set of keys: a ceiling on domestic credit, a floor under net international assets, and an indicative target for base money, in addition to using the occasions of periodic Executive Board reviews under Stand-By Arrangements to judge the need for additional action.

The exceptional situation in these countries may be expected to subside as and when inflation comes down and the exchange rate stabilizes at something closer to an equilibrium level. In that new situation, the concerns about inflation may to some extent have abated, but concerns about the payments position can no longer be safely disregarded. Increasingly, then, the CIS countries will find themselves in the position where the prescription offered by the simple version of the monetary model suffices: a ceiling on net domestic credit to protect the balance of payments, plus a floor under foreign reserves to ensure that

governments do not overreach themselves in defending the value of their currencies. At some stage, confidence in the currency and the banks, which is still painfully low in these countries, will rise and the resulting increase in the demand for money will pull in foreign reserves. When that occurs, it will be possible to rejoice over the increase in reserves without feeling qualms about the rise in the money supply.

For an entirely different group of countries, however, namely those that are part of a monetary union, the model would seem definitely to have lost most, if not all, of its applicability. In such countries there is no meaningful concept of a national money supply, and government finance, in particular the government's domestic borrowing requirement, becomes the only way to influence the level of demand. The IMF has had to figure this out in its dealings with the African countries of the CFA Sync area. Perhaps it will some day get an opportunity to apply this knowledge in Europe if a member of the future European Economic and Monetary Union finds it necessary to avail itself of the IMF's balance of payments support.

Annex VI

The Medium-Range Forecast in Hong Kong, China

The *Medium-Range Forecast (MRF)* is a projection of expenditure and revenue for the forecast period based on specific forecasting assumptions and budgetary criteria outlined below.

General Economic Assumptions

Growth in Gross Domestic Product (GDP)

There is a clear link between many of the government's major revenue sources and economic growth. For planning purposes the medium-range assumption as to annual GDP growth for the current MRF has been set at 5 percent in real terms.

Inflation

Over the forecast period the average year on year inflation is assumed to be 7.5 percent. It is emphasized that this is a trend assumption related to the GDP deflator.

Detailed Assumptions

A wide range of detailed assumptions relating to developing expenditure and revenue patterns over the forecast period are taken into account. These include:

- Estimated cash flow of capital projects;
- Forecast completion dates of these capital projects and their related recurrent consequences in terms of staffing and running costs;
- Estimated cash flow arising from new commitments resulting from policy initiatives;
- The expected pattern of demand for individual services;
- The trend in yield from individual revenue sources;
- New revenue measures in 1998–1999.

Excerpted from the Internet, September 1998. The full MRF presentation includes a number of diagrams derived from the tables, which are very useful for public understanding of the fiscal position.

Budgetary Criteria

In addition to the above forecasting assumptions there are a number of criteria against which the results of forecasts are tested for overall acceptability in terms of budgetary policy. Any significant breach of these parameters results in a review of the underlying programs and adjustments where necessary and appropriate.

The following are the more important budgetary criteria:

- *Total cash flow surplus/deficit.* The government aims to maintain adequate reserves in the long term.
- *Total expenditure growth.* It is intended that, over time, expenditure growth should not exceed the GDP growth *trend*.
- *Capital expenditure growth.* By its nature some fluctuations in the level of capital expenditure are to be expected. However, over a period the aim is to contain capital expenditure growth within overall expenditure guidelines, i.e., within the GDP growth *trend* but allowance is made for unavoidable expenditure on exceptional projects. Allowance is also made for a number of major projects due to start in the forecast period. In planning the size of the capital program the recurrent consequences of capital works (staffing, maintenance, etc.) are taken into account.
- *Revenue Policy.* The projections reflect the revenue measures introduced in this year's budget. Account is taken of the need to maintain over time the real yield from fees and charges, fixed duties, etc., and to review periodically the various tax thresholds in the light of inflation.

THE MRF FOR 1997–1998 TO 2001–2002

The current MRF is summarized in the following three tables which indicate the forecast operating position, capital cash flow, and consolidated reserves (*note a*).

It is emphasized that the forecasts are based on *trends* and, therefore, the actual results of any individual year may vary from the *trend* assumption.

Notes on the Medium-Range Forecast

(a) *Accounting policies*

- The Medium-Range Forecast, like the government's accounts, is prepared on a cash basis and reflects forecast receipts and payments, whether or not they relate to recurrent or capital transactions.
- The Medium-Range Forecast includes the General Revenue Account and the Funds (the Capital Works Reserve Fund, the Loan Fund, the Capital Investment Fund, the Disaster Relief Fund, and the Civil Service Pension Reserve Fund).

Table AVI.1 Operating Statement (General Revenue Account)

	Revised	1998–1999	Forecast		2001–2002
	Estimate 1997–1998		1999–2000	2000–2001	
	\$m	\$m	\$m	\$m	\$m
Revenue (<i>notes b and j</i>)	200,350	192,680	211,390	242,900	271,330
Less: Expenditure	161,770	182,480	200,740	227,830	258,570
Operating surplus for the year	38,580	10,200	10,650	15,070	12,760

Table AVI.2 Capital Financing Statement (The Funds)

	Revised	1998–1999	Forecast		2001–2002
	Estimate 1997–1998		1999–2000	2000–2001	
	\$m	\$m	\$m	\$m	\$m
Opening balances of the Funds	46,990	61,660	50,210	55,030	63,390
Add: Revenue (<i>note d</i>)	56,410	66,310	72,790	85,520	101,250
Add: Transfers from/to General Revenue Account (<i>note e</i>)	-5,840	-11,990	1,000	-2,000	-12,000
Less: Expenditure on capital projects (<i>note f</i>)	31,570	34,110	39,610	46,130	53,740
Less: Loans and Investments (<i>notes g and h</i>)	4,320	31,660	29,360	29,030	29,350
Less: Aid for disaster relief (<i>note i</i>)	10				
Closing balance of the Funds	61,660	50,210	55,030	63,390	69,550

Table AVI.3 Consolidated Reserves

	Revised	1998–1999	Forecast		2001–2002
	Estimate 1997–1998		1999–2000	2000–2001	
	\$m	\$m	\$m	\$m	\$m
General Revenue Account					
Opening balance	126,620	383,910	406,100	415,750	432,820
Operating surplus (per table AVI.1)	38,580	10,200	10,650	15,070	12,760
Land Revenue (<i>note j</i>)	17,870	-	-	-	-
Transfer from/to the Funds (per table AVI.2) (<i>note e</i>)	5,840	11,990	-1,000	2,000	12,000
Closing balance	188,910	406,100	415,750	432,820	457,580
The Funds – closing balances (per table AVI.2)					
	61,660	50,210	55,030	63,390	69,550
Fiscal Reserves at 31 March (<i>note k</i>)					
	250,570	456,310	470,780	496,210	527,130
Land Fund – opening balance (<i>note l</i>)	197,070				
	- 2,070				
- change in net worth					
Total	527,130				

- The Suspense Account of the Capital Works Reserve Fund is excluded from the Medium-Range Forecast the net revenue of which, to 30 June 1997, was subject to sharing between the government's account and the then Hong Kong Special Administrative Region Land Fund.

(b) General Revenue Account – Revenue

This comprises all receipts to be credited to any of the following revenue heads (except Transfers from Funds and revenue from Land Transactions), namely:

- Duties
- General Rates
- Internal Revenue
- Motor Vehicle Taxes
- Fines, Forfeitures, and Penalties
- Royalties and Concessions
- Properties and Investments
- Loans, Reimbursements, Contributions, and Other Receipts (excluding transfers from Funds)
- Utilities
- Fees and Charges

(c) General Revenue Account – Expenditure

This comprises all expenditure to be charged to the General Revenue Account in accordance with the Appropriation Ordinance, with the exception of the Transfers to Funds. It includes the day-to-day operational expenses of government departments together with minor capital purchases of a routine nature.

(d) Funds – Revenue

This comprises all revenue receivable by the Funds except transfers from the General Revenue Account.

(e) Transfers between General Revenue Account and the Funds

The transfers between General Revenue Account and the Funds are assessed with regard to the commitments of the Funds and their forecast cash flow requirements.

(f) Expenditure on capital projects

This comprises expenditure chargeable to the Capital Works Reserve Fund with respect to the Public Works Program (including land acquisition), capital subventions, major systems and equipment, and computerization.

(g) Loans

These comprise loans made from the Loan Fund, including loans to the Hong Kong Housing Society, schools, teachers, students, as well as housing loans for the Home Starter scheme and to civil servants.

(h) Investments

These comprise mainly advances and equity investments made from the Capital Investment Fund to trading funds and statutory bodies.

(i) Aid for disaster relief

This is actual expenditure made from the Disaster Relief Fund for providing relief to disasters that occur outside Hong Kong. Because of the unpredictable nature of disasters, no estimate of future expenditure is made for the forecasting period.

(j) Land revenue

In 1997–1998, revenue from land transactions of \$17,870 million was credited to the General Revenue Account before the enactment of a revised Capital Works Reserve Fund resolution effective from 1 January 1998.

(k) Fiscal reserves

The fiscal reserves represent the accumulated balances of the General Revenue Account and the Funds. The movement in the fiscal reserves from one year to the next year represents the estimated surplus/deficit for the year.

(l) Land Fund

For the purpose of the MRF, the balance of the Land Fund has been merged with the General Revenue Account from 1 April 1998 and its investment earnings are included under the revenue of the General Revenue Account effective on that date.

COMMENTARY ON THE MRF

Expenditure Growth

To demonstrate that expenditure growth over time does not exceed the trend growth rate in the economy, government spending plans should be compared with the budgetary guidelines. For monitoring purposes, government expenditure is consolidated with the expenditure of some other public bodies such as the Municipal Councils in order to compare total public expenditure with the size of the economy. The results are set out in table AVI.4.

Table AVI.4 Public Expenditure in the Context of the Economy¹

	Estimate		Forecast		
	1997–1998	1998–1999	1999–2000	2000–2001	2001–2002
	\$m	\$m	\$m	\$m	\$m
Opening expenditure	159,620	180,130	198,090	224,840	255,190
Capital expenditure	37,890	52,900	55,260	62,720	71,320
Total government expenditure	197,510	233,030	253,350	287,560	326,510
Add: Other public sector bodies	46,400	55,860	62,480	66,500	67,470
Total public expenditure	243,910	288,890	315,830	354,060	393,980
Gross Domestic Product					
(calendar year)	1,327,030	1,497,880	315,830	1,908,420	2,154,130
Growth in GDP					
Money terms	11.3	12.9	12.9	12.9	12.9
Real terms	5.2	5.0	5.0	5.0	5.0
Growth in public expenditure					
Money terms	15.5	8.4	9.3	12.1	11.3
Real terms	8.2	11.2	1.2	3.6	3.0
Public expenditure as a percentage of GDP	18.4	19.3	18.7	18.6	18.3

1 Public expenditure comprises expenditure by the trading funds, the Hong Kong Housing Authority, the Provisional Urban Council and the Provisional Regional Council, expenditure financed by the government's statutory funds and all expenditure charged to the General Revenue Account. Expenditure by institutions in the private or quasi-private sector is included to the extent of their subventions. The payments of government departments which are wholly or partly financed by charges raised on a commercial basis are also included (e.g., airport, waterworks). But not included is expenditure by those organizations, including statutory organizations, in which the government has only an equity position, such as the Mass Transit Railway Corporation and the Kowloon-Canton Railway Corporation. Similarly, advances and equity investments from the capital Investment Fund are excluded as they do not reflect the actual consumption of resources by the government.

Table AVI.5 shows the sum to be appropriated in the 1998–1999 budget analyzed between operating and capital expenditure and, after including expenditure from the various funds and other public-sector bodies, shows the derivation of public expenditure for 1998–1999 given in table AVI.4. The table also illustrates the effect of the budget revenue measures on the overall surplus/deficit position for 1998–1999.

Table AVI.5 Relationship Between Government Expenditure and Public Expenditure, 1998-1999

Components of Expenditure and Revenue	Government Expenditure and Revenue		
	Operating	Capital	Total
Taxation	144,335	1,420	145,755
Other revenue	45,280	3,550	48,830
	189,615	4,970	194,585
Increase in net worth of Land Fund	11,700	–	11,700
Capital Works Reserve Fund	–	52,960	52,960
Capital Investment	–	6,125	6,125
Civil Service Pension Reserve Fund	–	560	560
Disaster Relief Fund	–	5	5
Load Fund	–	6,660	6,660
Total	<u>201,315</u>	<u>71,280</u>	<u>272,595</u>
Cash surplus before budget revenue measures	21,190	18,375	39,565
Less: Effect of budget revenue measures	-13,515	-90	-13,605
Cash surplus after budget revenue measures	7,675	18,285	25,960

Annex VII

The Functions of a Ministry of Finance: The Example of Canada

Functions

The Ministry of Finance is the federal department primarily responsible for providing the government with analysis and advice on the broad economic and financial affairs of Canada. Its responsibilities include preparing the federal budget; preparing tax and tariff legislation; managing federal borrowing on financial markets; administering major federal transfers to provinces and territories; developing regulatory policy for the financial sector; and representing Canada within international financial institutions.

To fulfill the department's role, Finance officials monitor and research the performance of the Canadian economy in all important aspects—output and growth, employment and income, price stability and monetary policy, and long-term structural change. The department is also vitally concerned with trade, monetary affairs and other aspects of the global economy that impact on Canada's domestic performance.

Finance interacts with other government departments to encourage coordination and harmony among all federal initiatives which have an impact on the economy. As well, the departments constantly work toward improved cooperation, especially on fiscal and taxation issues between the federal and provincial governments.

In recent years, Finance has placed more emphasis on public consultation regarding policy directions and options. The department believes that a more open, accessible budget process can play an important role in assisting more effective, responsive decision-making.

The main objective of the department is to assist the government, the Minister of Finance and the Secretary of State (for international financial institutions) in developing and implementing fiscal and other economic policies that support Canada's economic and social goals. Specific activities include:

- Analyzing the economic and fiscal situation and prospects for Canada and other countries important to the economy;
- Recommending measures in the areas of expenditure, taxation, borrowing and cash management to meet the goals of government;
- Providing advice regarding the balance of payments, exchange reserves, international monetary and financial arrangements, coinage and related matters;

- Participating in international negotiations and meetings related to trade, finance, taxation and economic development. The department also provides the Canadian funding for international financial institutions such as the World Bank;
- Advising on federal-provincial fiscal and economic relations, and undertaking liaison and negotiation with the department's provincial counterparts. Finance is also responsible for determining and funding federal transfer payments to the provinces and territories under programs such as Equalization, the Canada Health and Social Transfer (CHST) and Territorial Formula Financing Agreements;
- Providing for advice, developing policies and coordinating with regulatory agencies regarding the future direction of the financial sector, particularly as it relates to banking and insurance in Canada;
- Communicating to Canadians the economic and fiscal objectives of the government.

General Organization

The Department of Finance reports to the Minister through its Deputy Minister, assisted by two Associate Deputy Ministers and a Senior Assistant Deputy Minister.

Ongoing economic analysis and policy development takes place in seven policy branches, one of them on a joint basis with the Treasury Board Secretariat. The department also includes branches responsible for legal services, consultations and communications, and corporate services (jointly with the Treasury Board Secretariat). Branches are headed by assistant deputy ministers; divisions within branches are headed by directors.

In addition to the role as head of the Department of Finance, the Minister of Finance reports to Parliament on the activities of a number of other agencies, such as the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI).

Economic and Fiscal Policy Branch

The branch analyzes the economic and fiscal situation of the country, and advises the Minister of Finance on the government's fiscal framework—including revenues, expenditures and debt requirements—as well as on monetary policy. It also provides analytical support for, and advice to, the Minister of Finance on a wide range of economic and financial issues related to the microeconomic policies of the government.

Monthly fiscal and quarterly economic reports are prepared, and there is continuous monitoring of fiscal developments at all levels of government as well as in major trading partners. It has three divisions as well as a secretariat for economic development policy:

Fiscal Policy Division

This division plays the primary role in analyzing the financial requirements of the government and tracking the developing fiscal positions of other levels of government. It also has lead responsibility for analysis and advice on the government's fiscal framework and coordinating the department's advice to the Minister on overall spending priorities. The division plays a key role in the budgetary process and drafting of budgetary papers. It also

reviews the form and content of the Public Accounts and other statements for which the Minister has responsibility under the Financial Administration Act.

Economic Studies and Policy Analysis Division

This division carries out policy-focused applied research—current and medium-term—on major economic and fiscal issues. Its work is undertaken within three sections—Structural Analysis, Macro Analysis, and Policy Analysis.

Economic Analysis and Forecasting Division

This division tracks, evaluates and forecasts Canada's economic performance. Activity is undertaken by two groups: the Economic Analysis Group which provides regular assessment of current economic conditions; and the Forecasting and Model Development Group which prepares the quarterly economic forecast and maintains close contacts with leading private-sector forecasters as well as provincial governments.

Economic Development and Corporate Finance Branch

The branch provides advice on a wide range of policies and issues relating to key sectors of the economy and regions. Its work focuses on three main objectives: assessing and developing initiatives and framework policies favoring economic growth and job creation across key sectors such as small business, science and technology, agriculture and fisheries, regional development as well as the government's approach to the environment and the economy, and energy and resource policy; furthering the government's agenda in the areas of commercialization and privatization; and ensuring that expenditure proposals and contingent liabilities are managed within the government's fiscal parameters and financial management structure.

Social Policy Branch

The branch provides advice on policy and financial management of federal social programs, and liaises with federal departments responsible for the development and administration of social programs.

The programs and policy areas include income security, pensions (public and private), employment and labor market issues, employment insurance, training, immigration, education, health, housing, communications, culture and the arts, aboriginal peoples, women's issues, child care, and social policy aspects of the Charter of Rights and Freedoms and other legal issues.

Tax Policy Branch

The branch is responsible for the development and evaluation of federal taxation policies and legislation. However, the actual collection of taxes and interpretation of tax law are the responsibility of Revenue Canada, a completely separate government department.

The branch consists of four divisions and an Intergovernmental Tax Policy group focused on specific aspects of taxation. However, many of the responsibility areas for policy development are shared and projects may involve officers from more than one division or group.

Law Branch

The branch prepares legislation and regulations in its areas of responsibility, which can range from taxation to financial institutions, budget implementation and trade issues.

International Trade and Finance Branch

The branch participates in international economic matters. These include the department's lead responsibility within the government for international financial institutions (the IMF, the World Bank group and the European Bank for Reconstruction and Development), import policy, foreign investment and tariff policy, and for participation in the G-7 industrial countries' economic policy coordination exercises.

Financial Sector Policy Branch

The branch provides policy analysis and advice regarding Canada's financial sector and the regulation of federally chartered financial institutions (banks, trust companies, insurance firms). It also manages the federal government's borrowing program, and provides evaluation and support to the Minister of Finance regarding Crown corporation borrowing, and financial market and exchange rate policy. This branch also provides information relevant to the investment decision-making process in a Canadian context for investors and potential investors in Government of Canada securities as well as for other financial markets participants.

Federal-Provincial Relations

The branch is responsible for the administration of the major federal transfers to provinces and territories and provides advice on all matters pertaining to federal-provincial fiscal arrangements and federal-provincial financial relations in general. The branch has policy and program responsibilities for the two main federal transfer payments to provinces—Equalization and the Canada Health and Social Transfer—as well as Territorial Formula Financing Agreements.

Annex VIII

A Model Organic Budget Law

GENERAL PROVISIONS

A budget law should deal clearly with objectives and matters of principle. It would be beneficial if the objectives were also to include a reference to “the achievement of efficient, effective, economical and moral (ethical) performance in the management of the state’s financial resources.” By including these as part of the budget law’s objectives, the sections in the law relating to legal responsibilities and obligations can, and should, then include a complementary requirement that the heads of agencies must manage the resources made available to their organizations through the budget in ways to ensure that the law’s objectives are met. This would expressly strengthen the process of calling them to account for their performance as financial resource managers and, in turn, the performance of their employees who are accountable to them. This would be a key concept in raising the awareness for better financial management over budget resource use. Key technical definitions should be stated explicitly in the budget law. It should in its introductory section identify the main actors responsible for implementing the budget law and then state specific responsibilities in following sections. Any breach of these responsibilities should incur a penalty.

DEFINITION OF THE BUDGET DEFICIT

To ensure that both government and the legislature focus on a clear analytical definition of the budget deficit, the definition of the deficit should be included in the budget law.

Table AVIII.1 shows that, from a sample of OECD countries, the budget law identifies the main actors (and especially the Ministry of Finance) responsible for the administration of the law. A technical definition of the budget, however, is not always included in the budget law. For example, France, Portugal, and the United Kingdom do not include any explicit provisions on the budget.

To promote macroeconomic management focus, the budget law should include a clear analytical definition of the budget deficit (or surplus) that excludes borrowings and use of bank balances from receipts and repayment of principal from expenditure and is equal to net financing. While macroeconomic analysis can be applied to the components of budgets

From Ahmad, Qiang, and Vito Tanzi, *Reforming China’s Public Finances*, IMF, 1995; and William Allan, “Toward a Framework for a Budget Law for Economies in Transition,” IMF Working Paper, 1994.

Table A.VIII.1 Provisions of Organic Budget Laws in Selected OECD Countries

Country	Technical Definition of Budget Deficit	Agencies Administering the Budget Law	Extrabudgetary Funds
Australia	Deficit defined in accordance with IMF accounting. No explicit provisions on definitions on revenue and expenditure (AA).	Executive Council; Department of the Prime Minister and the Cabinet Officer; Minister of Finance and his Secretary of State; Treasury Department; and Auditor General.	There are funds that do not go through the annual appropriation process (needs a special instruction).
France	Organic budget law contains no explicit provisions on technical definitions.	The Council of Minister; Minister of Finance and the Secretary of the Budget; Planning Commission; The National Institute of Statistics; and, the Office of Regional Development (LDF).	There are no funds that do not go through the annual appropriation process (needs a special instruction). All funds are presented in the annual estimates (LDB sec. 4).
Germany	Deficit defined in accordance with IMF accounting. The law includes provisions defining revenue and expenditure (LBP par. 38, FBC par. 25, 81).	The Federal Council; Financial Planning Council; Budget Committees; Federal Minister of Finance; The Federal Revenue (LBF, FBC).	There are funds that do not go through the annual appropriation process. All funds are presented in the annual estimates (C par. 12, FBC par. 37–39).
New Zealand	The law contains no explicit provision on technical definitions on budget deficit. Revenue and expenditure is defined (PFA par. 2).	The Executive Council; Minister of Finance; and the Treasury (PFA).	There are funds that do not go through the annual appropriation process. All funds are presented in the annual estimates (FPA par. 8, 9–12).
Portugal	Organic budget law contains no explicit provision on technical definitions.	The Plenary of the Republic; Minister of Finance and ministers of departments; and the Audit Court (AL par. 21, 22).	There are funds that do not go through the annual appropriation process. All funds are presented in the annual estimates (AL par. 3.)
Sweden	Deficit defined in accordance with IMF accounting. No explicit provisions on definitions on revenue and expenditure (GAG).	The Minister of Finance; Secretary of the Budget and the Budget Department; National Debt Authority (Treasury); and the National Audit Office.	There are no funds that do not go through the annual appropriation process. All funds are presented in the annual estimates (C chapter 9).
United Kingdom	The law contains no explicit provision on technical definitions.	The Treasury and Chief Secretary to the Treasurer; Treasury Officer of Accounts; Management and Personnel Office.; Paymaster General,s Office; Principal Finance Officer; and the National Audit Office (GAG sec. D, E).	There are no funds that do not go through the annual appropriation process. Not all funds are presented in the annual estimates (GAG section A, B).
United States	Deficit defined in accordance with IMF accounting. The law includes provisions defining revenue and expenditure (BSC page 32–34, CBP section 3).	The Congressional Budget Office; Treasury and its Secretary; Office of Management and Budget; heads of departments and agencies; and the Comptroller General (BSC page 2–4).	There are no funds that do not go through the annual appropriation process. All funds are presented in the annual estimates (BSC page 3–4).

independently of any legal definition, such a concept should facilitate communications between government and parliament in the context of transitional economies with relatively inexperienced administrations and legislatures.

As shown in the table, few OECD countries include an explicit technical definition of the budget deficit in their budget management law—or if included, the deficit is defined simply as the difference between gross expenditure and receipts. These countries have well-developed administrative mechanisms for dealing with the budget in the context of macroeconomic policy, so a precise legal definition has not been generally seen as necessary. For many developing countries and economies in transition, however, the budget law can play an important role in ensuring that both government and the legislature focus on a clear analytical definition of the budget deficit during the budget preparation, approval, and execution processes. Therefore, it is recommended that budget laws in these countries incorporate the following:

- Definitions of the main elements of receipts and expenditures that are to be included in the estimates—for instance, distinguishing “revenue” (tax and nontax), “grants,” “borrowing,” and “repayment of debt principal”;
- An analytical definition of the budget deficit or surplus (which excludes borrowings and use of bank balances from receipts and repayment of principal from expenditures).

APPROPRIATION AND OTHER PROVISIONS

A central feature of a budget law, as a control mechanism, is its specification of the way in which the use of public money is to be authorized. The budget law should stipulate that no money is to be spent unless there is an appropriation (an authorization to spend monies received in the public account, specifying both the amount and the purpose of the spending). Such provision will be the basis for ensuring control over all money and limiting the possibility of establishing funds not subject to budget laws or any misuse of funds. Thus, a formal budget amendment is needed to authorize expenditures in excess of the initial appropriation.

The budget law should in this area also include provisions that appropriations under any law, other than the annual appropriation law, shall be included in the budget estimates presented to Parliament and accounted for in the same manner. Any earmarking should be clearly specified. The law should also specify the basis on which transactions are recorded—for example, on a cash or accrual basis.

The government’s legal rights to collect revenues (taxes, fines, various levies, etc.) should be authorized by various law intended to apply equally to all persons and enterprises. The budget law should contain a provision to ensure that such obligations to the government shall not be waived or forgiven by officials without the express or delegated authority of the minister of finance, and in accordance with conditions that the minister may impose.

The budget law should legally define the difference between those bodies that carry out the functions of government (also known as agencies), and those that function in their

own right (defined as entities)—even if they are government-owned or -controlled. This distinction relates to the scope of the budget, which would deal with the receipts and appropriations only for the functions of government. In most market-oriented countries, entities such as state-owned enterprises pay dividends to the government, as well as taxes, which are both included in the budget. The budget also includes appropriations for the working capital and subsidies paid to the state-owned enterprises by the government. The day-to-day receipts and payments of enterprises as they undertake their business operations are not included in the state budget.

In defining or refining a system of budget law, the ability to classify each government body properly and consistently according to its status as well as the correct classification of budget receipts and payments and their consequent control and management is an issue of the greatest importance. Under the conventions of Government Finance Statistics, cash operating surpluses of state-owned enterprises are shown as nontax revenues, whereas losses are treated as subsidies.

POWERS OVER BUDGET MANAGEMENT

The way in which power over the budget is shared between the executive and legislative branches and within the executive is a reflection of political forces. Budget legislation may, in the process of debating the issues, help shape the way these issues are resolved, but it is unlikely that legislation aimed at creating strong executive powers can be successfully enacted unless the political environment is conducive to this result. Because of the relative weakness of the ministry of finance and the need for effective fiscal control in most developing countries and transition economies, however, it is recommended that sufficient authority to the executive be given—and particularly to the Ministry of Finance—to manage the budget as an effective instrument of macroeconomic policy.

Relative Powers of the Executive and Legislative Branches

The legislature must, of course, oversee the budget process, and OECD countries have few explicit constraints on the extent to which the legislature can modify the budget. As discussed in length in chapter 5, in most countries, however, there are practical limitations to legislative power in this regard, and it is generally recognized as being unnecessarily divisive and potentially counterproductive for the legislature to be involved in reshaping the executive budget proposals outside the discipline of an agreed macroeconomic framework. The budget law should clearly specify the limits of legislative authority.

Authority of the Ministry of Finance

The budget law, as stated above, should specify the central government role of the Ministry of Finance.

- Responsibility for supervising the preparation of the annual budget estimates for presentation to parliament, all government bank accounts, receipt and disbursement of funds, and all central government assets and liabilities, and be the signatory for all borrowing and lending by the government;
- The authority to require reports on any public accounts that are set up outside the budget framework;
- The responsibility for ensuring that expenditures and use of credit are controlled within the deficit limit specified in the annual appropriation law; and
- Authority for regulating local governments borrowings and reporting requirements.

BUDGET PREPARATION AND APPROVAL

The budget law should contain a section that specifies the principles and outlines the process whereby the expenditure plans of the government are prepared, presented to the legislature for review and approval, and appropriated by the legislature. In this area, the law should specifically cover the proposed macroeconomic strategy for the budget period and periods in the future. Estimates should be prepared for each annual appropriation law, providing details of the amounts to be drafted to each head of expenditure, the purpose of each head and performance to be achieved during the budget year. The budget law should specify the role of the Minister of Finance in supervising budget preparation, as well as the calendar for legislative action and the form and content of the budget presentation and the budget appropriations bill.

EXECUTION AND ADJUSTMENT OF THE BUDGET

The powers of the executive and the Ministry of Finance to control budget execution are crucial to enabling the government to adjust quickly to changing economic circumstances. To ensure such powers, the budget law should specify that no expenditure shall be undertaken by any spending ministry without a warrant (i.e., an authority issued by the minister to commit funds for certain purposes in a specified time) from the Ministry of Finance. Moreover, the minister of finance shall ensure that funds are authorized by law before issuing a warrant; that transfers between budget heads shall require supplementary appropriation laws; but that the minister of finance may approve transfer of funds between chapters within the same head and may issue regulations in this area.

Adjustment of the budget during the course of the year is a common problem in most countries. The budget law may permit the budget of each year to contain an appropriation line item that allows an identifiable amount to be spent on urgent and unforeseen expenditures, on the authority of the minister of finance. Such expenditures should be reported and should be subject to audit by the independent auditor-general.

The Ministry of Finance also exercises varying levels of authority over the rights of the ministries to move funds from one type of expenditure to another (virement) and to shift

spending from one budget period to another. In general, as discussed in chapter 16, OECD countries have streamlined controls in this area with a view to giving maximum flexibility to managers to allocate resources to achieve the required results. In Australia, Sweden and the United Kingdom, for instance, departments are given substantial freedom to reallocate resources for departmental running costs. In New Zealand, departments and agencies have the freedom to reallocate resources within the amounts appropriated to produce a certain class of outputs; other movement needs approval of the Governor-General or the Parliament. These provisions may or may not apply to a developing country, but should always be covered in a budget law.

GOVERNMENT BORROWINGS AND ISSUE OF GUARANTEES

In general, the power of the central government to borrow is vested in a single authority—the minister of finance is the appropriate authority in the government. Other ministers should not be permitted to negotiate loans. Some countries (e.g., Australia) require the authority of a law before borrowing. In New Zealand, however, the budget law gives blanket approval for the minister of finance to borrow if “necessary or expedient in the public interest.” As a rule, borrowing provisions do not restrict the instruments that can be used by the government nor discriminate among holders of government debt.

Most countries likewise allow the minister of finance to issue guarantees for loans contracted by public enterprises or other bodies. As discussed in chapter 2, this area of financial management presents many potential dangers and it is important that the issue of such guarantees be effectively monitored.

The main provisions suggested for this section of the budget law should cover: borrowing by the central government; authority to raise loans to finance the approved deficit to the limits specified by law; and regulations concerning the issue guarantees.

BANKING AND FINANCIAL ASSETS

In some countries, specifically the U.K., the budget legislation gives the minister of finance authority over all government banking arrangements and allows the minister discretion to deposit unused bank balances in commercial banks to ensure control over the use of funds and efficient cash management. In other countries, it is required that all government deposits are to be held by the central bank. The general practice in most OECD countries is that the Ministry of Finance or Treasury is responsible for government bank accounts. In this aspect, it is desirable to separate central banking from government functions. Prohibiting the central bank from receiving government deposits will strengthen the separation of central bank from government by giving its sole control over base money but it will weaken the role of the central bank as a fiscal agent of government.

Another aspect of financial management that may be treated in this section of the budget law is the establishment of bank accounts and accounting services for third parties

or for handling funds in transit to the consolidated fund account. It may be necessary for the government to hold funds in trust for a private citizen or organization or to establish suspense accounts for receipt of certain funds while awaiting processing and crediting to the consolidated fund.

FINANCIAL REPORTING AND AUDIT OF ACCOUNTS

Vital to the budget law are the requirements that the minister of finance should prepare appropriate reports and submit financial documents to an external auditor. The text discusses requirements in detail (see chapter 11). The budget law should specify the timing and types of reports required and the organizational responsibilities.

ACCOUNTABILITY

The budget law would require that accounts are prepared and audited. The form of accounting must be prescribed by regulations under the authority of the minister of finance. These would ensure that each and every operation is recorded in an accurate manner, to provide a continuously updated picture of government operations, with clear advantages for management. Hence, proper definition and implementation of the government accounting framework and methods are essential for budget management. Some of the main principles of government accounting methods include universality (all transactions should be subject to an accounting operation) and double-entry accounting, to ensure better control. The accounting plan must be structured to ensure the availability of an appropriate account (or subaccount) for each and every operation. The lack of accounts for recording operations, such as the setting of limits on commitments or payments, would hinder the monitoring and control of the operations. A proper definition of accounting schemes is important to ensure that each stage, in any given operation, is recorded in the appropriate account of the accounting plan. Inadequate definitions of accounting schemes may result in lack of information needed for monitoring and control of government operations.

Annex IX

An Illustration of Financial Reporting: Singapore

Statement of Assets and Liabilities As at 31st March 1994

Statement	31st March 1994 (\$ million)	31st March 1993 (\$ million)
ASSETS		
CASH		
At Banks	31,251.6	26,647.7
With Agencies	1.0	1.2
Imprests	16.2	14.3
In Singapore Municipal Provident Fund	0.1	0.1
In Skills Development Fund	8.2	11.0
	31,277.1	26,674.3
INVESTMENTS		
Government Stocks (Market value 31st March 1994-\$41,411.6)	40,938.0	43,355.7
Other Investments (Market value 31st March 1994-\$56,472.4)	57,712.3	39,320.6
Other Investments-Unquoted	17,245.3	13,755.2
Deposits With Investment Agents	1,857.6	1,246.4
Investments Held For Singapore Municipal Provident Fund- Quoted \$7.9 (Market value 31st March 1994-\$8.5) Unquoted \$17.9	25.9	25.0
Investments Held For Skills Development Fund-Unquoted	409.7	440.3
	118,188.9	98,143.2
OTHERS		
Securities Held as Statutory Deposits – Trust Companies	1.1	1.1
Funds for Hedging Currencies	900.7	1,296.4
LIABILITIES	150,367.7	126,115.0
CONSOLIDATED REVENUE ACCOUNT	38,269.0	23,956.5
CONSOLIDATED LOAN ACCOUNT	5,017.8	4,691.0
SPECIFIC FUNDS		
Development Fund	44,430.6	47,238.2
Sinking Funds	20,193.9	18,334.6
Revolving Fund	559.8	687.8
Contingencies Fund	1,000.0	1,000.0
Development Contingencies Fund	1,000.0	1,000.0
Government Securities Fund	31,653.3	26,077.2
Edusave Endowment Fund	2,537.5	1,523.0
Medical Endowment Fund	205.1	-
Singapore Municipal Provident Fund	25.9	25.1
Skills Development Fund	417.9	451.3
	102,024.0	96,337.2
DEPOSIT ACCOUNTS	5,056.9	1,130.4
	150,367.7	126,115.0

From the Report of the Auditor-General, Republic of Singapore, October 1994.

Notes:

(a) This statement does not include the following:

- (i) Government securities of \$35,891.9 million issued under the Development Loan Acts and \$30.0 million in external loans, details of which are shown in the "Statement of Government Securities, External Loans and Sinking Funds as at 31st March 1994";
- (ii) Loans repayable to government amounting to \$21,901.1 million, details of which are shown in the "Statement of Loans Repayable to Government for the year ended 31st March 1994"; and
- (iii) Funds administered by organs of state and ministries totaling \$639.1 million, details of which are shown in the "Statement of Public Funds Administered by Organs of State and Ministries for the year ended 31st March 1994."

**Statement of Consolidated Revenue Account
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Balance as at 1st April	23,956.5	17,722.5
Add:		
Operating Revenue	19,733.1	16,689.9
Investment Income	1,273.2	844.9
Loan Repayments	0.3	0.3
Capital Receipts	8,357.6	5,200.6
Investment Adjustments	465.6	205.6
	53,786.3	40,663.8
Deduct:		
Operating Expenditure and Other Outlays	10,638.5	10,639.1
Inter-Fund Transfers	4,878.8	6,068.3
Contingencies Fund	-	500.0
Edusave Endowment Fund	1,000.0	1,500.0
Medical Endowment Fund	200.0	-
Revolving Fund	(220.0)	-
Sinking Funds	3,898.8	4,068.3
Balance as at 31st March	38,269.0	23,956.5

**Statement of Consolidated Loan Account
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Balance as at 1st April	4,691.0	3,861.1
Add:		
Treasury Bills Issued	16,850.7	14,136.5
	21,541.7	17,997.6
Deduct:		
Treasury Bills Redeemed	16,523.9	13,306.7
Balance as at 31st April	5,017.8	4,691.0

Notes:

- (a) The balance as at March 1994 represents the net proceeds from outstanding Treasury bills with par value of \$5,050 million.
- (b) No loans were raised for Development Fund purposes in the financial year 1993/94. Loans raised under the Government Securities Act 1992 are shown in the Statement of Government Securities Fund.

**Statement of Development Fund
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Balance as at 1st April	47,238.2	48,677.3
Add:		
Recovery of Overpayment	250.0	168.8
Interest on Loans	672.5	913.6
Investment Income	2,019.3	1,781.6
Investment Adjustments	740.3	435.4
	50,920.3	51,976.8
Deduct:		
Development Expenditure	3,894.8	3,649.1
Net Lending	2,594.9	589.5
Loans	3,965.5	2,226.0
Less: Loan Repayments	1,370.6	1,636.5
Transfer to Development Contingencies Fund	-	500.0
Balance as at 31st March	44,430.6	47,238.2

**Statement of Sinking Funds
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Balance as at 1st April	18,334.6	16,551.3
Add:		
Investment Income	767.5	598.6
Investment Adjustments	281.4	146.5
Transfer from Consolidated Revenue Account	3,898.8	4,068.3
	23,282.3	21,364.6
Deduct:		
Registered Stock Redeemed	3,088.5	3,030.0
Balance as at 31st March	20,193.9	18,334.6

**Statement of Revolving Fund
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Balance as at 1st April	687.8	625.0
Add:		
Advances Repaid	238.3	205.5
	926.1	830.5
Deduct:		
Advances Given	146.2	142.7
Transfer to Consolidated Revenue Account	220.0	-
Balance as at 31st March	559.8	687.8

Note: The total provision of the Revolving Fund as at 31st March 1994 is \$1,160.8 million. This is represented by \$600.9 million outstanding advances and \$559.8 million unutilized provision. During the year, an amount of \$220.0 million was returned to the Consolidated Revenue Account.

**Combined Government Revenue and Expenditure
For The Year Ended 31st March 1994**

	1993/94 \$ million	1992/93 \$ million
Operating Revenue	20,655.5	17,772.4
Tax Revenue	16,223.7	14,237.1
Fees and Charges	3,393.6	2,377.0
Others	1,038.2	1,158.3
Less:		
Operating Expenditure	9,001.2	8,512.3
Expenditure on Manpower	2,179.8	2,054.8
Other Operating Expenditure	4,632.4	4,460.0
Grants-in-Aid	1,871.1	1,698.0
Pensions	318.0	299.5
Less:		
Development Expenditure	3,894.8	3,649.1
Government Development	1,999.7	1,748.1
Capital Grants	1,357.2	1,394.9
Public Housing	537.9	506.2
Surplus/Deficit (-)	7,759.5	5,611.0
Less:		
Contribution to Edusave Endowment Fund	1,000.0	1,500.0
Contribution to Medical Endowment Fund	200.0	-
CPF Share Ownership Top-UP Scheme	242.4	-
Budget Surplus/Deficit (-)	6,317.1	4,111.0
Add:		
Net Investment Income	2,722.2	1,157.9
Investment Income	4,060.1	3,225.1
Less: Debt Servicing	1,231.2	1,980.2
Expenses on Investments	106.7	87.0
Less:		
Net Lending	2,594.6	589.2
Loans	3,965.5	2,226.0
Less: Loan Repayments	1,370.9	1,636.8
Add:		
Net Capital Receipts	8,315.0	5,155.6
Capital Receipts	8,357.6	5,200.6
Land Sales	5,476.7	4,021.8
Other Capital Sales	2,880.9	1,178.8
Less: Agency Fees on Land Sales	42.6	44.9
Add:		
Investment Adjustments	1,487.3	787.5
Excess of Receipts Over Outlays	16,247.0	10,622.8

Notes:

- (a) Excludes investment income apportioned to Government Securities Fund, Edusave Endowment Fund, and Medical Endowment Fund.
- (b) Excludes investment adjustments apportioned to Government Securities Fund.

Annex X

Information Systems for Fiscal Management

By Ali Hashim and William Allan

INTRODUCTION

As countries that were part of the former Soviet Union and Eastern Europe move from centrally planned to market economies, and as other developing countries proceed to open up their economies and free them from regulatory controls, public-sector managers in these countries are required to perform a new set of functions, such as: (i) designing appropriate fiscal and monetary responses to changing macroeconomic conditions; (ii) ensuring transparency and accountability in the deployment and use of public resources; (iii) improving the effectiveness and efficiency of public expenditure programs; (iv) mobilizing domestic resources and managing external resources (foreign aid and loans); and (v) decentralizing operations with adequate controls. In the new environment, increased scrutiny of governmental actions, accountability, and the ability to exercise financial controls are not only a domestic requirement but also important factors in determining international creditworthiness by multinational agencies and by the international investment community in general, in the context of global investment choices. Ready access to accurate and timely information for decision making is a paramount requirement to function effectively in this environment.

The information used by public-sector managers is generated as the agencies responsible for government financial management processes perform their functions, such as budget preparation, execution of budgetary expenditures, collection of revenues, etc. Since many of these functional processes require the processing of a large number of transactions, in limited periods of time, across a countrywide network of offices, the process of retrieving information from manual records and reclassifying it in a format or classification scheme appropriate for management decision making can be extremely time-consuming and labor-intensive. In such an environment, in the absence of some degree of automation, the basic data required for economic management may simply not be available with the required

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degree of timeliness and accuracy. Computer-based information systems provide public-sector managers with a set of tools to access reliable and timely information for decision making in an environment that requires consolidation of large amounts of data across dispersed locations. Thus, such systems enable rapid compilation and consolidation of data from across a countrywide network of Treasury or tax offices at the central Ministry of Finance. Data in the system databases can be presented in a variety of formats in accordance with management requirements.

Furthermore, many of the functional processes in the fiscal management area are repetitive in nature and follow a prescribed set of rules. For example, the rules for processing expenditures, or those for calculating taxes and duties can be explicitly stated. In these cases, computer-based systems present public-sector managers with unique opportunities to process business transactions efficiently, apply necessary controls, and simultaneously gather timely and accurate information required for decision making. Two aspects are particularly important:

- Computer-based information systems make it possible to integrate transaction classification and posting with transaction processing. This means that as a transaction is processed, e.g., as a payment is made, it can be simultaneously classified and posted to the relevant account. This ensures that all transaction data are promptly and correctly included in system databases.
- Use of computer-based systems enables automation of many controls and procedures. As the transaction is processed the system can apply the necessary controls, e.g., ensure that a proper budget allocation exists prior to making a commitment or approving a payment. Manual intervention is required only in cases that require an exception to the procedures. In these cases, the system would keep an appropriate audit trail that would include details regarding the authorization for the exception.

Despite their advantages, the implementation of information systems for the automation of financial management processes in the public sector poses a number of major design and implementation challenges. First, the investments required are very sizable and can easily span several years. Investments in such systems in moderate-sized countries could easily range from US\$10 million to US\$50 million over a five-year period. Secondly, the implementation of these systems generally requires substantial reform in existing institutional arrangements. Thirdly, different information flows among different elements of the system have to be closely integrated to achieve the full advantages of computerization. It is vital that the second and third of these problems be tackled effectively in systems design and implementation to realize the benefits of improved efficiency and better fiscal decision making.

It is essential, therefore, to assess carefully the costs and benefits of information system for financial management in light of the data will, administrative and institutional landscape of the specific country in question, before embarking on the introduction of such systems. The last section identifies and discusses the critical factors without which such systems cannot be successful.

It is only too common, particularly where substantial reforms in the underlying management process are required, for systems to be implemented piecemeal without significant

reform and little attention paid to critical flows of information between system components. The end result is often a set of partial information systems with overlapping and/or conflicting functionality, and a resulting lack of integrity in the overall fiscal databases. For design and implementation of effective government fiscal management information systems, it is essential therefore, that (i) required reforms in the underlying financial management processes be clearly agreed and understood as the basis for systems design; and (ii) functional and technical specifications for system design be based on these processes, and (iii) provide clear guidelines for integrating all of the subsystems needed to support government fiscal management (GFM).

To assist in the process of design of government fiscal management systems, this paper starts with a discussion of the essential characteristics of integrated systems giving some emphasis to the need to identify core and noncore elements of the overall GFM systems network. It describes a methodology that could assist in the design of an integrated network of systems. It goes on to discuss briefly the key functional processes of government fiscal management, and the main characteristics of the information systems required to support these processes. It uses the information on GFM functional processes and systems to develop a framework that identifies the various elements of a GFM information systems network and describes critical interlinkages. In view of their central place in the financial management process, the paper then discusses the functional processes, information flows, and information systems for budget execution, accounting, and fiscal reporting in some detail. Finally, it closes with a discussion of some of the factors that determine the choice of technology for the component modules of the GFM systems network and the prerequisites for successful implementation of integrated financial management systems.

CHARACTERISTICS OF INTEGRATED SYSTEMS

Integrated systems are not monolithic. For practical system implementation it is essential that system elements be developed in a modular way. These modules are integrated in the sense that they can exchange data and that there is a single secure point of entry for commonly used data. Modules in an integrated system can be distinguished as core modules and noncore modules. Core modules are those that are essential to the operation of the system and that define standards for data exchange for other system components. Noncore modules, by contrast, perform an ancillary function and should provide data in the form required by the core system or use data in a way that be reconciled with core system data. As will be discussed in more detail later, the general ledger system¹ (GLS), which maintains the data base for GFM, and accounts payable and receivable, which are the main transaction processing systems, would generally be considered to be the core of most GFM systems. Other systems such as debt management or tax and customs administration, though of vital importance to GFM, must be seen as supportive of the core system by (i) adhering to the data exchange standards of the core and (ii) reconciling data and reports with core data and reports.

A basic underlying principle for the design of integrated systems is that they be structured along functional rather than organizational lines. A number of organizational units

and agencies are closely involved with different aspects of GFM and they need to share information among themselves. A particular GFM system module should provide support to a functional area across all these organizations. This approach enables the creation of systems and data bases in which the primary responsibility for the timely provision of a particular subset of data resides with the organization responsible for that function. However, data in the system data bases should be accessible to all other relevant organizations (subject to appropriate security controls). Adherence to this design principle eliminates duplicative data gathering and, more importantly, enables all agencies responsible for specific GFM functions to work with the same set of data, thereby eliminating risks of data inconsistencies, which are inevitable in separately gathered data.

The *first step* toward achieving integration is to develop a framework that provides an overview of the systems network required to support GFM. This framework would address questions such as:

- What are the different information systems modules that are required to support GFM functional processes?
- What is the scope, scale, and type of a particular systems component?
- How do these systems modules interrelate in terms of their information flows?

This framework is developed by analyzing the basic functional processes associated with GFM, the overall regulatory framework that underpins these processes, their information requirements, functional responsibilities of agencies commonly responsible for the processes, information flows between the processes, the nature, volume, and frequency of these flows, and the data characteristics of the information used and created by the processes.

The framework would consist of:

- A *systems architecture* that identifies the major component modules of the systems network required to support GFM, the type of information maintained by each systems module and the information flows between various modules; and,
- A *technology architecture* that identifies the appropriate technology choices for the hardware and software to set up the various modules.

Once the initial framework has been set up and the pre-requisites and criteria for integration have been spelled out and incorporated in the implementation plan, the actual implementation and integration of systems modules is a goal that can be phased over time.

GFM FUNCTIONAL PROCESSES AND INFORMATION SYSTEMS ARCHITECTURE

This section describes in brief the major functional processes associated with government fiscal management. The information systems architecture required to support these processes, showing the core elements of a GFM systems network required to support GFM functional processes and the main information flows between elements, is available on request from

the authors. The functional processes associated with government fiscal management and the information requirements for these processes have been documented, inter alia, by Davies, Hashim, and Talero (1994), and Hashim and Allan (1994). A description of the major functional processes and the associated information systems for GFM is given in table AX.1.

INFORMATION SYSTEMS FOR BUDGET EXECUTION, ACCOUNTING, AND FISCAL REPORTING: THE TREASURY LEDGER SYSTEM

As stressed in the text, the main objectives of public expenditure management are expenditure control, strategic resource allocation, and good operational management. GFM systems provide decision makers and public sector managers with a set of tools to support these objectives. The architecture of the information systems network is determined by the basic functional processes that public sector managers employ to achieve these objectives and the overall regulatory framework that underpins these processes. The overall regulatory framework consists of the following elements: (i) the control structure; (ii) the accounts classification; and (iii) the reporting requirements. The information systems will need to incorporate features to ensure that they abide by the requirements of this framework. Therefore, *the regulatory framework needs to be in place—possibly, reviewed and modified—before productive work can commence on the design of computer systems to support fiscal management.* A full discussion of the overall regulatory framework is in the text and will not be repeated here.

The information systems for budget execution, accounting, and fiscal reporting—or the Treasury Ledger System (TLS) as they are often called—are the centerpiece of the GFM systems network and constitute the core of the government's financial management information system. The TLS would normally be used by:

- the Treasury and its regional offices, to perform the basic accounting functions and to undertake budget implementation;
- the Budget Department of the MOF, to obtain the status of actual expenditures and perform the processes associated with budget preparation and monitoring;
- the Cash Management Department of the Treasury, to provide the information it requires for cash management and implementation of cash limits;
- line agencies, to cater to their accounting and financial information needs; and
- the government auditing organization, to access financial transaction data for auditing purposes.

In a fully automated accounting system, as it exists in most developed countries and several middle-income countries, the basic accounting processes are automated and data captured only once as an accounting transaction progresses through the system. Such a system, introduced along with a modern budget classification system and an appropriate chart of accounts, would enable expenditures and revenues to be recorded at a very detailed level and related to specific programs and projects. Data recorded at this level can be directly used for program and project management. These data would also easily be amenable to cross-classification in other ways as required for financial analyses. In the

Table AX.1 Government Fiscal Management Processes and Information Systems

Government Fiscal Management Processes	Information Systems Support
<p><i>Macroeconomic Forecasting</i></p> <p>This process assists expenditure and resource planning by developing a macroeconomic framework linking the growth of national income, savings, investment, and balance of payments to public expenditures and revenues. The process helps in the development of: aggregates in the budget, notably revenues, expenditures, and the overall fiscal deficit and its financing; the balance between the capital and recurrent components of the budget; composition of expenditures by the main sector spending agencies; revenue forecasts consistent with macroeconomic assumptions; forecasts of nontax revenues based on macroeconomic projections; estimates of resources available from domestic and external borrowings; projections of current expenditure.</p>	<p><i>Information Systems to Support Macroeconomic Forecasting</i></p> <p>This group of systems assist the MOF with macro fiscal forecasting and the development of the macroeconomic framework. This is in turn used by the MOF to advise the Cabinet on aggregate budget parameters and guidelines for budget agencies to submit budget estimates. These systems require data from external economic data bases, and the assumptions regarding GNP, inflation rates, and the central government deficit. Additionally they require information on programs and projects the government intends to implement over the period of the MTEF, data on estimates of tax and nontax revenues, data on domestic and external borrowings, etc., maintained by other components of the GFM systems network, the manpower component, maintenance, and other operating expenses.</p>
<p><i>Budget Preparation</i></p> <p>The process of budget preparation starts with the development of a budget circular indicating economic prospects, broad policy objectives and how the budget is expected to attain them, and sectoral allocations/ceilings consistent with the macroeconomic framework. The next step is the preparation and analysis of line agency expenditure proposals and revenue forecasts and their consolidation into an annual budget document after a series of discussions at the Cabinet level, between line ministries, the MOF, and budgetary committees of Parliament and approval by the legislature. These discussions focus on how the budget proposals would meet the policy objectives outlined in the budget circular, on priorities of the various proposals, the validity of the resource requirements contained in these proposals, and how they can best be accommodated in the overall budgetary envelope.</p>	<p><i>Information Systems to Assist in Budget Preparation and Approval</i></p> <p>The budget preparation systems receive details of ongoing and planned programs and projects from the various line agencies, consolidate them, and produce from them the documents that form the basis of the negotiations between the line agencies and central agencies (MOF). After the budget is finalized by the Cabinet, the systems produce the approved budget estimates. The systems record and maintain the budgetary proposals and income estimates of all government agencies and record any changes during the budget preparation, approval, and amendment processes. To assist in the evaluation of the budget proposals, the system should be able to access and generate the baseline data on the manpower component, maintenance, and</p>

Table AX.1 (continued)

Government Fiscal Management Processes	Information Systems Support
<i>Budget Execution, Accounting, and Fiscal Reporting</i>	<p>other operating expenses from the relevant past-year databases. Examination of the capital expenditures requires data on the status (physical and financial) of government-approved projects, (both locally and foreign-funded). The budget preparation systems need to be supplemented with tools (such as those for cost-benefit analysis evaluation and performance measurement) that assist the sector and core agencies in deciding between alternative program proposals.</p>
<p>This set of processes cover the functions associated with implementing the budget, including the procurement of goods and services in accordance with budget estimates, the recording and accounting of all government transactions and development of periodic reports to monitor the overall flow of spending or use of appropriations, over the course of the year, highlighting major deviations from the planned budget and suggesting corrective measures.</p>	<p><i>Information Systems for Budget Execution, Accounting, and Fiscal Reporting</i></p> <p>These systems are the centerpiece of the GFM systems network and are the primary repository of financial data and serve as the basis of the government’s Financial Management Information System (FMIS). These systems are used to perform the processes associated with budget execution, monitoring, and control, to obtain the status of actual expenditures on ongoing projects. These systems also monitor and evaluate the overall budget implementation processes and produce the necessary fiscal reports. In addition, these systems would provide useful financial information to the line ministries, and spending units (in their respective areas) to enable them to better manage their work programs.</p> <p>Systems support is focused on four main systems (i) budget and warrant control; (ii) accounts payable; (iii) accounts receivable; and (iv) the treasury general ledger system (TLS) or the financial general ledger (FLS) system, and together they constitute the government’s Core Accounting System (CAS). The first of these is concerned with maintaining data on spending authority. These systems maintain data on approved budgeted appropriations (both capital and recurrent), sources of financing for programs and projects, budget transfers, supplementary</p>

Continued next page

Table AX.1 (continued)

Government Fiscal Management Processes	Information Systems Support
<p><i>Cash Management</i></p> <p>This includes the processes of developing agency and central cash flow forecasts, the release of funds to spending agencies, the monitoring of cash flows and expected cash requirements, the issue and redemption of government securities for financing government programs.</p>	<p>allocations, and fund releases (warrants) against budgetary allocations over the course of the year. The second and third groups of systems are used to process transactions as soon as possible after they occur, and record data on commitments and actual expenditures against budgeted allocations. The TLS/FLS is used for the compilation of summary records for control and analysis.</p>
<p><i>Debt Management</i></p> <p>This process defines the tasks associated with maintenance of records on all contracted public debt on an individual loan basis and classified according to source and type of loan. This process also assists in economic and policy analysis by determining, for example, the debt implications of different fiscal and deficit financing policies by preparing projections of debt service commitments under existing and anticipated contracts.</p>	<p><i>Cash Management System</i></p> <p>The Cash Management System assists the government in maintaining an up-to-date picture of the government's liquidity position and cash requirements. It obtains information on actual agency expenditures and cash balances in government (including agency) accounts from the general ledger. Revenue inflows, borrowing, loan disbursements, Treasury bills, government bonds, and cash deposit maturities are obtained either from the general ledger or from the specific systems for these areas, for example, the debt management system. Using this information, the government can decide on (i) budget ceilings and fund releases to line agencies; and (ii) the timing of the issues and redemptions of government securities, to provide short-term financing for shortfalls.</p> <p><i>Debt Management System</i></p> <p>This system maintains information on public domestic and external borrowings. This includes information contained in loan documents and transactions and issues of government securities. In addition to accounting information, this system also provides important information required in the formulation of fiscal policy, such as forecasts of drawdown and debt servicing liabilities and debt implications of different fiscal and deficit financing policies. Payment related to government borrowings are carried out by the central system based on the data in the debt management system.</p>

Table AX.1 (continued)

Government Fiscal Management Processes	Information Systems Support
<i>Revenue Administration</i>	Loan receipts recorded in government accounts are processed by the central accounting system and then used to update the debt data base maintained by the debt management system.
The process deals with the administration of tax policies and covers the actual levy and collection of revenues including taxes and duties as laid down in these policies, and the valuation and collection of non-tax revenues, such as stamp duties, user fees, charges for services.	<i>Systems for Revenue Administration</i>
<i>Personnel Administration</i>	This group of systems assists the government in, first, the processes associated with the formulation of tax and tariff policies, and then, the collection of tax and non-tax revenue. A number of separate systems are involved in this group: for example, those supporting the administration and collection of income taxes, customs duties, or VAT, and those supporting the collection of various types of non-tax revenues, such as stamp duties. The revenue administration systems provide summary information on revenue collections to the Core Accounting System. Revenues collected by the tax and customs administration departments would be recorded at an aggregate level in the FLS, and would be reconciled with deposits made in the banking system.
Activities associated with the development and maintenance of the government's human resource policies including manpower planing, complement control, civil service pay and pension polices, and the fiscal impact of these policies and their administration.	<i>Systems to Assist in Fiscal Aspects of Personnel Management</i>
<i>Auditing</i>	The aspects of personnel management that are relevant for GFM are those processes associated with post management and complement control and with payroll and pension payments. The corresponding systems modules therefore form important elements in the GFM network of information systems. The payroll, pensions, and employee advances systems post summaries to the central system periodically.
The process deals with the analysis and scrutiny of public, financial, and other transactions to ensure compliance with government policies and procedures and to ensure cost-effective use of public funds in accordance with overall government priorities.	<i>Systems to Support Auditing</i>
	Auditing takes place at two levels; internal audit at line ministries during the course of the fiscal year, and external audit by the Auditor General through random checks and on the final accounts for the FY. These systems assist the internal and external audit agencies in their functions.

absence of an automated accounting system, data recording would not be at as detailed a level. More important, cross-classification of data to other schema would be very cumbersome and therefore seldom carried out. The introduction of an automated accounting system would ensure completeness of data capture (that is, no transaction would be processed outside the system) and rigorous application of appropriate financial controls to all transactions processed by the system.

The information contained in the system databases would provide the MOF and other core financial agencies with comprehensive management information related to the country's financial resources. In addition, the system would provide useful financial information to the ministries and other spending units (in their respective areas) to enable them to better manage their work programs.

Policy Framework and Institutional Reforms

As mentioned earlier, the institutional and policy framework associated with budget preparation and execution needs to be in place—possibly, reviewed and modified—before productive work can commence on the design of computer systems to support budget execution, accounting, and fiscal reporting. The international financial institutions have been extensively involved in advising governments developing policy and institutional reforms to enable the systems for budgeting and accounting to be set up and function in accordance with international best practices. These reforms are especially important in transition economies where the legal and institutional infrastructure needs to be set up *ab initio*. Some of the key actions and policy reforms that need to be undertaken prior to the implementation of the actual computer systems for budgeting and accounting, are discussed at length in the text and are only mentioned below. However, the discussion below of budget execution using the Treasury Ledger System is much more detailed than in chapter 8, and the reader should find it useful as the underpinning of the information system itself:

- Development of a comprehensive budget law;
- Adoption of a budget classification system consistent with the IMF's GFS methodology, and final design of a Treasury chart of accounts embodying this classification system for implementation;
- Centralization of all government payments through the Treasury and consolidation of bank accounts to a single account at the CB;
- Development of detailed regulations and operating manuals on budget execution.

Key Characteristics of the Treasury Ledger System (TLS)

The TLS is normally implemented at the Treasury head offices and at each of the regional and district branches of the Treasury to process and control central government payments in their respective areas. Local government payments are not normally part of the system. Nevertheless, the implementation of the Treasury system would not preclude the installation of a similar system for local governments.

The system encompasses the functional requirements for the budget implementation and accounting processes and would normally cover the appropriation, commitment, funds allocation, and payment processes for both the investment and current budgets. The details of the functionality of the TLS are given below.

The Treasury Ledger System would have the capability to:

- record initial budgets and distribute the budget appropriations as approved by the legislature, to spending ministries and keep a record of initial budgets, revised budgets, and budget transfers, for a typical government spending unit.
- distribute appropriation and commitment authorizations to spending units and record commitments incurred by a spending unit against the approved limits and the appropriation during the course of a year.
- distribute fund allocations to spending units and keep a record of the amounts of funds allocations against the appropriations and any changes thereto.
- record expenditure against commitments and fund allocations (e.g., due to purchase orders, or other payments). The system will have facilities to check availability of appropriation, commitment, and funds allocation prior to approving a payment.
- print consolidated payment instructions for action by the banking system.
- record revenue and other receipts against appropriate account heads.
- if required, print checks against payment instructions and/or make arrangements for the electronic transfer of payment information to an external paying entity (e.g., a bank).
- consolidate data from all ministries and regional offices, as necessary. The system will have good report-writing facilities and enable easy retrieval and reporting on data in the system data bases, in a variety of formats. The system would be able to produce the commonly required accounting and management reports.
- restrict access only to duly authorized staff.

Implementation of the Treasury Ledger System: Activities and Tasks

As mentioned earlier, implementation programs for information systems to support budget execution government-wide must be sequenced carefully starting with the specification and design of appropriate financial management processes and organizational arrangements to support these processes. This should be followed by the development of functional and technical specifications for the information system to support these processes and then finally by the acquisition and implementation of the hardware and software. Quite often, government agencies will require the assistance of external consultants in managing systems implementation.

Budget Execution Using the Treasury Ledger System

Specific details of how the various government agencies involved in budget execution would use the related information systems in the performance of their duties as they relate to the execution of the budget are described in this section.

- *Budget appropriations.* The process begins with the recording of the approved budget (and any amendments thereto) by the Ministry of Finance (MOF) in the Treasury Ledger System (TLS), by individual appropriation item or revenue estimate. The Budget Department of the MOF prepares and registers in the TLS the detailed allocation of budgetary appropriations by ministry, and advises ministries accordingly. This should be done within the limits of appropriation approved by the Parliament.
- *Cash requirements forecast.* At the start of the year, financial plans detailing projected outlays and receipts are entered into the cash management system. As the year progresses sector agencies prepare quarterly/monthly requests for funds by category of spending. These are also input into the system.
- *Commitment limits.* It may be appropriate for the Treasury to propose commitment limits against spending unit expenditure items. The Treasury does this after taking into account the balance in the CB accounts and the balance in ministries' expenditure items by accessing the system.
- *Fund allocations (warrants).* The Treasury would then make fund allocations to ministries for each category of spending. Under ideal circumstances, the fund allocations would be consistent with the proposed commitment limits communicated to the ministries earlier. Both proposed and actual cash allocation quarterly limits would also be consistent with the commitment levels and budget appropriations. The degree of consistency in the process will largely depend on the quality of the budget initially prepared, the initial financial planning process, and the revenue collection outcome.
- *Ministries inform spending units.* The ministries would then notify their respective spending units of the budgetary appropriations commitment limits and fund allocations. These limits would be entered into the system. The advance knowledge of indicative cash limits, as well as of quarterly commitments limits, will allow agencies to make the best arrangements and to set priorities in a situation of scarce resources, so that any necessary cuts in expenditures by agencies can be made in a more orderly, rational, and effective way.
- *Requests for expenditure and actual commitment transactions.* As the year progresses, sectoral ministries will process requests for expenditure. After verifying the appropriateness of the expenditure and availability of budget appropriation and funds, actual commitments would be recorded in the system. If the ministries and spending units are directly linked to the system, they will record the commitment themselves. If they are not, they will advise the Treasury of these commitments. The Treasury will then record the commitments in the system. In the case of spending units (SUs) located outside the center, the transactions will be recorded in a parallel system through a Regional Treasury Unit (RTU).
- *Verification of receipt of goods and payment orders.* Following the verification for a given expenditure, ministries directly linked to the system would record the corresponding payment order in the system. The system would automatically check that the order falls within the funds allocation limit set for that ministry. The outlying spending units would process a payment order through the RTU. The latter would check the payment order issued by the SU and register it in the TLS. In the verification stage, once all the requirements for a particular obligation have been met, the ministry or spending unit should confirm that the commitment is ready for payment.

- *Payment processing.* At the same time as payment orders are registered in the TLS, the banking system must be advised to make the necessary payment (that is, to transfer funds from a central government account to the creditor). In a fully developed system this can be done automatically. At the end of each day, the TLS would structure a file with complete information on the creditors and payments to be made, as advised by ministries and spending units. This file would be sent to the CB or by the RTU to the regional branch of the CB that holds the government account. The applicable bank would transmit the relevant information (and funds) to each commercial bank, to credit to the appropriate account and debit the government account. The appropriate bank would confirm to the TLS (through the RTU) the debits in the government account. Alternatively, the applicable Accounting Office could forward to the appropriate bank a consolidated listing of the registered payment orders requiring payment. Action by the banking system would be as described earlier, but confirmation to the Accounting Office would be manual.

It should be noted that the process outlined above can be simplified for certain types of expenditure, either administratively or by automated procedures in the TLS. Some of these cases are discussed below.

- *Commitments for civil service salaries.* Salary commitments may be advised only once a year on an estimated basis and adjusted as necessary during the year.
- *Payment of civil service salaries.* In theory, each payment of each civil servant could be treated as a discrete payment and processed in the manner already described. However, given the number of individual payments involved, the similar structure of each payment, the regular occurrence of payments, and the additional personnel issues that need to be considered, it is preferable to develop a separate subsystem for processing salary payments—the payroll system—in a manner compatible with the overall expenditure process.
- *Small expenditures.* The commitment (and verification) of small expenditures (up to a predetermined limit) can be entered into the system simultaneously with the order for their payment. However, the system must know in advance which appropriation items allow such simplification, to prevent misuse.
- *Commitments for the investment component of the budget.* Commitment control for the current component of the budget can be operated satisfactorily on a within-year basis, primarily as an aid to sound cash management activities. However, in the case of the Investment component, where many projects have a financial life of more than one year, it is often useful to maintain an accurate record of the forward expenditure commitment generated by undertaking the project. If this is done, the government has a better understanding of the flexibility available to it for future investment decisions. This process can be accommodated in the FLS by extending the commitment control field against each investment appropriation line item to cover two years beyond the budget year. As long-term commitments are entered, the financial impact is recorded, for budget and outyears. Tracking the implementation of capital projects normally requires separate subsystems at the agency levels. For these, it is important to maintain data on both the financial and physical status of projects, including historical data.

- *Receipts.* Government receipts (such as taxes and duties) are often paid into accounts set up by the corresponding revenue collection agency in commercial banks. They are then transferred to the TSA at the CB. A periodic report from the CB informs the Treasury and the appropriate revenue collection of the details of the collections.

Alternative Institutional Arrangements for Expenditure Processing

Responsibility for payment processing

The previous sections describe the commonly occurring institutional setting in which: (i) all payments from line agencies are channeled through the Treasury; (ii) the Treasury is responsible for making payments from the Treasury Single Account (TSA) which is held at the CB; and, (iii) the CB is responsible for the retail banking operations associated with government payments and receipts.

However, in those countries where the institution of the Treasury and the necessary legal framework for budget preparation and execution is in place and the need for financial discipline is recognized government-wide, several alternative institutional arrangements are often put in place for managing the payment process. The first variation on the standard institutional setting is that in some countries the spending ministries/ spending units are directly responsible for making payments from the TSA instead of the payments being channeled through the Treasury. The TSA is nevertheless still held at the CB and the latter continues to be responsible for retail banking operations related to government payments and receipts. This system may result in a quicker response time for payment transactions since the payment authority resides in the agency itself. In this case, the responsibility to ensure compliance with budget execution limits and procedures is delegated to the agency. For this system to be successful, the MOF needs to ensure that necessary controls are adhered to by the agency prior to making a payment. The budget control responsibility can be exercised by officers from the central Treasury who are outposted to the line agency, or by line agency finance and accounting staff.

It may be mentioned that if a computer-based system is used for controlling budget execution and for processing payment transactions and the system design incorporates the necessary controls, the location of the payment authority is not as important as it would be in a manual system. Prior to allowing a payment, the accounting system software would normally ensure that a budget appropriation exists, a warrant allocation (cash) is available, and a prior commitment has been made (in those cases where commitment accounting has been implemented). Manual intervention would normally only be required to override some of these restrictions. In these cases the system would keep a log of the event including the date, time, amount involved and the name of the authorizing officer. This will ensure that the controls prescribed for budget execution are adhered to.

In a manual system, the finance personnel located at the spending agency or the Treasury would need to ensure that these controls are applied in each case. In a spending agency-based payment system, if the spending agency finance personnel are functionally and administratively responsible to the head of the spending agency, they may be subject to pressures to process payment transactions that do not comply with specified procedures. It may

therefore become more difficult to ensure that prescribed controls and procedures are adhered to in a decentralized system as compared with a Treasury-based central system.

Banking arrangements

A further variation that is often implemented is that the retail banking operations are delegated to one or more fiscal agents (normally authorized commercial banks) by the CB. This model is put in place in those cases where the CB does not have an adequate network of provincial/regional branches or does not have the capacity to handle the large volume of transactions associated with government payments and receipts. In these cases, the fiscal agent(s) makes payments on behalf of the Treasury, the CB recoups all payments made by the fiscal agent(s) for government operations and the fiscal agent(s) makes daily deposits of all government revenues to the TSA in the CB. This model can be used in both situations described above, namely, in the case where the payments are channeled through the Treasury or where the agencies are directly responsible for authorizing payments. The arrangement has the advantage of more expeditious payments to government creditors in view of the greater capacity of commercial banks to process these transactions. Three aspects are important for the efficient functioning of this system. First, the float of all payments to be transferred to the TSA should be as small as possible. Secondly, the bank accounts should continue to be under the control of the Treasury even though they may be operated by the agencies. Finally, their balances should be cleared to the TSA periodically to ensure that government has an accurate idea of the total amount of cash available in the system so that it can optimize its borrowing strategies.

The necessary mechanisms to ensure that the Ministry of Finance has the necessary information on bank accounts can be implemented more easily in an information technology-based environment. However, it is necessary to note that mere existence of an electronic connection is not sufficient. For the necessary controls to be implemented, the bank accounts would need to be under the control of the Ministry of Finance/Treasury so that it can obtain data on balances in these accounts and make transfers from them independently of the spending agencies.

The centralized payment processing through Treasury offices is implemented by the United Kingdom, Canada, France and Australia amongst other advanced countries. The government of New Zealand has put in place a decentralized payment system in which agencies directly process expenditure transactions and have direct access to bank accounts. Systems to ensure accountability are important to assess the readiness of a country to move from a centralized to a decentralized system. Table AX.2 lists the institutional arrangements adopted by several countries for payment processing.

TECHNOLOGY ARCHITECTURE

The technology architecture defines the nature of the hardware, software, and communications technology required to support the information and systems architectures. The elements of a technology architecture include descriptions of:

Table AX.2 Examples of Institutional Arrangements for Payment Processing

Country	Payment Transactions Processed by	Treasury Single Account Held at	Government Payment Transactions Processed by	Remarks
Hungary	Spending units send expenditure transactions to Treasury units for processing	National Bank of Hungary	National Bank of Hungary makes payments to government creditors	Prior to the establishment of the Treasury and setting up the TSA, MOF transferred cash directly to spending unit accounts. Government did not have access to accurate and timely information on the cash available in agency bank accounts. This led to generation of idle balances. There was little control on whether expenditures followed budget appropriations. To remove these problems, under IMF advice, the government has set up treasury/ TSA based payment arrangements.
Kazakhstan	Spending units send expenditure transactions to Treasury units for processing	National Bank of Kazakhstan	National Bank of Kazakhstan makes payments to government creditors at the center and oblasts. At rayons, banking operations are handled by designated commercial banks	Kazakhstan has, at the advice of the IMF, moved from a decentralized payment system to one in which government monies are located in the central bank and payments are processed by Treasury units at the center, oblasts, and rayons. This has enabled the government to implement more efficient cash management practices and exercise better control on expenditures.
Ukraine	Spending units send expenditure transactions to Treasury units for processing	National Bank of Ukraine	National Bank of Ukraine makes payments to government creditors at the center and oblast headquarters. At rayons, retail banking operations are handled by designated commercial banks	Ukraine is also in the process of implementing a centralized payment system under IMF advice.

Table AX.2 (continued)

Country	Payment Transactions Processed by	Treasury Single Account Held at	Government Payment Transactions Processed by	Remarks
Turkey	Spending units send expenditure transactions to accountancies managed by MOF/ General Directorate of Public Accounts, for processing.	Central Bank of Turkey	At the center payments are made by the central bank. In the regions/provinces by Ziarat Bank, a designated commercial bank	Government payments are handled by the central bank at the center. In the regions, the Ziarat Bank acts as the government's fiscal agent.
Pakistan	Spending units send expenditure transactions to the offices of the Accountant General for processing	State Bank of Pakistan	National Bank, a government owned commercial bank	In Pakistan government payments are processed by offices of the Accountant General. However, the central bank has designated the National Bank to act as its fiscal agent. The Accountant General has an account in the National Bank (NB), which is a government-owned commercial bank. The NB performs the retail banking operations on behalf of the central bank. This enables the government to maintain central control but at the same time take advantage of the large network of National Bank branches to facilitate payment to government creditors.
New Zealand	Spending units process expenditure transactions directly	Central bank	Designated private banks	New Zealand operates a decentralized system. However, agencies are held responsible for ensuring that all budgetary expenditures are in accordance with the approved budget. Moreover, agency bank accounts are cleared every night to enable the Treasury to get an idea of the total cash available in the system.
Jamaica	Spending units process expenditure transactions directly	Bank of Jamaica	Designated private banks	Jamaica has opted for a decentralized system. The government would like to give full freedom to line agencies to implement their programs and projects as approved by the parliament. However, the agency bank accounts are not cleared on a daily basis. This can cause buildup of idle balances.

- the nature, size, and distribution of the computer processing facilities and associated workstations;
- the nature of the communications interconnections between the computer processing facilities; and
- the nature and type of applications development and systems software, database management systems software (DBMS), office support systems software, special-purpose software to support analytical capabilities, text management, desktop publishing, etc.

The definition of the technology architecture provides the basis for:

- selecting appropriate technology to support the systems architecture;
- guiding the acquisition of hardware, software, and communication facilities; and
- ensuring integration and compatibility of component elements of the architecture.

The different elements of the technology architecture will be country- and application-specific. This paper therefore restricts itself to a discussion of the factors that need to be kept in mind while making technology choices.

Application-Specific Factors

The technological requirements for the various systems modules described in the foregoing sections could vary quite significantly. Some of the application-specific factors that determine the choice of information technology are:

- The volume of data to be handled and the sizes of the data bases required to be maintained;
- The volumes and rates of the transactions that take place against the data bases and the numbers of concurrent users of the system;
- The volumes and frequency of the information flows between component parts of the system or with other systems modules;
- Whether the information processing requirements are centralized at a single location or are distributed to a number of widely separated locations, and if the latter, how frequently the information maintained by the system is required to be aggregated at the center or referred to by other agencies of government;
- The type of data handled by the system: whether it is primarily alphanumeric or textual, and whether it pertains to a given time slice or requires time series;
- The nature of output facilities required by the system: desktop publishing, graphics, report writing, and imaging;
- The nature of analytical facilities required, e.g., modeling, statistical analysis tools.

The systems characteristics identified in table AX.3 broadly define the information technology requirements of the systems modules. In general, the data volumes and transaction rates determine the computing power requirements at a particular node of the system and

the degree of sophistication required in the data base management software used. High-transaction-rate systems with a large number of concurrent users require sophisticated data base management software.

The data distribution profiles and the nature and frequency of information flows between component modules of the system or with other modules of the PFM network determine the nature of the telecommunications facilities that will be required. The frequency of information flows between the nodes of the network determines whether the telecom link needs to be active all the time or whether information transfer at periodic intervals would suffice. Thus, for example, information systems to support tax administration would ideally have distributed processing facilities available at all important taxation centers, which would be connected with each other and with the center by telecommunications facilities. On the other hand, systems for macroeconomic forecasting or debt management, which are primarily operated by the MOF, would need only limited telecommunications access to other systems in the network.

Systems that handle large quantities of text information, as opposed to straight alphanumeric information, require special text-management software. Similarly, systems that require image processing capabilities have special hardware/software requirements. Systems that require special analytical or modeling tools, graphics, desktop publishing, or report writing capabilities require the use of appropriate software for this purpose.

Requirement for a Multitiered Network

Several elements of the GFM systems network such as those for budgeting and accounting and for tax administration, require systems modules at the line agency and central levels with facilities for generating, storing, and processing data at each level and for exchanging data between levels. The data volumes encountered can vary widely across the nodes of the network. These systems require a multitiered network. This could consist of stand-alone microcomputers, local area networks (LANs), or minicomputers, located at the nodes (MOF, other core agencies, the line agencies, and subordinate/regional Treasury and tax offices) and connected by telecommunication lines.

The transaction processing and data base management at each node are carried out by the local computers. The summary or detailed data required for the applications are transmitted to the computer in the agency responsible for that system (e.g., to the MOF's Budget Division for the budget system, to the Treasury for the accounting and cash management systems). This configuration is often preferred because (i) computing power is distributed commensurate with node requirements, making this system less vulnerable to malfunctions at the central site; and (ii) end-users at the line agencies have more control over their technological and data resources, which inculcates a sense of ownership in the systems. In the absence of good telecommunication facilities, the data transfer between the nodes and the center could be periodic (say, daily, weekly, or monthly, depending on the application system) in an off-line/batch mode. The size of each node's computers would depend on the amount of its data and the number of its transactions. They could be stand-alone microcomputers, microcomputers connected by a local area network (LAN), or fairly large-capacity minicomputers at the center and larger line agencies.

Table AX.3 Technological Requirements for GFM Information Systems

Systems for	Relative Data Volumes and Transaction Rates	Requirement for Distributed Processing, Data Transfer, and Access Facilities	Analytical Processing, Modeling, and Statistical Analysis Facilities	Text Management Facilities	Report Writing, Desktop Publishing Facilities	Availability of Off-the-Shelf Package Software Solutions
Macroeconomic forecasting	Low	Operated by the core agencies at the center.	Economic modeling and statistical analysis	Some	Good report-writing and graphics facilities	
Budget preparation	Moderate; involves annual submission of budget proposals from line agencies to MOF	Some; budget proposals are prepared at line agency offices and need to be transferred to the MOF at the center	Some analytical capabilities are required to perform cost-benefit analysis during budget preparation and development of alternative scenarios	Budget proposals normally contain descriptions of agency programs and outputs/outcomes.	Good desktop publishing facilities. The systems should prepare a camera-ready version of the budget that is ready for printing after approval by Parliament.	Some financial packages have facilities to assist in budget preparation.
Budget execution, accounting, and fiscal reporting	Very high; all budget transfer, commitment, verification, and payment transactions need to be processed	Major requirement; budget execution transactions are processed at line agencies and/or regional/district Treasury offices. Information needs to be transferred to the center periodically	Mainly a transaction processing system. Some analytical facilities to determine expenditure trends, etc.		Good report-writing and some graphics facilities are required	A number of financial packages are available to implement the general ledger, accounts payable, receivable, and procurement, modules. Examples are: packages offered by SAP, ORACLE, PEOPLE SOFT, J.D. EDWARDS, AGRESSO, NAVISION, etc.
Cash management	Moderate; cash requirements from agencies, and cash allocations to them are processed by system	Some; cash requirements are received from line agencies and warrants allocations are distributed to them	Some analytical capabilities to forecast cash requirements.		Good report-writing and some graphics facilities are required	Financial application packages can assist in this area.

Table AX.3 (continued)

Systems for	Relative Data Volumes and Transaction Rates	Requirement for Distributed Processing, Data Transfer, and Access Facilities	Analytical Processing, Modeling, and Statistical Analysis Facilities	Text Management Facilities	Report Writing, Desktop Publishing Facilities	Availability of Off-the-Shelf Package Software Solutions
Debt management	Moderate; all loan receipt and payment transactions need to be processed. For a large loan portfolio this number could be substantial	Some; agencies need to inform the center of debt utilization information	Some analytical capabilities to analyze debt and borrowing strategies		Good report-writing and some graphics facilities are required	UNCTAD and the Commonwealth Secretariat have developed debt management systems. These systems are in use in a number of countries
Revenue administration	High; all transactions relating to assessment/ payments of various types of taxes need to be handled by the systems.	Major requirement; revenue collection transactions take place at a network of offices. Information needs to be transferred to the center periodically	Mainly a transaction processing system. Some analytical facilities to determine tax policy options		Good report-writing and some graphics facilities are required	ASYCUDA developed by UNCTAD and SOFIX developed by the French government are examples of systems for customs administration. In use in a number of countries
Personnel management	High; all personnel actions need to be handled by these systems	Some; these systems are normally operated by line agencies. Information needs to be transferred to the center	Mainly a transaction processing system		Good report-writing and some graphics facilities are required	A number of application packages are available
Auditing	Moderate; these systems obtain sample transaction data from other GFM systems for analysis.	Some; auditing systems need access to other transaction processing systems of the GFM network.	Specialized transaction sampling facilities		Good report-writing and some graphics facilities are required	Several packages are available in the market to help in computer-assisted auditing.

Systems Portability and Scalability

A key consideration while designing such systems is that for systems modules that are to be implemented at multiple levels, the software should be similar at each node and scaleable—that is, able to be run on small or large computers without major changes. These properties can be achieved by choosing compatible computers offered by a single vendor that offers multiple size configurations. However, this would restrict further additions to the network to this vendor and line of computers. To avoid these restrictions, the application systems should be developed using tools and DBMS software that can operate on machines of different sizes offered by several vendors. This feature is called software portability.

To ensure vertical and horizontal portability, and scalability, the hardware should be an open system—assembled from components that conform to generally (though not universally) accepted standards. The hardware and software would therefore be interchangeable, providing greater flexibility. It will be some time before there is a full set of products on the market that truly conforms to *open systems* standards; at present, the UNIX environment comes the closest. Most vendors now offer a version of UNIX. Since UNIX versions vary slightly with the vendor, some application changes may be required before a version can be used on a different vendor's machine; however, time and effort involved in making these changes would be small compared with entirely rewriting the applications.

Another consideration in choosing the application development environment is that certain tools, such as fourth-generation languages (4GLs), RDBMs, and graphic user interfaces (GUIs) make it easy to add or change application features, including changes in data base structures, associated programs, and report formats. The use of these tools increases application development productivity and therefore reduces development time. These tools also enable end-users to access the data bases themselves and to program simple reports.

Off-the-Shelf Application Software

It is important to choose an appropriate software strategy during project implementation. In-house development of application software often appears more attractive in terms of the resources required for developing a core or a prototype application. However, such systems can provide only the most basic functionality, and efforts to enhance them to a full-functionality system usually turn out to be very time-consuming and expensive. In general, it is advisable to opt for packaged software solutions where feasible. Packaged software can be acquired for systems with relatively standardized requirements. Off-the-shelf application software packages that were originally designed for the corporate environment are now becoming increasingly popular in the public sector in areas such as financial management, accounting and personnel management. A few packages are also available for use in more specialized areas such as customs administration and debt management. Though they may initially appear to be more expensive when compared with a modest in-house prototype, the adoption of such packages could result in significant savings in both time and money in the long run. The use of off-the-shelf software would enable faster implementation of a full-function system, continuing software support with periodic upgrades and good documentation. It is therefore suggested that possibilities of using such packages be explored

before embarking on an exercise of in-house development. However, systems with country-specific requirements may need to be custom-developed. The cost and risks associated with such projects are higher.

While conducting a review of software packages the project team will need to ensure that: (i) the software package provides the required functionality; (ii) local support is available for the package and it is possible to obtain and install upgrades and/or changes in the packages in-country as they become available; (iii) the vendor for the package provides customization assistance as may be required; (iv) the costs associated with any customization are identified clearly in the total cost; (v) the package runs on a range of hardware and operating software which is compliant with the hardware/software strategy proposed for the systems; (vi) adequate documentation is available to enable package installation and use, and (vii) potential licensing arrangements can accommodate the use of the package at multiple sites in the country.

CRITICAL SUCCESS FACTORS

Government Commitment and Management Support

Improving the quality of fiscal management systems would introduce transparency in the fiscal and resource allocation processes. This would adversely affect those who benefit from the current weaknesses. These interests may act to delay project actions or divert the project from its objectives. *Continued government commitment to the reform of the public sector and to strengthening the basic financial management institutions is therefore a primary critical success factor for successful project implementation.*

Introduction of a new institutional structure for budget execution would require reorganization and realignment of the roles and responsibilities of related government agencies, such as the MOF, the Central Bank, and the Treasury and their relationships to the line ministries, and fundamental reforms of the functional processes that these agencies perform. Computer-based information systems should be viewed as a means of assisting in implementation of reengineered business processes and procedures. Implementation of these changes would *need government support at the highest levels* to ensure that the change process is completed smoothly. A phased and gradual introduction of new policies and procedures and a broad appreciation program, for public-sector managers, in the advantages offered by the new systems and processes would allow a wider appreciation of benefits and would enhance ownership.

At the project level, ensuring sponsorship at the highest levels of the functional areas involved in the project and participation from the widest range of users, is necessary. Steps taken to involve users in the design and implementation phases also ensure that the project is owned and adopted by the users once it is completed. Senior functional management input is particularly important during the earlier planning and design phases of the project. The main skill requirements for these phases are an in-depth knowledge of the functional area and a managerial capacity to ensure that the project is accepted by users within the functional area. The technical aspects become important only during the later implementation phases.

Interagency Coordination

Successful implementation of an integrated network of information systems, such as defined here, is crucially dependent on cooperation between diverse users. Project preparation and implementation is complex as it is done in a multiagency environment. Forming a *steering group with representatives from all major stakeholders* would ensure that all participant agencies' needs are taken into account during systems design so that the agencies do not have to resort to independent and duplicative initiatives. In this context, the active participation and involvement of line agencies in the design and implementation of systems is especially important. It would also establish systematic data-sharing arrangements, protocols, and schedules between the various systems so that all agencies have access to financial data as required. The lead responsibility for the different component modules of the overall system should rest with the organizations directly responsible for the corresponding functional process. This committee would also be a vehicle to provide user input to the technical team responsible for implementing the project.

Organizational Capacity and Skills

Systems reform projects may need to cope with the organizational capacities of the agencies responsible for implementation of reforms and the management of project implementation. The numbers and skill levels of finance and technical staff required to set up such systems are considerable. To ensure sustainability, the project may need to supplement existing skills and provide for financing and hiring of project implementation specialists, fiscal management specialists, and other technical skills as required. The government may need to review salary scales of staff in key areas to retain them within the civil service and to explore other modes of employment and avenues for hiring staff, for example, hiring staff for specific assignments from the private sector and outsourcing the technical maintenance and operation of some systems. In any case an ongoing policy of training would need to be adopted to cope with the significant attrition rates that can be expected.

On the technical side, an information systems organization should be established or existing organizational units strengthened, to *incorporate and retain* the skills and to manage the systems planning, development, and operation. The following skills are required: (i) high-level project design and planning skills; (ii) project management skills; (iii) technical implementation skills, to operate and use the hardware and software; (iv) user support skills, to develop user and technical documentation, to train end-users, and to set up a hotline as well as more formal training for end-users.

Setting Priorities for Systems Implementation

The systems for budgeting, accounting, revenue administration, payroll, and personnel management, constitute the basic transaction processing systems in the overall network required to support GFM. They are the repositories of most of the data that are required by the other modules of the network and form the foundation for modules of the network that

support fiscal planning and provide the decision support mechanisms. These systems are characterized by high data volumes, and several of them require distributed processing facilities. The order of magnitude of effort involved in their implementation is much higher than that for the other systems in the network. The nature of the business processes involved in these functions, the high data volumes and transaction rates associated with these systems make them primary candidates for computerization. As a matter of fact, in the absence of some form of automation, these areas are liable to generate severe backlogs of data, which can result in major gaps in the information required for fiscal management. These areas therefore present the major opportunities for automation. In view of their size, however, they also represent the systems most likely to encounter problems if the implementation process has not been planned carefully. The development of an overall framework outlining the nature and scope of the different modules of the information systems network and the interconnections between these modules would enable the project to be put in proper perspective. It will focus attention on the specific parts of the systems network that are included in the scope of the project, and what other modules these systems would need to interface with.

Formal Project Planning

The implementation of government-wide computer systems to support GFM process is a substantial undertaking. It is very important that agencies involved in the exercise be aware of its dimensions. Formal project planning methodologies should be used to design, implement, and monitor the systems. When such methodologies are appropriate and cost-effective in the specific country context, it is advisable to implement such projects in a phased manner so that they can be put in place and adequately monitored in a controlled environment. A phased implementation also ensures that they do not exceed the absorptive capacities of the organizations where they are implemented.

Systems and Data Administration

Information system support would normally be distributed among several agencies across government. Therefore, coordinating mechanisms should be created to ensure that a common set of policies, procedures, and standards is put in place for *managing data and systems across government*. The standards should, inter alia, cover the protocols for communications, data entry, editing, and updating screen input and output formats, back-up and recovery, security, contingency and disaster planning, and technical and user documentation.

Local Technical Support

It is imperative that the hardware and software chosen be supported locally. The vendors must have a local presence to be able to provide training and technical support during the life of the system.

Management of Change

Implementation of computer-based systems to support GFM requires an understanding not only of the business processes and information requirements, but also of the social, cultural, and political environment of the organization and the country within which they are being implemented (Walsham, Symons, and Waema 1988). It has been argued that computer-based systems are social systems in which technology is only one of the elements. The organizational arrangements required to ensure a social fit therefore take on increasing importance.

Implementation of information systems is intimately connected with, and normally has a direct impact on, the way people do their day-to-day work. It is imperative that appropriate change management procedures are also instituted, in addition to formal training programs, to ensure that staff feel comfortable in their new work environment and in particular do not feel insecure on account of misplaced fears of job redundancy, etc.

At a more complex level, information systems may lead to redefinition of the relative authority and power relationships of individuals and groups within organizations. The change management exercise would need to address these aspects also.

As an example of the types of issues involved, in the case of implementation of taxation systems, staff responsible for the processing of business transactions will need to learn a new way of doing their work. In view of the efficiencies in transaction processing mode possible by automated systems, the numbers of staff required to process routine business transactions may go down generating fears of redundancy. A parallel program of retraining and redeploying excess staff may be required. At the management level, officials who are responsible for ensuring that all transactions pertaining to their areas are processed speedily and recorded in their books would normally encourage the installation of computer-based information systems to make their jobs easier. However, installation of computer-based information systems would also add transparency and thus accountability to government operations. In fact, installation of these systems can provide the systemic underpinnings for and give a major boost to anticorruption efforts. (Recall, however, that new possibilities for corruption will be opened up at the same time for those with a good understanding of the new technology.) For these very reasons such projects could encounter resistance in project implementation. This is another reason why such projects would need a sponsor at the highest levels who could overcome the social and political constraints and pilot the project through the initial stages.

NOTES

¹ In traditional government accounting, the ledger is the summary book of account used to control each item of expenditure under heads and subheads of appropriation for each government fund.

Annex XI

Questionnaire for the Assessment of Public Expenditure Management Systems

By Lawrence J. O'Toole

This questionnaire is designed to help evaluate of the efficiency of budget systems, especially in developing countries and transition economies. It can be used informally to help think about the problems; it can be used as the basis for a formal review of the budget system; or individual sections can be used in analyzing specific budgeting sub-systems. (Some redundancy of the questions among sections is deliberate, to facilitate the third purpose.)

Questions demand a “yes or no” answer, and a negative answer suggests that action could be considered, **if appropriate**, to produce the situation described in the question. The questionnaire may appear too prescriptive, in attempting to reflect “good practice”. Readers are asked, therefore, to note that many questions describe specific elements which may be desirable but not essential in the specific country; others describe elements to be considered for later implementation after the basic foundations are in place, and yet others describe elements which may be inappropriate for the specific country. In most developing countries, therefore, several of these questions will not be relevant. National experts are best suited to make the judgement of whether one or another element is desirable and timely in their own country, provided that they take the trouble to review the lessons of international experience, as summarized in this book or elsewhere. Finally, note that this questionnaire is illustrative rather than exhaustive: a large number of possible questions are not included, partly from space limitations and partly because they would not be sufficiently general in relevance to various countries. However, the questionnaire does follow the key priorities of good budgeting, as discussed at length in the text. It should be used in conjunction with the text and with the Glossary.

This questionnaire relies upon the work of many organizations and individuals, both academics and practitioners. A particularly rich source was the *Public Expenditure Management Handbook* of the World Bank, 1998. The questionnaire was edited for the purposes of this book. Lawrence J. O'Toole is a consultant in public management.

INSTITUTIONAL AND LEGAL FRAMEWORK

Organic Budget Law

The legal framework for budgeting includes the constitution and the organic budget law (OBL). In many countries, the constitution deals with three principles: the requirement that all public money be paid into designated accounts and that these funds can be spent only under the authority of the legislative; the definition of the state's financial relations with subnational governments; and the relative powers of the legislature and the executive government in public finance. Where they are not stated in the constitution, these key principles should be dealt with in the organic budget law. Depending on legal traditions, some countries have less detail in the OBL and more in secondary legislation and administrative policies. Others do the opposite. It is generally preferable to limit the OBL to key provisions of lasting importance, and define other rules in lower-level legislation which can be amended more easily when circumstances change. As noted, this questionnaire should always be interpreted in the light of specific national practices.

Does the OBL (or lower-level legislation, as appropriate):

- provide a clear and comprehensive definition of public money and determine that all of it is to be managed in accordance with this law?
- authorize the government accounts into which all public money must be paid and from which expenditures are made only by appropriation of the legislature?
- limit the creation of extrabudgetary funds to special cases, authorized by separate statute?
- ensure that the finances of statutory funds are included in the overall fiscal position reflected in the budget?
- ensure that activities of statutory funds are reported to government and legislature with the same regularity as other government entities?
- ensure that the Ministry of Finance (MoF) regulates financial management of statutory funds?
- require that the budget deal comprehensively with all revenues and expenditures of the state?
- require that asset and liability transactions involving public money be included appropriately in the budget?
- define authority for issuing and reporting on loans and guarantees?
- define the different classes of budgetary institutions, agencies and enterprises, the authority for creating and dissolving such entities, and the rules by which entities in each class are linked to the budget?
- define the principles of intergovernmental fiscal relationships, while leaving the allocation of powers and responsibilities among subnational governments to separate local government laws?
- provide that subnational governments are allowed to borrow only from the central government? Or that their borrowing is subject to approval by MoF?
- provide that subnational governments are required to report monthly on total revenues, expenditures and bank balances, including for local extrabudgetary funds?

- define the schedule for presentation of the budget by government and for its consideration and approval by the parliament?
- provide for interim funding to continue normal government business when parliament has not approved the Budget in time for the start of the fiscal year?
- establish restrictive conditions on the use of reserve funds and emergency spending, such as requiring approval by minister of finance and full reporting to parliament?
- define the authorities at each level of the administration to transfer credits among headings and between appropriations in the approved Budget?
- provide clear criteria, and disclosure standards, for all tax and customs remissions and for the write-off of other debts due to the government?
- bind all persons responsible for spending public money to observe the principles of efficiency and effectiveness and to implement management control practices?
- establish sanctions for overspending and/or program and project performance?
- provide authority for Ministry of Finance (MoF) to make regulations in all areas of Budget preparation and execution, accounting and reporting, fees and charges, financial management, management control, internal audit, cash and debt management, public procurement etc.?

Legislative/Executive Relationships

These relationships are determined by the Constitution, by the OBL and other laws, by parliamentary rules of procedure, and by customary practice. Does one or more of these sources provide:

- defined limits on the powers of the legislature to amend the draft budget bill?
- time limits and/or remedies for the legislature's delay in voting on the budget?
- an opportunity for the legislature to approve the fiscal framework targets in advance of the detailed budget estimates?
- conditions and limits for handling draft legislation which has budgetary consequences not foreseen in the current budget?
- for the mandatory presentation by government of the essential minimum of budget documentation to specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and major identifiable fiscal risks?
- the timetable for reporting to the legislature during the year and in the Final Account, an accounting basis for reports which is consistent with that of the budget, and arrangements for external audit?
- for an external auditor in the form of a supreme audit institution which is independent of the executive government and reports to the parliament?
- a special parliamentary committee to study the Final Account and external audit reports?
- a procedure by which the legislature votes discharge?

Scope of the Government Budget

Does the budget include:

- all funds or financial mechanisms except as specifically exempted by statute?
- complete information on financial plans and operations of statutory extrabudgetary funds, and on their transactions with the budget?
- all spending under permanent appropriations as well as those to be annually voted?
- all fiscal transfers to subnational governments for general and special purposes?
- information on investments, transfers, or other transactions between the Budget and state-owned enterprises?
- a statement of contingent liabilities resulting from state guarantees of third-party debts, and an estimate of payments likely to be required under those guarantees during the budget year?

BUDGET PREPARATION

Setting the Framework

Macroeconomic and expenditure forecasting

- Is this responsibility assigned to MoF or, if divided between agencies, are roles precisely defined?
- Are economic forecasts produced at specified intervals?
- Are internal forecasts validated by systematic comparison to economic forecasts from public and private sources?
- Do the expenditure forecasts include both permanently appropriated and annually voted funds?
- Are the forecasts used to formulate revenue and expenditure assumptions and a framework of fiscal targets for approval by Council of Ministers?
- Are the same economic assumptions required to be used in the budget estimates submissions by ministries?
- Are systematic forecasts of expenditures mandatory with all new policy proposals?

Ministry envelopes/ceilings

- Are budget ceilings for aggregate spending and for sector ministries recommended by MoF and approved by the Council of Ministers?
- Do they cover both recurrent and capital components of the budget?
- Are they communicated prior to the preparation of the sector estimates submissions?
- Are sector ministers able to re-allocate among their agencies within the sector ceiling?

Multi-year perspective

- Are there medium-term projections of aggregate expenditure, consistent with the macroeconomic targets? How are they formulated?
- Are the projections used to frame the annual budget process? How?
- Are the expenditure projections and fiscal targets made public and widely disseminated?
- Are the projection and fiscal targets updated annually?
- Are policy decisions linked to the annual budget process?
- Are conflicts between resource needs and availability referred to a higher level (e.g., Council of Ministers) for resolution?

Process

- Is there a well defined, and widely understood, sequence of steps in the budget process, and does it allow practical intervals for the work at each stage?
- Does MoF issue an annual budget circular or regulation and does it provide a clear set of rules for the budget process and the main forms to be used in sectoral budget requests?
- Does the budget circular include sectoral spending limits, or clear rules for determining them?
- Are sectoral budget requests required to separate the funding of existing policies from requests for funding of new proposals?
- Are sectoral budget requests consistent with government policies and priorities?
- Are sectoral budget requests consistent with the macroeconomic assumptions and budget ceilings?
- Is all donor-financed expenditure incorporated in the budget?
- Is there a well-defined procedure for obtaining decisions on new policy proposals?
- Is there a clear role for MoF in analyzing and assessing sectoral budget requests prior to inclusion in the draft Budget?
- Are there established rules or practices to guide MoF negotiations with spending units?
- Are there clear rules for arbitration, by the appropriate higher levels (e.g., Prime Minister or Council of Ministers) of remaining differences between MoF and spending units?

Public investments

- Does the process for selecting and approving public investments assure consistency with policy, good sense and national economic profitability?
- Are all investments included for the budget year fully financed from assured sources?
- Are all investments financed both by the budget and by official external donors included?

- Are there sufficient local currency provisions in the budget to complement foreign funding for projects?
- Are the recurrent cost implications of investments estimated, and the results incorporated in the annual budget and expenditure projections?
- Is there sufficient coordination between investment programming and the annual budget process to ensure (i) consistency with overall policy; (ii) financial consistency between capital and current expenditure; (iii) consistency with the medium-term estimates?

Presentation to the Legislature

Does the draft budget reveal:

- the minimum documentation required by the OBL?
- a clear and comprehensive plan for all public spending, both that which continues under existing statutes and that which must be annually appropriated?
- the linkage of expenditures to specific organizations, objectives, and activities?
- funding that relates to new initiatives?
- the hierarchy of accountability among persons and organizations entrusted with public funds?
- clearly defined appropriations to be voted?
- format and language accessible to citizens and media as well as to legislators?

BUDGET EXECUTION AND MONITORING

Laws, Regulations, or Policies

Do the laws, regulations, and policies:

- define the authorities at each level of the administration to transfer credits among headings and between appropriations in the approved budget?
- provide clear criteria, and disclosure standards, for all tax and customs remissions and for the write-off of other debts due to the government?
- define procedures for mid-course review and amendment of the budget?
- establish sanctions for overspending?

Distribution of Responsibilities

Is the MoF empowered to:

- issue (normally through the Treasury) the warrants, or equivalent, which authorize spending units to begin spending their budget appropriations?
- reduce authorizations below the level of parliamentary appropriations if revenues fall below expectations?

- give prior approval for transfers of funds (virement) between chapters within the same budget heading, and set rules for transfers between items within chapters?
- demand the fulfillment of specific conditions before releasing certain appropriations such as major investments?
- control the release of investment funds from official donors and obtain reports on execution?
- issue regulations and standards for accounting and reporting, financial management, management control, and internal audit throughout the government sector?
- require reports from spending units on financial and task performance?
- demand access to supporting documentation from spending units as required?
- report, through the Council of Ministers, to the legislature on budget execution at least twice a year and whenever there are major changes in the forecast outturns?

Are spending agencies required to:

- have installed standard accounting and control systems and trained staff to use them?
- make forecasts of monthly cash flows for the budget year and submit these for MoF approval?
- make regular reports to MoF (or the Treasury) on spending in comparison to budget and cash flows in comparison to forecast?
- review, approve, and monitor direct disbursement programs by official donors in their sector?
- receive expenditure statements from aid agencies, and record the expenditures in the government accounts?
- maintain a budget planning and control framework which links spending to detailed functions (activities)?
- supervise subordinate agencies and state-owned enterprises in accordance with government-wide rules?
- develop and maintain systems of management control throughout their own and subordinate organizations?
- maintain a program of internal audit that meets MoF standards?
- be subject to formal rules that guard against overspending relative to budgeted amounts (e.g., central agencies, chief accountants, or banks having the authority to refuse expenditures if there are insufficient funds in the ministerial account)?

Do the legislature and Council of Ministers have appropriate responsibilities for:

- reviewing periodic reports on financial performance relative to the budget?
- revising targets and/or policies as required by the changed circumstances?
- blocking expenditures and amending laws as required by changed economic circumstances?
- defining national emergencies and approving spending changes to deal with them?

Cash Management and Treasury Function

- Are all public revenues deposited in the Treasury Single Account under control of MoF (Treasury department)? **OR** by spending units, to their separate subaccounts of a state Treasury system? **OR** by geographically remote spending units, to separate bank accounts operated by means of imprest advances, whereby a new advance is provided upon receipt of an accounting for the use of the previous one?
- If separate bank accounts are permitted, is MoF responsible for opening, closing, and either directly operating them or monitoring their operation?
- Are payments made through the central Treasury which authorizes and processes payment orders from spending units? **OR** by spending units, from their subaccounts within the financial limits authorized by MoF for the subaccounts?
- Are budget credits released to separated accounts only at the rate required for payments?
- Is information on actual expenditure available to MoF (or the Treasury) in time for effective monitoring?
- Does MoF (or the Treasury) control cash balances daily relative to borrowings?
- Do agencies have a system of commitment accounting that ensures expenditures do not exceed budget?
- Are there are sanctions for overspending?
- Are there clear and limited provisions for carry-over of expenditure?

Public Procurement

Is public procurement conducted:

- under laws and regulations which conform to international good practice?
- under the guidance of a control government office?
- with exemptions subject to decision only at appropriate senior levels?
- with regular reporting to the office of supervision?
- subject to a transparent dispute resolution system?
- subject to swift and certain penalties for fraud and abuse?
- with the right balance between protection and efficiency?

Accounting and Reporting

- Are all accounting and budgeting classification or coding schemes fully integrated into a single common classification under regulation by MoF (or the Treasury)?
- Does the classification scheme include both economic and functional categories conforming to IMF/GFS standards?
- Does the system provide for recording commitments as well as cash transactions?
- Are physical assets inventoried and policies on valuation and accrual accounting (if any) established?
- Are there manuals setting out the procedures and regulations for the accounting system?

- Are liabilities (such as those for civil service pensions) determined in accordance with generally accepted principles?
- Are financial statements/final accounts prepared in accordance with a recognized set of accounting standards?
- Are expenditure statements produced during the fiscal year and presented to the legislature?
- Are the Final Accounts produced, audited, and presented to the legislature shortly after the end of the fiscal year?
- Do the accounts include expenditures undertaken directly by aid agencies?

Management Control

- Is the managers' responsibility for management control defined in laws or regulations?
- Are organizational structures, competencies, policies, and procedures designed to prevent errors and to detect and correct errors that have occurred?
- Are control systems integrated with line management reporting systems and with budget planning system?
- Do the internal audit units in spending organizations review management control arrangements and recommend improvements to top executives?
- Is there a central office of control in MoF or elsewhere which issues standards, provides technical advice, and monitors performance?
- Are international comparisons taken into account when standards are established?
- Are computerized information systems designed to management control standards and verified by specialized audit staff?

AUDIT

Internal Audit

- Are internal audit units directly responsible to the head of agency to ensure their independence from operating units?
- Do internal audit units have capacity, or access to outside expertise, for audit of computerized systems?
- Are the knowledge and skill qualifications for internal auditors established and monitored by the central office of control?
- Are the internal audit reports directed to the top management and a copy provided to the external auditor?
- Are internal audit units expected to coordinate audit plans with those of the external auditor?
- Is a code of conduct for internal auditors enforced?

External Audit

- Is there an external auditor (“supreme audit institution,” or SAI), established by law with independence from the government and reporting to the legislature?
- Does the SAI cooperate with the SAIs in other countries and the international audit associations?
- Is the supreme audit institution empowered to audit the management control systems and permitted the discretion to use sample audits of individual transactions?
- Does the SAI inspect the management control systems and recommend improvements as opposed to using most resources for the audit of individual transactions?
- Does the SAI coordinate auditing plans with internal audit units and does it make use of internal audit reports to avoid duplication of effort?
- Are the SAI’s reports made public?
- Does the legislature have a special committee and/or procedure for reviewing SAI reports?
- Does the government have procedures for following up and responding to SAI recommendations?
- Does the SAI use a manual of audit practices consistent with international standards?
- Does the SAI have the capacity, or access to outside expertise, to audit computerized systems?

EVALUATION

- Is there a requirement for carrying out evaluations of programs/projects?
- Is there a requirement for evaluation of a certain percentage of programs/projects each year? Or for every government operation to be evaluated at a specified fixed interval?
- Does MoF or another appropriate authority establish policies and standards for evaluation?
- Are the results of evaluations published?
- Are the results used in budget decision making?

PERFORMANCE MONITORING

- Does the government foster an environment that supports and demands performance?
- Is there a clear understanding of the differences and limitations of input, output, outcome, and process indicators?
- Is there a clear understanding of when to use, and when not to use, performance indicators?
- Are appropriate quality safeguards in place?

- Is the combination of indicators suitable to the specific sector, circumstances, and capacity?
- Are the performance indicators (i) clear, (ii) relevant, (iii) cost-effective, (iv) adequate, and (v) monitorable?
- Do managers have clear short- and long-term performance targets?
- Are there sufficient safeguards and reviews of the probable impact of introducing performance indicators on relevant variables?
- Are there feedback mechanisms from the users and the public at large to supply data on performance?
- Are there provisions for systematic periodic dialogue with managers on the problems and successes of their units?
- Are there swift and predictable consequences for nonperformance?
- Is there a systematic collection, analysis, and reporting of performance information to verify compliance with strategic goals and to provide a sound basis for future policymaking and implementation?
- Do agencies use benchmarking (using good practices, processes, or results in organizations with similar challenges against which to compare their own performance)?
- Does MoF as well as sector ministries have “kick-the-tires” groups to test the realism and problems of the specific performance indicators?

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