PUBLIC EXPENDITURE MANAGEMENT HANDBOOK

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This handbook has evolved over the past two years. It reflects the contributions of many people. The handbook was coordinated by Malcolm Holmes, PRMPS. It draws heavily on the work of Ed Campos, Sanjay Pradhan, Ali Hashim, and Mike Stevens of the World Bank, and Bill Allan of the IMF. Other contributors include Allen Schick, Rob Laking, and Serif Sayin. Research support was provided by J.P. Singh and Shiro Gnanaselvan. Jane Armitage reviewed an early version of the handbook. Pascale Kervyn, Helga Muller, and Professor Philip Joyce reviewed the draft. Vicky Mendoza, Agnes Yaptenco, and Mariagracia Schierloh provided technical support and Barbara McGarry Peters edited the handbook. The report was produced by the Poverty Reduction and Economic Management (PREM) Network of the Bank under the guidance of Cheryl Gray.

Comments on the handbook should be addressed to Malcolm Holmes at the World Bank, 1818 H Street, Washington, D.C. 20433; telephone 202-473-7189, fax 202-522-7132, email address mholmes@worldbank.org. Additional material on public expenditure management, much of it elaborating on and updating material in the handbook, can be found on the Bank's internal public expenditure web site. This web site will be regularly updated and it is intended to make it publicly available in the near future.

PART I

Guidelines for Improving Budgetary and Financial Management in the Public Sector

PART II

Diagnosing the Weaknesses and Improving Budgetary and Financial Management in the Public Sector

FOREWORD

Public expenditure issues are encountered wherever there is a discussion of government, the public sector, and development. Over the years, the World Bank has invested considerable resources in analyzing public expenditures and the impacts of different interventions on sustainable development. This work has both broadened and deepened our understanding of development priorities justifying government intervention.

This handbook highlights the fact that good analysis and sound policy are not enough to ensure sound and sustainable development outcomes. As was emphasized in the *World Development Report 1997: The State in a Changing World*, if the institutional arrangements—the rules of the game, both formal and informal—are not supportive or demanding of good performance, the results will not be sustainable on the ground.

Of particular interest is the concept of three levels of budgetary outcomes—aggregate fiscal discipline, strategic prioritization (allocative efficiency), and operational performance (technical efficiency). The need to pay attention to the interaction between these three levels, and to the institutional arrangements within which they are embedded, are compelling messages.

This handbook provides a broad framework for thinking about public expenditure management and how it affects budgetary outcomes. In addition, useful practical insights will reward the diligent reader. Those associated with the production of this handbook would acknowledge that this is not the final word on this subject. More empirical and theoretical work is needed. There is a particular need to understand the lessons from reforming OECD countries for Bank member countries. There is also the need to document the experience of developing countries and economies in transition if we are to have a fuller understanding of what works and what does not.

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INTRODUCTION

This handbook provides a framework for thinking about how governments can attain sound budget performance and gives guidance on the key elements of a well-performing public expenditure management (PEM) system.

The multiple purposes that budgeting serves - legislative control of the executive, macroeconomic stability, allocations to strategic priorities, managerial efficiency - make budget reform an ongoing task, a pilgrimage more than a destination. For any reform agenda, the handbook highlights the importance of the budget's interaction with other systems and processes of government. The handbook therefore focuses attention on three key principles that underpin a well-performing public sector: clarity in who has the authority to make what decisions, the matching of authority (flexibility) and accountability, and the capacity and willingness to reprioritize and reallocate resources.

PRINCIPLES OF SOUND BUDGETING AND FINANCIAL MANAGEMENT

The approach in the handbook is shaped by principles that focus on the institution[1] and are widely accepted as underpinning sound budgeting and financial management.

Comprehensiveness and **discipline** lead the list. This is because the annual budget process is the only mechanism available, at least between elections, to discipline decision making. Comprehensiveness requires a holistic approach to diagnosing problems, understanding all the links and evaluating institutional impediments to performance and then finding the most appropriate entry point to launch phased reform that will eventually expand to become comprehensive. The budget must encompass all the fiscal operations of government and must also force policy decisions having financial implications to be made against the background of a hard budget constraint and in competition with other demands. Effective restraint requires comprehensive coverage, and choosing the most appropriate policy instrument to achieve a particular policy objective means that, for sound PEM, current and capital expenditure decisions need to be linked. Discipline, coupled with economy, also implies that the budget should absorb only the resources necessary to implement government policies.

Legitimacy means that decision makers who can change policies during implementation must take part in and agree to the original policy decision, whether it is made independent of or during budget formulation. Legitimacy also means that decisions made during the budget process should focus on those that affect policy. Associated with legitimacy is the principle that line agencies should decide how to make best use of inputs and that the community and the private sector should make decisions that they are best placed to make.

Flexibility is linked to the concept of pushing decisions to the point where all relevant information is available. Operationally, managers should have authority over managerial

[1] Institution is used in this handbook in the sense of the rules of the game - the humanly devised and socially shared constraints that shape human interaction. For a discussion of the implications of this approach, see "Introduction to the Guidelines for Assessing Institutional Capability" by Sue Berryman.

decisions and, programmatically, individual ministers should be given more authority over program decisions. This must be accompanied by transparency and accountability, but it also requires a tight strategy. Too often in the public sector, implementation is tight but strategy loose.

Predictability is important for efficient and effective implementation of policies and programs. The public sector will perform better where there is stability in macro and strategic policy, and funding of existing policy. This requires attention to the balance between the short term and long term. Fiscal policy must take account of the need to ensure the timely flow of funds to programs and projects. This requires a medium-term approach to the adjustment of budgetary imbalances, program development and evaluation.

Contestability in policy development and service provision is the quid pro quo for greater predictability as it ensures that existing policy is subject to review and evaluation and that line agency performance is subject to continuous improvement.

Honesty denotes a budget derived from unbiased projections of both revenue and expenditure. Sources of bias can be both technical and political. Optimistic projections soften the budget constraint on strategic priority setting and lead to a failure to implement priority policies efficiently and effectively.

Information underpins honesty and sound decision making. Accurate and timely information on costs, outputs and outcomes is essential.

Transparency and **accountability** require that decisions, together with their basis and the results and the costs, be accessible, clear and communicated to the wider community. Transparency also requires that decision makers have all relevant issues and information before them when they make decisions. Decision makers must be held responsible for the exercise of the authority provided to them. These are essential as quid pro quos for greater flexibility and also increase the demand for accurate and timely information.

INSTITUTIONAL ARRANGEMENTS

The handbook centers on improving institutional arrangements and management practices to create incentives for better resource allocation, resource use and financial management. The handbook illustrates effective institutional arrangements, but does not advocate a particular mechanism. It does, however, advocate that each country try to understand how its particular institutional arrangements impact on budgetary outcomes.

The approach has been influenced by the practice of both poorly performing and well-performing governments and by extensive research that builds on the theory of institutions. Theory and practice show that a country's institutions - both formal and informal - have a decisive influence on budgetary outcomes at three levels:

Level 1: Aggregate fiscal discipline
Level 2: Allocation of resources in accordance with strategic priorities
Level 3: Efficient and effective use of resources in the implementation of strategic priorities

The total amount of money a government spends should be closely aligned to what is affordable over the medium term and, in turn, with the annual budget; spending should be appropriately allocated to match policy priorities; and the spending should produce intended results at least cost.

The interdependence of the three levels is one of the most powerful findings of both practice and theory. The pursuit of aggregate fiscal discipline is often done in such a way as to undermine both level 2 and 3 performance - arbitrarily reordering priorities and devastating service delivery and operational performance more generally. Similarly, a lack of discipline and budgetary realism in making strategic policy choices leads to a mismatch between policies and resources, resulting in inadequate funding for operations. More positively, fiscal stability creates an environment that encourages sound level 2 and 3 performance. In turn, sound performance at these levels feeds back into fiscal stability.

World Development Report 1997: The State in a Changing World emphasizes the importance of reinvigorating institutional capability and on balancing restraint with flexibility:

> State capability refers to the ability of the state to undertake collective actions at least cost to society. This notion of capability encompasses the administrative or technical capacity of state officials and of supporting systems and processes, but is much broader than that. It also includes the deeper institutional mechanisms that give politicians and civil servants the flexibility, rules and restraints to enable them to act in the collective interest.

REFORMING PEM

The handbook argues that improvements in PEM require:

- A greater focus on performance - the results achieved with expenditure. This has the potential to engage all stakeholders in pursuit of budgetary and financial management reform.

- Adequate links between policy making, planning and budgeting. This is essential to sustainable improvements in all dimensions of budgetary outcomes.

- Well-functioning accounting and financial management systems. These are among the basics that underpin governmental capacity to allocate and use resources efficiently and effectively.

- Attention to the links between budgeting and financial management systems and other service-wide systems and processes of government - for decision making, for organizing government, for personnel management. A well-performing public sector requires that all component parts work well and, where appropriate, together.

The handbook also provides guidance on how to recognize and deal with weaknesses in budgeting and financial management. It confronts concerns traditionally raised about donor-supported reform efforts. These include political commitment, the balance between simplicity and comprehensiveness, and country implementation capacity.

Political commitment. This clearly is important, but commitment does not occur in a vacuum. In many respects, political will is a function of the quality of the advice provided to politicians and the base of support for reform. Advocates of reform have to confront the reality that political interests are often served by non-transparent, non-accountable systems for resource allocation and use. Involving all relevant stakeholders by focusing on performance at all three levels of budgetary outcomes (aggregate fiscal discipline, prioritization and technical efficiency) is essential to changing the incentives of politicians. This also means that "big bang" reforms are less likely to succeed: the time frame for budgetary reform is not the short term, but the medium to long term. Whether donors contribute to undermining political will in particular situations also deserves attention.

Simplicity/comprehensiveness. This relates to keeping it simple. This is almost certainly true of reform efforts, but they must be based on comprehensive analysis. It is also true that reforming budgetary and financial management systems without paying attention to the other service-wide systems, processes and structures of government is likely to produce little change. An important aspect of comprehensive analysis is an assessment of the informal rules that might stand in the way of effective reform of the formal rules.

Country implementation capacity. An often heard refrain is to match reforms with implementation capacity. This is another form of the plea to keep it simple. A noteworthy dimension of this admonition is the need for donor coordination. The implementation capacity problem is importantly a function of donor demands. At the same time, the institutional approach taken in the handbook emphasizes expanding capacity by getting the incentives right. As a minimum, attempting to build capacity from the supply side without addressing the incentives embodied in the institutional framework will do little to improve performance. Building systems and processes that both encourage and demand performance will, in turn, unleash human and organizational capacity.

WHAT'S WRONG WITH BUDGETING

The decision to prepare this handbook came out of the continuing poor budget performance in many countries and draws strength from the improvement in budget outcomes over the past 20 years in a number of countries.

Poor performance is often to be found in the weak links between policy making, planning and budgeting (Box 1). At one level, policy making and planning are unconstrained by what a country will be able to afford over the medium term. At another level, policy making and planning are insufficiently informed by their budgetary implications and by their likely impacts in the wider community. The inadequacy of hard budget restraints on decision makers at the planning and budget formulation stage of the cycle leads to inadequate funding of operations, poor expenditure control and unpredictability in the flow of budgeted resources to agencies responsible for service delivery.

BOX 1
WEAKNESSES IN RESOURCE ALLOCATION AND USE

Weaknesses that undermine public sector performance include:

- Poor planning;
- No links between policy making, planning and budgeting;
- Poor expenditure control;
- Inadequate funding of operations and maintenance;
- Little relationship between budget as formulated and budget as executed;
- Inadequate accounting systems;
- Unreliability in the flow of budgeted funds to agencies and to lower levels of government;
- Poor management of external aid;
- Poor cash management;
- Inadequate reporting of financial performance; and
- Poorly motivated staff.

Readers will be all too familiar with the link between undisciplined fiscal policy and the resulting adverse consequences on the economy and on the poor - those least able to protect themselves. Less often is the link made between ineffective budgeting systems and unsustained policy choices and sectoral allocations delinked from strategic priorities. More rarely is the link made between poor budgeting systems and unsustained policy choices and sectoral allocations. Even where links are made, they rarely become a rationale for budget reform.

The inexorable growth of "investment projects" and public sector employment means that the annual budget process allocates extremely limited domestic resources to keep too many projects and activities alive. This places upward pressure on expenditure (manifested as arrears in many countries). The lack of comprehensiveness in the coverage of fiscal operations also leads to weak PEM systems. This is associated with a lack of transparency and the often well-founded assumption that there will always be some fund or donor to bail out the individual, the project, the program, the sector or the country. In turn, this soft budget constraint is reinforced by the lack of timely expenditure data and accountability mechanisms that focus attention on results.

Another characteristic of weak PEM is the incentive to spend budget allocations as soon as possible - there is no guarantee that the funds appropriated will be available later in the year. Perhaps the best indicator of the state of the PEM system is the relationship between what is budgeted and what is actually spent at the program level. Rather than looking for the problem in budget execution, reformers need to look at the relationship between policy making, planning and budgeting.

Poor aid management also signals a weak PEM system. Not surprisingly, countries heavily dependent on aid are more likely to have weak PEM. Major problems emerge from different priorities (not only between a donor and a country, but between donors) and the poor coverage of aid funding in the budget.

These weaknesses are not newly discovered. In 1980, Caiden wrote: "If ever there was a subject which has been overwritten, overanalyzed and overtheorized with so little practical result to show for the effort, it is budgeting in poor countries."

Box 2 outlines assumptions about budgeting in developing countries, as perceived by Caiden.

BOX 2
TEN COMMON (AND QUESTIONABLE) ASSUMPTIONS ABOUT BUDGETING IN DEVELOPING COUNTRIES

- There is a common pattern of budgeting that will fit all circumstances.
- The aim of budgeting is economic planning.
- Improved budgeting depends on adequate resources.
- Budget decisions can be separated from policy decisions.
- Whatever is best coordinated is best.
- Comprehensive decisions are superior to partial decisions, and complex solutions are better than simple solutions.
- The prerequisites of budgeting are a matter of technique and will, rather than the product of environmental conditions.
- Politics are not as important as economics.
- Good budgeting is a matter of regulation.
- Budgeting is relevant to development.

Source: Caiden, "Budgeting in Poor Countries: Ten Common Assumptions Re-examined," *Public Administration Review*, January/February 1980.

The evolution of budgeting over the past 100 years has influenced the practice of resource allocation and use in all countries. It is easy to say that developing countries are different, but all countries need effective fiscal discipline, a capacity to allocate resources to strategic priorities and to use resources efficiently and effectively. It is reassuring that the key weaknesses that led to the burst of budget reform in OECD countries over the past 20 years all have their parallels in developing countries and economies in transition (Box 3).

Have we really learned anything in the past 20 years that justifies further writing, analyzing and, yes, even theorizing? We believe the answer is yes, and Schick's idea about "Getting the Basics Right" - discussed in the next section - gives us a clue as to why. What we have needed is a much broader view of what the basics are.

BOX 3
THE CHARACTERISTICS OF BUDGET SYSTEMS REQUIRING REFORM

Many of the weaknesses in budgeting reflect the failure to address linkages between the various functions of budgeting. The following factors contribute to budget systems and processes that create a disabling environment for performance in the public sector, both by commission and by omission:

- Almost exclusive focus on inputs, with performance judged largely in terms of spending no more, or less, than appropriated in the budget;
- Input focus takes a short-term approach to budget decision making; failure to adequately take account of longer-term costs (potential and real), and biases in the choice of policy instruments (e.g., between capital and current spending and between spending, doing, and regulation) because of the short-term horizon;
- A bottom-up approach to budgeting that means that even if the ultimate stance of fiscal policy was appropriate (and increasingly after 1973 it was not) game playing by both line and central agencies led to high transaction costs to squeeze the bottom-up bids into the appropriate fiscal policy box;
- A tendency to budget in real terms, leading either to pressure on aggregate spending where inflation is significant (which was often validated through supplementary appropriations) or arbitrary cuts during budget execution with adverse consequences at the agency level;
- Cabinet decision making focused on distributing the gains from fiscal drag across new spending proposals;
- Cabinet and/or central agencies extensively involved in micro decision making on all aspects of funding for ongoing policy;
- Last minute, across-the-board cuts, including during budget execution;
- Weak decision making and last-minute cuts cause unpredictability of funding for existing government policy; this is highlighted to the center by central budget agencies on the alert to identify and rake back "fortuitous savings;"
- Strong incentives to spend everything in the budget early in the year and as quickly as possible, since the current year's spending is the starting point for the annual budget haggle and the fear of across-the-board cuts during execution;
- Existing policy itself (as opposed to its funding) subject to very little scrutiny from one year to the next. (This and previous point epitomize the worst dimension of incremental budgeting.);
- Poor linkages between policy and resources at the center, between the center and line agencies, and within line agencies because of incremental budgeting;
- A lack of clarity as to purpose and task and therefore poor information on the performance of policies, programs and services, and their cost because of poor linkages;
- The linking together (in association with the point above) within government departments of policy advising, regulation, service delivery and funding and an aversion to user charging; and
- Overall, few incentives to improve the performance of resources provided.

GETTING THE BASICS RIGHT

In 1997, Schick argued that the lesson for developing countries, from perhaps the most radical reform of the core public sector among OECD countries, was "Get the Basics Right" (Box 4). In other words, reformers should focus on the basics on which reform is built, not on particular techniques. This means that central budget agencies have to take the lead in putting in place the basics to support all three functions of the budget - control of public resources, planning for future resource allocation and management of resources - and should build institutional mechanisms that support and demand a performance orientation for all dimensions. "Getting the basics right" also means that there should be a balance between restraint and flexibility and recognizes that this will shift as the basics are embedded. Introducing mechanisms to promote transparency and accountability, key elements of the restraint framework, will check abuse of flexibility and generate demand for information. As chapter 5 emphasizes, however, budget reform is not something that can be neatly sequenced. Reform will attract the interest of decision makers where it is directed at solving a particular problem. Reformers must be opportunistic and use performance problems to drive a demand for "getting the basics right."

BOX 4
GETTING THE BASICS RIGHT

In elaborating his argument for "Getting the Basics Right," Schick states:

- Foster an environment that supports and demands performance before introducing performance or outcome budgeting.
- Control inputs before seeking to control outputs.
- Account for cash before accounting for accruals.
- Establish external controls before introducing internal control.
- Establish internal control before introducing managerial accountability.
- Operate a reliable accounting system before installing an integrated financial management system.
- Budget for work to be done before budgeting for results to be achieved.
- Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
- Have effective financial auditing before moving to performance auditing.
- Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

STRUCTURE OF THE HANDBOOK

The handbook is divided into two parts. Part I consists of five chapters.

Chapter 1 reviews the evolution of 100 years of budgeting practice, highlighting responses to the growing and multifaceted demands being placed on the budget. This chapter suggests that approaches to budgeting, resource allocation and financial management are constantly changing to reflect which of the three functions of budgeting is in the ascendancy - control of public resources, planning for the future allocation of resources or management of resources. The Chapter focuses particularly on the lack of sustainability of budget reforms built around particular tools or techniques. Key messages are that reform efforts usually fail because they are incomplete and that public sector policy making, planning, budgeting, and management systems and processes must be integrated.

Chapter 2 elaborates the institutional arrangements that affect incentives for better budgetary outcomes, including mechanisms that improve aggregate fiscal discipline, strategic prioritization and operational efficiency. The chapter discusses the political nature of budgeting and the need to balance restraints with flexibility. Transparency and accountability figure importantly in this process. Transparency demands that the reasons for decisions and the results and costs of these decisions be accessible, clear and communicated to the wider general public. Transparency also means that decision makers should have all relevant issues before them when they make decisions. Accountability means that decision makers at all levels must be held accountable for the exercise of the authority (flexibility) provided to them. The chapter also argues that information on expenditure, costs and results is crucial to both decision making and effective expenditure control. The chapter ends by explaining how these concepts can be made operational at the three levels.

Chapter 3 deals in some depth with linking policy, planning and budgeting at both a sectoral level and across the whole of government. The chapter provides guidance on institutional mechanisms that facilitate the allocation of resources over the medium term based on strategic objectives. The chapter states that affordability must influence policy making, planning and budgeting early in the budget cycle and that adjustment will only be sustained where it takes place through policy change. A medium-term approach that encompasses all expenditure provides a linking framework and facilitates the management of policies and budget realities to reduce pressure throughout the whole budget cycle. The result is better control of expenditure and better value for the money within a hard constraint. Medium-term expenditure planning at the sector and government-wide levels are linked. Necessary components of the whole-of-government system include information on the costs of existing policies and programs over the medium term, a sense of what is affordable in aggregate over the medium term, and mechanisms to set priorities inter- and intrasectorally in the process of resolving the tensions between what is affordable and what is demanded.

Chapter 4 provides guidance on improving accounting and financial management information systems (FMIS), an essential part of an efficient PEM system. The chapter takes a modular approach to integrating a FMIS, starting with a core accounting system to meet basic information needs. The core would contain modules for accounts payable, accounts receivable and the general ledger. This system would support forecasting at the macro level, budget preparation and approval at the strategic level, and budget execution, core accounting and fiscal reporting at the operational level. Subsidiary systems that are also essential to a well-performing public sector are described - payment, cash, debt and civil service management systems, revenue administration, and auditing. With the core as a foundation, government could then expand as capacity developed to move toward a fully integrated FMIS.

Chapter 5 explains how current approaches to reform reflect the lessons of previous experience. This chapter argues that reform efforts fail not only because they are incomplete, but also because they are often designed to solve a technical problem when the problem lies in the institutional framework. The chapter suggests institutional changes that governments might need to make in the framework and points out that the changes are most likely to be successful where some overall vision of a well-performing public sector frames the reform agenda. The chapter also suggests that sequencing take account of the state of the basics, but that reform proceed in parallel at the center of government and at the sector/organizational level. Central agencies focus on reforming the policy, planning and budgeting systems so that they are more supportive and demanding of a performance orientation, while sector and agency level bodies focus on developing outcome and output information, supported by cost information.

The key message of this chapter, and of the handbook, is that sustainable reform, whether it be comprehensive or concerned with one component of the system, will be built by considering all three levels of budgetary outcomes and the broader political, social and economic environment. The chapter concludes with a summary of the components of successful reform programs: aggregate, binding fiscal targets; incentives for better allocation and use of resources; autonomy of line agencies; and accountability of line managers. The conclusion also emphasizes the broader context within which reform is embedded and that a well-performing public sector requires: a clear understanding of who has the authority to make what decisions; the matching of authority (flexibility) and accountability; the capacity and willingness to reprioritize and reallocate resources.

Each chapter highlights in boxes particular concepts of sound resource allocation, budgeting or financial management, drawing on country experiences wherever possible.

Part II of the handbook contains diagnostic checklists and questionnaires for use by World Bank task managers and member countries to pinpoint country strengths and weaknesses in budgetary and financial management practices.

CHAPTER 1
DEVELOPMENTS IN BUDGET PRACTICE

An emerging consensus on the role of the budget across all countries centers on how the budget affects: (a) macroeconomic performance; (b) allocation of resources; and c) efficiency and effectiveness of resource use. This chapter reviews over a hundred years of budget reform, which contributed to the current consensus.

A HISTORICAL PERSPECTIVE ON BUDGET REFORM

The broad functions of budgeting that are competing for attention are: control of public resources, planning for the future allocation of resources and management of resources. The relative strength of each depends on the current view of the function of budgeting and budgeting tool and techniques, but also depends on the strength of particular organizations and/or institutional arrangements to support these functions. Throughout much of the century, Ministries of Finance and Central Banks (and the IMF) have been aggressive advocates of control of public resources. They have usually been supported by institutional arrangements whereby all revenues have to be paid into a central fund and only are drawn on by authority of the legislature. This helps explain why line item budgeting has been so enduring. Support for the other two functions has been much more ephemeral. Allen Schick's argument in the Introduction, "Getting the Basics Right," i.e., focusing on the basics on which reform is built, not on particular techniques, means encompassing all three functions as legitimate and building institutional mechanisms that support a performance orientation for all of them. Central budget agencies have to take the lead in focusing attention on these three dimensions.

Line Item Budgeting

Prior to the late 19th century, budgeting in most countries was characterized by weak executive power, little central control and processes that were idiosyncratic. Traditional "line item" budgeting is itself a reform born of a concern that the lack of adequate spending controls was contributing to an environment where there was increasing danger of substantial corruption. For this reason, the budget reformers of the late 19th and early 20th century advocated budgeting systems that would promote accountability over the detailed use of resources. The early reform movement focused on the effective control of budget accounts, establishing economy and, to a lesser extent, efficiency as the primary values of budgeting.

In a line item system, expenditures for the coming year are listed according to objects of expenditure, or "line items." These line items are often quite detailed, specifying how much money a particular agency or subunit will be permitted to spend on personnel, fringe benefits, travel, equipment, and the like. The most important focus of the budget system is to specify the line item ceilings in the budget allocation process and to ensure that agencies do not spend in excess of their allocations. In many systems, central budget offices and finance ministries play the role of "controller" through establishing detailed procedures designed to prevent overspending. The strengths of such a system lie in its relative simplicity, lack of ambiguity, and potential for control of expenditures through easy comparison with prior years and through the detailed specification of inputs.

The line item approach was not compatible with the demands accompanying the expansion of government. Budgets organized according to line items gave no information about why money was spent, or on the efficiency and effectiveness of programs. Further, these line-item systems were almost all associated with a short time horizon, leading to failure to take longer-term costs into account. In addition, the focus on detailed line-item control led to micromanagement of agency budget implementation by central budget offices and finance ministries. Many subsequent budget reforms have attempted to remedy these deficiencies, first by focusing on management through a budgeting approach known as performance budgeting, and later by focusing on policy and planning through the more ambitious program budgeting. More recently, it has been recognized that the problem with budget structure is not so much with line item budgeting as with excessively tight ex ante control of the detail and the lack of a performance orientation in public sector institutions.

Performance Budgeting

This type of budgeting drew on a long-term concern with the efficiency of government and attempted to integrate information about government activities into the budget process so that budget decisions could be based to a greater degree on the relationship between what government did and how much it cost. The specific reform, known as "performance budgeting," was designed to allow managers to develop measures of workload and unit cost.

A performance budget usually divides proposed expenditures into activities within each organization and a set of workload measures that relate the activity performed to cost. Performance budgeting allows the budget to be built, not incrementally (as in traditional line item budgeting), but on the basis of anticipated workload. Managers could arrive at a budget by simply multiplying the cost of a unit of output by the number of units needed in the next year.

Performance budgeting indicated a shift from budgeting based on expenditure control, to budgeting based increasingly on management concerns. The emphasis was not on making government-wide budgetary trade-offs, but on measuring the workload of an agency. The focus was on the work to be done, not on the usefulness of the objectives themselves. Performance budgeting was rarely adopted as a government-wide budgetary process, but is significant because it emphasized the integration of activity information and budgeting. This emphasis was to be continued in future reform efforts.

The major criticism of performance budgeting was that efficiency - an important goal in budgeting - is an inadequate criterion for allocation. One of performance budgeting's key strengths - linking what was to be produced with the resources required within the annual budget cycle - was also a weakness in that it distracted attention from policy outcomes, which require a perspective beyond the annual budget cycle. What was needed, according to these reformers, was a method of budgeting that would also take into account the effectiveness of expenditures. These considerations led to program budgeting.

Program Budgeting

Beginning in the 1960s, reforms began to focus on planning for the use of public resources. The predominant early reform of this type, program budgeting, is most closely associated with the efforts to institute a planning-programming-budgeting system (PPBS) during the administration of U.S. President Lyndon Johnson. In this chapter, similar systems will be called program budgeting.

In contrast to performance budgeting, program budgeting was explicitly focused on budgetary choices among competing policies. While performance budgeting was designed to discover the most efficient method of accomplishing a given objective, program budgeting treated the objectives themselves as variable. Program budgeting was not a management system, but a resource allocation system. It was a specific alternative to the traditional manner of making budgeting trade-offs, which focused on marginal adjustments to the status quo. Program budgeting attempted to link program costs with the results of public programs.

Key to program budgeting is the program - a public policy objective along with the steps necessary to attain it. The budget is classified in terms of programs, rather than along organizational lines. Program budgeting requires that program objectives stretch beyond a single fiscal year. In addition, program budgeting requires effectiveness measures, which means the measurement of outputs and outcomes. Advocates of program budgeting hoped that budget allocation decisions would be made according to the marginal value that could be attained from varying use of public resources.

Program budgeting is the principal budget reform (beyond traditional line item budgeting) that has been exported to developing countries. In practice, program budgeting has not been very successful in either developed or developing countries. Criticisms range from those who believe that program budgeting is so flawed in concept that it would be inapplicable in any setting, to those who believe that the prerequisites that would be necessary to bring the reform to developing countries are currently not present.

The principal argument is that it flew in the face of existing budgetary traditions and relationships; in particular, many people strongly objected to the suggestion that the budget process, which is inherently political, could be made "rational." To these people, even the idea of a program (not at all self-evident) is political. Further, the effort often failed because the attempt to create programs independent of organizational affiliation proved impossible, in light of the incentives present for civil servants to think in organizational terms. Program budgeting has had an impact where programs have been agency or, at most, sector specific. In addition, critics argue that it is impossible to compare programs on the basis of effectiveness and choose among them, since there is no common index of worth for public programs.

Other critics do not see program budgeting itself as a flawed concept, but rather stress the conditions that are needed for program budgeting to be successful. These might include, for example, adequate information about programs and about social, economic and environmental conditions. Critics argue that these conditions are not present in many countries, thereby making it impossible for program budgeting to take root and flourish. In addition, they argue that developing countries often lack the trained personnel needed to carry out the requisite analyses, although this point is usually exaggerated. More serious is the lack of stability necessary to enable longer-term budgetary planning and the lack of consistent political commitment necessary to allow the reform to be fully implemented. Boxes 1.1 and 1.2 present evidence for these criticisms, but particularly point out the lack of a necessary foundation for budget reform in Sri Lanka and Jamaica.

BOX 1.1
PROGRAM BUDGETING IN SRI LANKA

Sri Lanka engaged in budget reform in earnest beginning in 1969. This ultimately led to the widespread adoption of a system that closely paralleled program budgeting. By 1974, virtually the entire government was presenting the budget in a program budget format. By 1975, a modest amount of performance data was also being presented by each of the twenty-three ministries.

The program budgeting reform was spearheaded by a program budget unit, which was established in the Ministry of Finance in 1971. This unit issued guidelines on budget preparation, designed the required documentation, advised departments on the development of performance measures and objectives, and reviewed department performance against budgeted targets. By the mid-1970s, the Sri Lankan budget reform seemed set to succeed.

In 1977, the socialist government was replaced by a free-market focused government. The program budget unit was disbanded by the new government, depriving program budgeting of focus and impetus. Department budget offices continued to submit the required reports for a time, but the sanctions that had existed for failure to do so were eliminated and ministries became much more lax in their adherence. Further, by the 1980s, the government no longer had any method of forecasting cash flows. Following the recommendation of the IMF, each ministry was required to report monthly expenditures, but not in relation to programs or performance. Sri Lankan budgeting came full circle; cash flow budgeting triumphed over performance monitoring.

Program budgeting failed in Sri Lanka for these reasons: (a) the reform had found no powerful friends in the executive or the legislature; (b) there was a lack of skilled manpower to carry out the reform; (c) program budgeting occurred without important parallel financial and administrative reforms - particularly related to accounting and auditing - that might have sustained it; (d) the replacement of organizational structure with programs as the focus of decision making did not occur and, perhaps most important; (e) a rapid, comprehensive and centralized introduction of program budgeting was ill considered in the Sri Lankan administrative environment. A more cautious and selective approach would have increased the likelihood that the reform could have been sustained.

Source: *Government Budgeting in Developing Countries*, Chapter 6, Peter Dean.

However, the disappointments with program budgeting are not limited to developing countries. Many of the problems identified in developing countries contributed to disappointing results in developed countries as well. One problem is that such reforms can quickly be overwhelmed by the information they generate. Reforms linked to program budgeting also have a centralizing tendency that overwhelms the center and can alienate line agencies. Second, tools or techniques designed to enhance program or agency performance will only add value when they are introduced into a public sector where other institutional arrangements support a performance orientation. Third, the performance information generated on program outcomes will be only one of the pieces of information feeding into resource allocation decisions. Too often there have been unrealizable expectations that the performance information will provide “the answer.” Even where a form of program budgeting has taken root, the links between annual budget allocations and longer-term policy outcomes are elusive.

BOX 1.2
BUDGETING IN JAMAICA

The Jamaica Public Administration Reform Project, approved by the World Bank Board in May of 1984, contained three components: human resource management, financial resource management, and line agency restructuring. The financial management reforms included US $600,000 to help the government convert from a line-item budget system to an output-oriented performance budget system.

This portion of the project was not considered a success. This is partially the result of poor project design, which did not recognize that the same problems that existed in the previous line-item system (poor organization, poor planning, and lack of expenditure and revenue forecasting ability) would impair a new system as well. The fact that accounts were kept only manually and in a line-item format was a significant impediment to the development of the new system. The starting point should have been a revamped accounting system, but no provision was made for this.

There were significant problems in implementation. The reports that were necessary for the operation of the system often either were not filed in a timely fashion, or not at all. The speed of implementation was satisfactory, but no corrective actions were taken in response to problems identified in the early phase. These included the fact that quantitative performance measures were often a very misleading proxy for the type and quality of goods and services provided. Budget presentation never translated into budget implementation nor into accountability for performance. Line ministries did not have commitment to the system, and the desire of the Ministry of Finance to hold ministries accountable for the use of line items undermined the reform to performance accountability.

Source: Project Completion Report, Jamaica: Public Administration Reform Project (Loan 2423-JM).

Zero-based Budgeting (ZBB)

In a "pure" ZBB system, a 1970s era reform, instead of concentrating on budgetary changes at the margin, all programs are evaluated each year. The process of arriving at a budget is literally to start from scratch. At the national level, that would require answering such questions as, "What if we didn't have an army and navy?" or "What if Social Security did not exist?" In practice, no government ZBB system went this far. Many more governments have used a variant of ZBB in which agencies were asked to rank their programs within funding limits. The question thus became, "What if the Ministry of Defense only received, e.g., 90 percent of the current year's funding?" This has not proved useful as an annual budget tool, although there have been examples where one-off use of this approach has been useful.

THE WAY FORWARD

Advocates continue to suggest that the failures of these performance-oriented tools or techniques have been in implementation, rather than in concept. They contend that the system could succeed with strong political backing, a program of training, gradual introduction of the system, and complementary reforms that would encourage performance. Still, a truly successful performance tool or technique is hard to find anywhere, particularly at the central government level. What can be said is that where budgeting systems and processes are performance oriented it is because the institutional framework both encourages and demands performance. Such a framework embodies incentives for ministers to cooperate on key strategic decisions; for individual ministers to be given authority over program decisions and to be held accountable for living within their budgets; and for managers to manage, but the framework demands that they manage well.

The following chapters will focus on how all three functions - control of public resources, planning for future allocation of resources, and management of resources - can be addressed simultaneously and will emphasize the key role of institutional mechanisms that promote transparency and accountability. The focus will continue to be dominated by executive government. However, since the failure of many of the reforms based on the tools and techniques discussed above can be linked to their failure to address the interests of the full range of stakeholders who are affected by the performance of the budget, institutional mechanisms to engage these stakeholders are also highlighted. It is many of these latter factors that provide the incentives for politicians to take performance seriously.

The final chapter will argue that in considering the sequencing of reform, line item budgeting can be adapted to be a key component of a budget system and process that creates strong incentives for a greater performance orientation. It is one of the basics that has to be functioning effectively before more performance-oriented tools and techniques such as performance and program budgeting can be sensibly introduced. But the message of this handbook is that a performance orientation is not very much about particular tools, techniques or structures, but rather the appropriateness of a country's institutional arrangements.

CHAPTER 2
INSTITUTIONAL ARRANGEMENTS FOR BETTER BUDGETARY OUTCOMES

The experience of the 100 years of reform, discussed in chapter 1, and important theoretical developments in the field of institutions have provided new insights into what goes into a well-performing budget system.

One is the acknowledgement that the budget has an impact on three levels of public sector outcomes:

1. aggregate fiscal discipline
2. resource allocation and use based on strategic priorities
3. efficiency and effectiveness of programs and service delivery

These three levels are a reformulation of the three functions - control of public resources, planning for the future allocation of resources, and management of resources - that have driven reform over the past 100 years.

A second insight is that institutional arrangements - the rules of the game, both formal and informal - influence the quality of the outcomes. Underlying the approach in this handbook is the premise that resource allocation is fundamentally political and that budgeting plays a key role in disciplining decision making - from the political to the managerial.

This institutional perspective in no sense means that the traditional concerns about budgetary performance are to be ignored. On the contrary, some - notably concerns about the budgetary information base - become even more important. The institutional approach looks at these issues through a somewhat different lens - the lens of the rules of the game. Perhaps the tendency to overestimate revenue in many countries reflects not so much technical shortcomings as the incentives operating on the system. Box 2.1 illustrates that politics lies at the heart of overestimating revenue. Perhaps the failure to implement advanced integrated financial management information systems (FMIS) is not a result of technical and capacity shortcomings, but rather the inadequate incentives to demand information for the potential users of the outputs of the system, notably politicians and high-level public sector managers.

A third insight is that the budget will only function effectively on the three levels if decision making and management systems and processes are performance oriented. Budgetary reforms will not automatically lead to better budgetary outcomes if nonbudgetary institutional arrangements are not supportive. The budget is too often seen as a process unto itself, when it is part of a broader set of governing, institutional and management arrangements. Figure 2.1 shows that the budget process, system and directly related institutional arrangements may largely explain level 1 outcomes. But, by the time we get to level 3 outcomes, the budget is only one influence among several, all of which need to be pulling in the direction of better performance if outcomes are to improve.

BOX 2.1
REVENUE PROJECTIONS IN THE PHILIPPINES

In the Philippines, overly optimistic revenue projections have marked the budget process. Politics accounts for a significant part of the problem. Strong pressures are imposed on analysts to produce such projections for the annual budget and the medium-term expenditure framework (MTEF). Because politicians in reality tend to *cut* (not raise) taxes and strenuously avoid legislating tax increases, the projected revenue stream rarely materializes. The end result has typically been cutbacks in the allocation of funds to agencies, required by "unforeseen circumstances."

Two recommendations have been suggested to address these concerns:

1. Technical assistance might help develop a revenue estimating model. Since the existing poor quality of revenue estimation is in part due to the absence of adequate data, an important first step would be to ensure that the type of information needed for proper estimation of revenue is collected and processed. The second step would be to develop a more sophisticated revenue estimation capability in the Department of Finance.

2. Institutional reform might also help in making revenue projections more realistic. Cabinet and others should restrain themselves from pushing revenue analysts to make overly optimistic forecasts. One way to avoid this would be to have an outside group of experts make the economic forecasts which serve as the basis for the budget. This approach is used in several countries (e.g., Netherlands, which uses forecasts made by a committee of experts) and is accepted as an unbiased determination.

Source: Penner, Rudy, et al, "Capital Budgeting in the Philippines" (draft), Prepared under USAID Contract # 492-0450-c-00-3091-00, 1994.

BALANCING RESTRAINT AND FLEXIBILITY

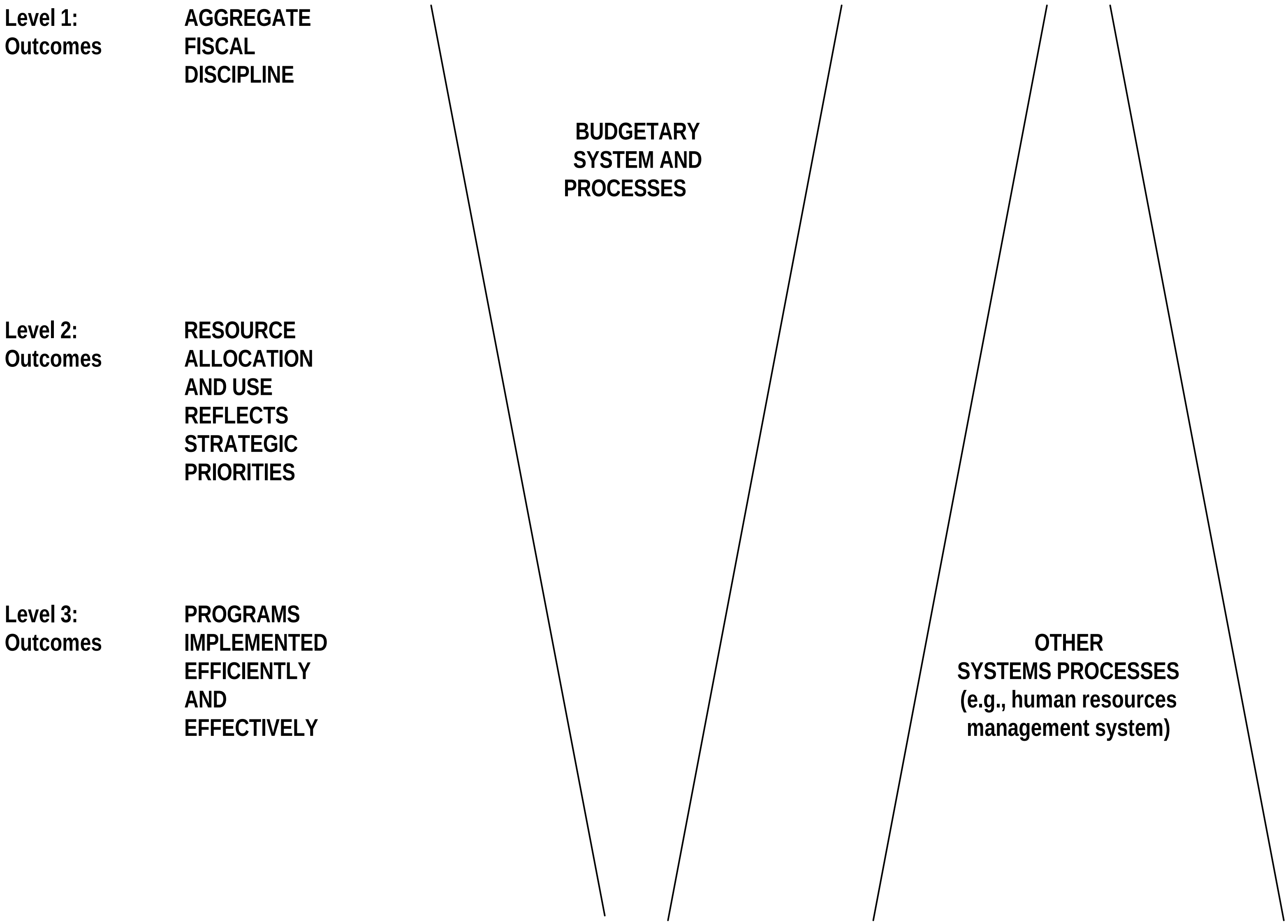
Chapter 1 points out that the focus of budgetary reform efforts has often been either too narrow or too technical (and more often than not, both). Institutional arrangements must be designed so as to discipline and facilitate decision making and the scrutiny of those decisions by the appropriate players, whether that be the President, ministers collectively, individual ministers, the legislature, the community, central agencies, line agencies, individual managers, or front line service providers.

These players often have dual roles, both as creators of institutional arrangements (regulators) and as performers of tasks (doers). A well-performing public sector will have a clearly defined system of authority delegation. Figure 2.2 highlights the downward delegation to agents, the upward reporting requirements by agents and the associated institutional arrangements and their organizational support, which underpin a well-functioning government. The conceptual framework mainly represents delegation of authority and control mechanisms

Figure 2.1

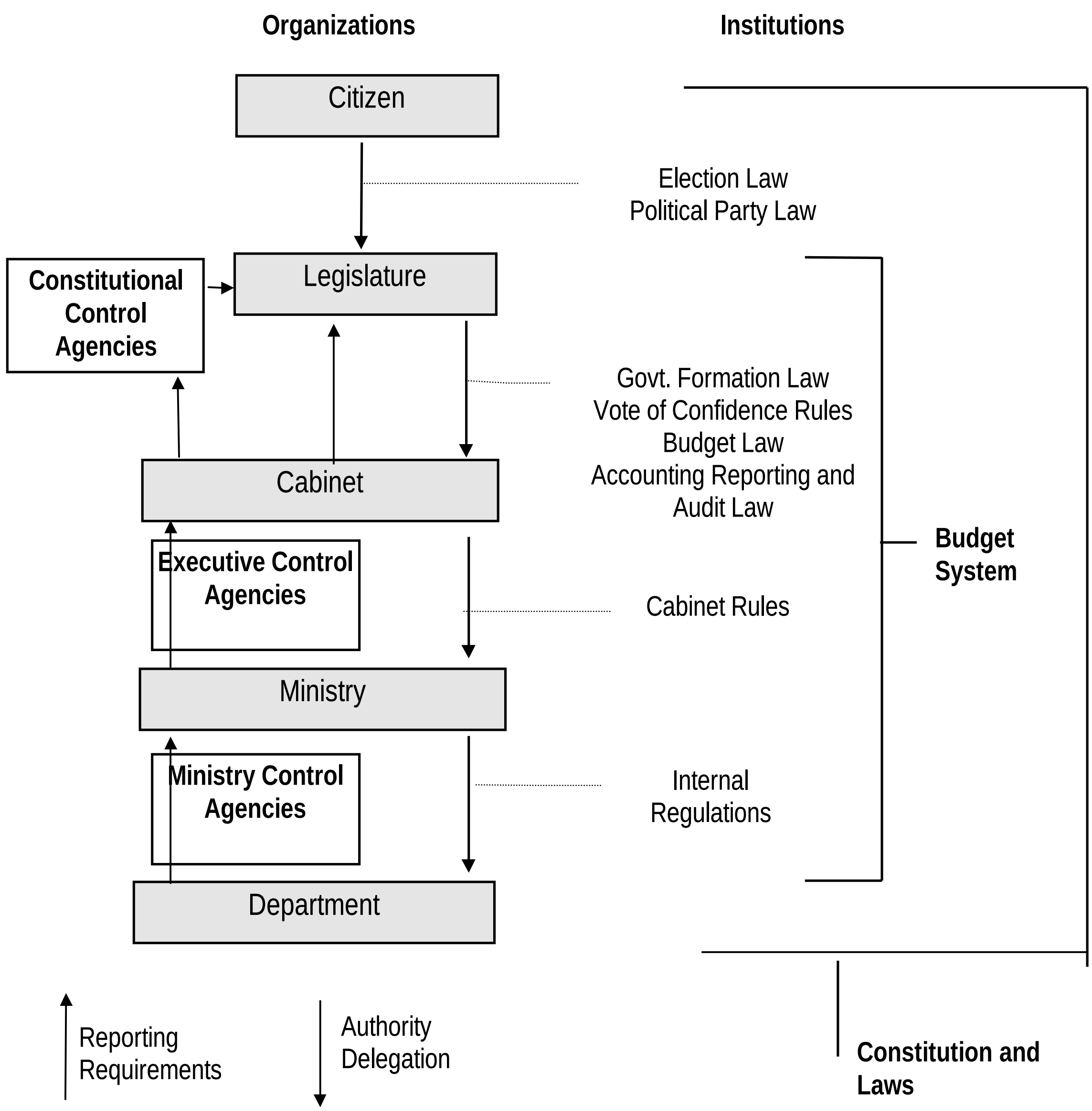
RELATIVE IMPORTANCE OF DIFFERENT ELEMENTS OF THE INSTITUTIONAL FRAMEWORK AT EACH LEVEL OF BUDGETARY OUTCOME

INSTITUTIONAL ARRANGEMENTS



in a parliamentary system of government. There are, of course, variations of this model such as the more diffused system of authority and control within the presidential system of government. In such systems, the inter-relationships are not quite so linear, but mechanisms (checks and balances) have nevertheless been developed to balance autonomy and flexibility with restraint.

Figure 2.2
CONCEPTUAL FRAMEWORK



The regulatory design and the decisions on "which player does what" reflect a concern, implicit or explicit, for what is known as the agency problem. Agents to whom authority is delegated face incentives that are different from those of their principals. This can contribute to outcomes at variance with those sought by principals, particularly considering the inevitable information asymmetries.

At the apex of the formal regulatory framework in most countries is the Constitution. Below that there are many formal and informal rules that bear on budgetary outcomes. These institutional arrangements regulate the relationships among the players, through a combination of regulations external and internal to executive government, simultaneously to impose restraints, define flexibilities and set, monitor and enforce standards. The latter requires information, transparency and accountability mechanisms.

Getting the right balance between restraint and flexibility is the key to better outcomes at all three levels. The challenge for each country is to determine the appropriate balance. Introducing mechanisms to promote transparency and accountability—key elements of the restraint framework—will check abuse of flexibility and generate demand for information.

Restraint. Far too often policy and planning decisions are insufficiently disciplined (restrained) by the realities of the budget constraint over the longer term. The absence of restraint early on in the policy, planning and budgeting cycle often results in weak expenditure control further down the line - a common symptom of poor expenditure management, and evident in many countries. A genuinely hard budget constraint has been shown to be one of the central features of a well-performing public sector (Box 2.2). But, to be fully effective, the constraint must be realistic, particularly in relation to sector policy demands, and it must involve a significant degree of predictability.

BOX 2.2
BUDGETARY INSTITUTIONS THAT PROMOTE AGGREGATE RESTRAINT HELP AVOID LARGE DEFICITS

A recent study of 20 Latin American countries suggests that greater transparency and hierarchy (i.e., systems that give considerable power over departmental spending totals to the Ministry of Finance) are associated with lower budget deficits. The study found that countries with the least transparency and fewest aggregate spending controls ran public deficits averaging 1.8 percent of GDP, while those with the highest combined transparency/aggregate control mechanisms ran surpluses of, on average, 1.7 percent of GDP.

Source: World Development Report (based on WDR Background Paper: Alesina, Alberto, "Politics, Procedures and Budget Deficits"), 1997.

Performance at all three levels of budgetary outcomes is adversely affected where the absence of restraint begins with weak aggregate fiscal discipline. At the same time, caution should be exercised since imposing overly rigid restraints at the top may help to maintain discipline at the aggregate level but may not necessarily translate into improvements at the sectoral and organizational levels. For example, the rules of the supranational central bank have contributed to aggregate fiscal restraint in many of the African Francophone countries affiliated with the CFA zone. This has led to the buildup of arrears in many countries, and it does not appear to have led to a greater concern for level 2 and, particularly, level 3 outcomes.

Lack of restraint in policy making and planning means that resources for the annual budget are too often already overcommitted. The consequence is inadequate funding for operations and maintenance. World Bank Public Expenditure Reviews (PER's) have shown clearly how future resourcing needs to support past and current policy, and planning decisions cannot be met. Box 3. 3 in chapter 3 illustrates remedial actions. Yet countries, often with the active support of donors, continue to pursue an expansionary planning path. Decisions do not adequately consider future cost and the likely future aggregate resource constraint. Institutional mechanisms that symbolize and promote this situation are the dual budget system and the traditional Public Investment Program (PIP).

Mechanisms to promote aggregate fiscal restraint during budget formulation are important and help to improve overall expenditure control. However, restraint during the budget year is also important to minimize resource reallocations during the year. This practice is rampant in many countries, signaling that either the original budget did not reflect the real priorities of government or that financial and/or policy discipline does not exist (Box 2.3). Either way, strategic priorities are unlikely to be properly reflected in actual expenditure, and operational performance will be adversely affected. At the same time, the legitimacy of the budget process and the credibility of budget ceilings will be undermined.

BOX 2.3
DIVERGENCE BETWEEN BUDGETED AND ACTUAL SPENDING IN UGANDA

To increase allocations to important, yet underfunded, sectors, Uganda identified a number of Priority Program Areas (PPA's) in the early 1990s that would receive priority in resource allocation. Donors supported this approach by linking funding flows to increases in budget allocations for PPA's. However, review of actual spending patterns indicated that actual spending was largely at variance with budgeted priorities. Large amounts of supplementary expenditures were incurred by powerful ministries. The result was that the average deviation in actual allocation versus budgeted allocation for PPA's was over 90 percent, with the range varying between 70 percent for the Ministry of Education and 590 percent for the Ministry of Justice.

Source: Campos, Ed and Pradhan, Sanjay "Budgetary Institutions and Expenditure Outcomes," 1996.

Increased restraint contributes to better budgetary outcomes, but so does increased flexibility. The important task, therefore, as Schick put it in the Introduction, is "getting the basics right," i.e., to get the right balance between flexibility and restraint. Decision makers and managers should have flexibility to do their jobs and take actions needed to improve outcomes on the ground. However, appropriate restraints should be in place to ensure that their actions do not lead to indiscipline. The 1997 WDR identifies a variety of institutional mechanisms that impose restraint on decision makers and managers and help achieve this balance. These mechanisms include competitive pressure from markets, and voice and participation from civil society. Within the state, the mechanisms include checks and balances on the executive via the legislature and the judiciary. Within the executive, they include rules and restraints such as hard, but predictable, budget constraints, a clear strategy with explicit statement of priorities, requirements to report results, and accounting and auditing standards.

Flexibility. The importance of flexibility has been highlighted by the experience of core public sector reform in a number of OECD countries. At the operational level, increased managerial freedom, combined with a hard, but predictable, budget constraint, has been consistently identified as providing a key incentive for improved performance. For strategic decision making, giving individual ministers more responsibility for resource allocation decisions creates incentives to reprioritize expenditure within a hard budget constraint and increases accountability for results. Australian reforms of the 1980s illustrate this point (Box 3.3 in Chapter 3).

For many developing countries, the signs are that too little flexibility and too much restraint has often led to increasingly poor outcomes at all three levels, but particularly at levels 2 and 3. The separation of policy, planning and budgeting, the subject of Chapter 3, has had the major negative consequence of virtually eliminating the capacity and willingness of many governments to reprioritize and reallocate. Box 2.4 illustrates the negative consequences that flow from an inflexible implementation framework (level 3).

BOX 2.4
THE NEGATIVE EFFECT OF TOO MANY CENTRALIZED CONTROLS IN ECUADOR

By the early 1990s, Ecuador's resource allocation and personnel administration systems were highly centralized and rule oriented. Yet, there was growing relations that despite the tight institutional framework, the system was failing to control and limit the use of publicly held financial and human resources. In fact, the proliferation of controls actually sowed the seeds of its own malfunctioning. The highly centered budget system had generated numerous devices for circumventing the normal budgetary process, including earmarked revenues and off-budget activities. Similarly, the centralized financial control system, including but not limited to extremely cumbersome procurement processes and a reliance on pre-controls, had led to a proliferation of autonomous entities exempt from many of those controls. The highly centered personnel management system also failed to improve public sector outcomes. Public employment, for instance, grew inexorably over the previous decade and a half and a plethora of labor regimes, as supplements and other devices for circumventing the controls built into that system emerged. These undermined good management and produced poor public sector outcomes.

The country is now in the process of undoing many of the centered controls and moving towards a more delegation-oriented institutional framework. However, movement is slow because of the resistance that is typically encountered in moving from a transaction-specific control regime to a more decentralized one. As an example, a plan was proposed in 1995 to devolve payment controls and two years later still had not been implemented, largely because of central agencies' fears of fiscal indiscipline.

Source: Reid, Gary, "Improving Micro Budgetary Performance: The Case of Ecuador," Discussion Draft; and World Development Report, 1997.

Too much flexibility, without appropriate checks and balances, is also problematic and has led to rampant corruption in many countries. Documented causes of high corruption levels are: distorted policy environments, a low probability of being caught and punished, and mild consequences if caught relative to the benefits of corrupt practices. The implication is that corruption flourishes where public officials have a lot of flexibility and discretion in decision making, but are inadequately restrained by mechanisms that check arbitrary action. Overall, this undermines state credibility and investment, and growth suffers over the long run.

While too much flexibility and too little restraint engenders corruption, too little flexibility and too much restraint builds rigidities and inhibits innovation and change. An important starting point is to identify which level of decision making is best served by more or less flexibility and then build in transparency and accountability mechanisms to restrain flexibility.

As a general rule, strategy should be tight and implementation loose or, to put it another way, key strategic decisions should be more centralized, and operational decisions more decentralized.

The weakness in many countries is loose strategy and tight implementation. The center and the donor community may seek to make implementation tight because of the weak strategic framework. Strategy is often loose because policy formulation is dispersed among various government (and sometimes donor) agencies. Effective coordination mechanisms at the center of government are therefore crucial to developing a tight strategic framework. In the Republic of Georgia, for instance, streamlining has removed overlapping and conflicting positions and strengthened coordination. The fate of draft laws is now decided in the presence of all members of the President's economic council before submission to the parliament. The reforms have helped to enhance consultation and coordination, thereby increasing transparency in central government decision making.

Transparency and Accountability

Transparency underpins accountability, whether this be transparency in the form of timely and reliable ex post external audits or in specifying ex ante performance targets. Transparency demands that the reasons for decisions and the results and costs of these decisions be accessible, clear and communicated to the wider general public. Decision makers must be held responsible for the exercise of the authority (flexibility) provided to them. In summary, decisions made, the basis upon which they were made, and their results and their costs must be made available.

A dimension to transparency not directly linked to accountability is also crucial to sound budgetary outcomes. This is that decision makers should have all relevant issues before them when they make decisions.

The task is to identify institutional arrangements that will help government confront these real world problems in building an effective public expenditure management system. Transparency and accountability mechanisms lie at the center of a system that will encourage commitment by all the players to government's formal rules on spending and the deficit and to impose costs on politicians and bureaucrats for violations. Similarly, transparency and accountability are important to committing players to level 2 and 3 rules.

Recently, the IMF has developed a Code of Good Practices on Fiscal Transparency, which is summarized in Box 2.5. The entire Code can be found in Annex J.

Information

Lack of adequate information is one of the characteristics of weak budgeting systems. This usually begins with unreliable and late input information on expenditure and costs, which is crucial to decision making and effective expenditure control. The audit function plays an important role in turning input data into information. Audit features that are crucial, but often missing are: internal audit, a component of the management of executive agencies; external audit, independent of the executive; and timely audit reports.

BOX 2.5
IMF CODE OF GOOD PRACTICES ON FISCAL TRANSPARENCY

1. **Clarity of Roles and Responsibilities**
The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

    There should be a clear legal and administrative framework for fiscal management.

2. **Public Availability of Information**
The public should be provided with full information on the past, current, and projected fiscal activity of government.

    A public commitment should be made to the timely publication of fiscal information.

3. **Open Budget Preparation, Execution, and Reporting**
Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

    Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.

    Procedures for the execution and monitoring of approved expenditures should be clearly specified.

    Fiscal reporting should be timely, comprehensive, reliable, and identify deviations from the budget.

4. **Independent Assurances of Integrity**
The integrity of fiscal information should be subject to public and independent scrutiny.

Underpinning the expenditure information system is an accounting system. Most developing countries have the basics of an accounting system but do not use it effectively. In a number of countries accounting systems are not well integrated with planning, budgeting, cash and debt management, and auditing systems. Information on non-cash resources (assets, liabilities, people) often do not exist.

Performance information of either the outputs of government or the outcomes of government policy is scarce. A more results-oriented public sector will require this information. The challenge will be to define the information required for the various levels of decision making and to avoid overloading the center. Management information systems that integrate information on costs, expenditure, outputs, and outcomes will need to be developed.

A key point is if the institutional arrangements and the incentives embodied in those frameworks are set up "right," i.e., if flexibility and restraint are appropriately balanced and mechanisms for transparency and accountability are introduced and enforced, quality information will be demanded and used to improve public sector performance.

OPERATIONALIZING THE THREE LEVELS

There is no single best way to classify these institutional arrangements. To assist diagnosis and action, it may be useful to focus on the roles and responsibilities of the various players, either as regulators or doers, through the policy making, planning and budget cycle.

Level 1: Aggregate Fiscal Discipline

Institutional arrangements for aggregate fiscal discipline can range from formal constitutional restraints on aggregate expenditure (Indonesia) through formal laws (Maastricht, New Zealand, Australia) to public commitments by the executive (with or without the commitment of the legislature - U.S.). Commitments of this nature can usefully be supported by formal legal requirements that all government revenue be paid into a single fund and only be available for spending where there is an appropriation of funds by the legislature. All of this should be supplemented by restraints imposed by financial markets and a free press. For many countries, international financial institutions may play a key role, particularly in the absence of open financial markets. An independent Central Bank can also play an important role in disciplining aggregate expenditure. For example, the supranational central bank of the CFA franc zone countries imposes limits on the advances it will make to member countries to 20 percent of the previous year's tax revenues. A key point is that each country will choose the particular mix of institutional arrangements that will support aggregate fiscal discipline.

When players have made the commitment, they are technically required to produce an estimate of what is affordable, in aggregate, over the medium term. This will require a capability to model the economy (Jacques Polak in "The IMF Monetary Model - A Hardy Perennial" in *Finance and Development,* December 1997, gives evidence that this does not require sophisticated modeling techniques.). The level of government expenditure derived from the model can provide the constraint or can be used as a guide to the setting of the constraint. Determination of the estimates is not merely a technical exercise. Evidence shows that there are cases (Box 2.2) where incentives cause an overestimation of revenue in the budget and future years. While this overestimation may not lead to an undermining of fiscal discipline, the inevitable cuts in expenditure to achieve fiscal targets invariably have very damaging effects on level 2 and 3 outcomes.

The production of the fiscal framework will usually be the responsibility of the central economic agencies with input from the Central Bank. The aggregate expenditure ceiling will feed into the deliberations of the Cabinet on the appropriate stance of fiscal policy for the coming budget year. The ceiling, together with its rationale, should be part of the budget circular kicking off the annual budget cycle. The ceiling may need to be adjusted through the planning and formulation phase to reflect new information, but the adjustment should be kept to a minimum.

When decision makers formally set the aggregate expenditure ceiling at the appropriation (legislative) stage (implicitly or explicitly), they must enforce the ceiling, monitor actual expenditure during budget execution, and identify as far in advance as possible pressure points on aggregate expenditure. An important restraint on decision makers is the requirement that actual expenditure be reconciled with budget estimates during budget execution, and on time and publicly at the completion of the budget year.

Comprehensiveness and transparency are essential for effective aggregate fiscal discipline. Formal rules designed to achieve aggregate fiscal discipline create incentives for evasion, particularly to take activities off-budget or to engage in creative accounting. Extrabudgetary funds, earmarking and quasi-fiscal activities are among the egregious examples of ways of getting around aggregate fiscal discipline.

Level 2: Resource Allocation based on Strategic Priorities

Given aggregate fiscal discipline, the second key challenge is how to prioritize competing claims on scarce resources. Prioritization is fundamentally political. Politicians set priorities based on their understanding of the preferences of their key constituencies. The challenge is to structure institutional arrangements to provide the incentives for tight strategic allocation of resources and improve the quality of information needed to do this effectively.

Level 2 is the most difficult to "get right’ because it is the most dependent on the political process. It is crucial that "political government” provide legitimacy to policy decisions and the resource implications over the life of the policy, by being at the center of the process of reconciling what is affordable in aggregate and strategic sector policy demands. The choices made at this level can be informed by information and analysis, but they are importantly value based and path dependent. Designing and sustaining institutional arrangements that facilitate and require choices to be made in the public interest is very demanding. Restraints, in terms of tight strategy and affordability, are crucial here, but there is an important component of flexibility required.

Characteristics of institutional arrangements that support sound strategic policy making follow:

- A cohesive political executive must have a vision of where to take the country and must legitimize decisions made.

- A forum is needed within which decision making is constrained by resource availability over the medium term and in which policies have to compete with each other as ideas, and for funding. This will be facilitated where there are tight links between policy making, planning and budgeting. The perceived legitimacy of the policies that emerge from this competition will be enhanced where civil society, the private sector and the legislature are appropriately involved.

- Programmatic decisions for budget formulation must devolve to line ministers. This requires a capacity at the center to assess the appropriateness of these decisions against the overall strategic policy objectives of government and their financial implications over the life of the policy. Sector expenditure ceilings will have to be decided upon in the forum. These sector ceilings will need to be consistent with the aggregate fiscal constraint and, as much as possible, be compatible with individual policy decisions made in the forum during budget formulation and with other existing policies. The latter will require estimates of the cost of existing policies over the medium term.

- Where aid is important, there must be a cohesive and comprehensive approach to aid management. The strategic policy priorities of government must be the driver of decisions that involve aid financing.

To support these institutional arrangements, there is a need for information on:

- the cost of existing government policies over the medium term,
- output and outcome information on each of these policies, and
- cost, output and outcome information for new policy proposals.

In turn, the generation of reliable and timely information will require sound accounting systems and rules, well-functioning financial and nonfinancial management information systems, and a monitoring and evaluation capacity within the executive. An external audit function, independent of the executive, is a crucial element of the institutional arrangements for checks and balances.

Once the executive has formulated the budget, policy choices embodied in the budget must be presented to the legislature in a way that allows for effective oversight. Whatever the structure of appropriation chosen, the legislature must be provided with information on expected costs, expenditure, outputs, and outcomes of individual policies.

Monitoring for consistency with policy during budget execution is the responsibility of individual sector ministries. The legislature and the center can support this concern for the implementation of approved policies by requiring an ex post reconciliation of actual and budgeted expenditure by sector and program, and by requiring sector ministries and agencies to report publicly on actual outcomes and outputs.

The cycle begins again with this information feeding into the next budget round.

Level 3: Operational Performance - Efficiency and Effectiveness

Figure 2.1 shows that operational performance is dependent on many factors, only some of which are directly linked to institutional arrangements associated with budgeting. Those that can be directly linked include:

- the legitimacy given to policies through the decision making process, which is central to their efficient and effective implementation;

- the predictability of funding to approved policies - both within the budget year and from one year to the next (This is not an argument for protecting government expenditure at all costs and in all circumstances, but it is suggesting that if those responsible for implementation are to be given an adequate planning horizon then there must be the maximum amount of predictability in funding. Where changes in funding are required because of either changing macroeconomic or sector priorities, these should be effected as far as possible through policy change, as opposed to merely reducing - less often increasing - funding.);

- the increased delegation to line managers of the authority to make financial decisions commensurate with the responsibility for producing outputs and achieving outcomes (The ex ante specification and subsequent reporting of outputs and outcomes discussed under level 2, together with external auditing of financial compliance and performance, provide the basis for the accountability of sector and line managers. However, they can only be held accountable where they have the authority to make decisions over the mix of inputs - both financial and nonfinancial - within a hard, but predictable, budget constraint.);

- a genuinely "hard" budget constraint - upwards and downwards - during budget execution.

Other conditions that determine the quality of operational performance include exit and voice opportunities (e.g., competition and client surveys), merit-based personnel practice and, more generally, a regulatory environment that encourages and requires sound operational performance. These issues are discussed in the 1997 WDR (See also Box 5.8 Disincentives to Sound Operational Performance in chapter 5).

Institutional arrangements that have the greatest bearing on organizational performance
might be summarized as follows:

- resources and systems support commensurate with responsibilities (financial/human);
- clarity of purpose (outcomes to be achieved);
- clarity of task (outputs to be produced);
- authority (flexibility) to pursue the purpose and undertake the task;
- accountability for use of authority.

Building on the Framework

The following two chapters take the above discussion of the three levels and elaborate specific components of a well-performing budgetary system and process. Management of the three levels can be effectively integrated only through a perspective that goes beyond the annual budget cycle. Chapter 3 looks at the need to link policy, planning and budgeting in a medium-term expenditure framework (MTEF) at both the whole of government and sector levels. Chapter 4 outlines the key considerations in implementing a sound financial management information system (FMIS), the basic component that consistently underpins efficient PEM.

Part II of this handbook contains a questionnaire to assess the quality of institutional mechanisms (Annex A), a checklist of practices to assess a country's stage of development and a matrix to assess financial management/budget reforms and to evaluate improvements (Annex B).

CHAPTER 3
LINKING POLICY, PLANNING AND BUDGETING IN A MEDIUM-TERM FRAMEWORK

I have so often maintained it in this House that I am almost ashamed to repeat it, but unfortunately it is not a principle which has yet entered into public opinion - expenditure depends on policy.

Disraeli to UK House of Commons in 1862, Quoted in Heclo, 1981

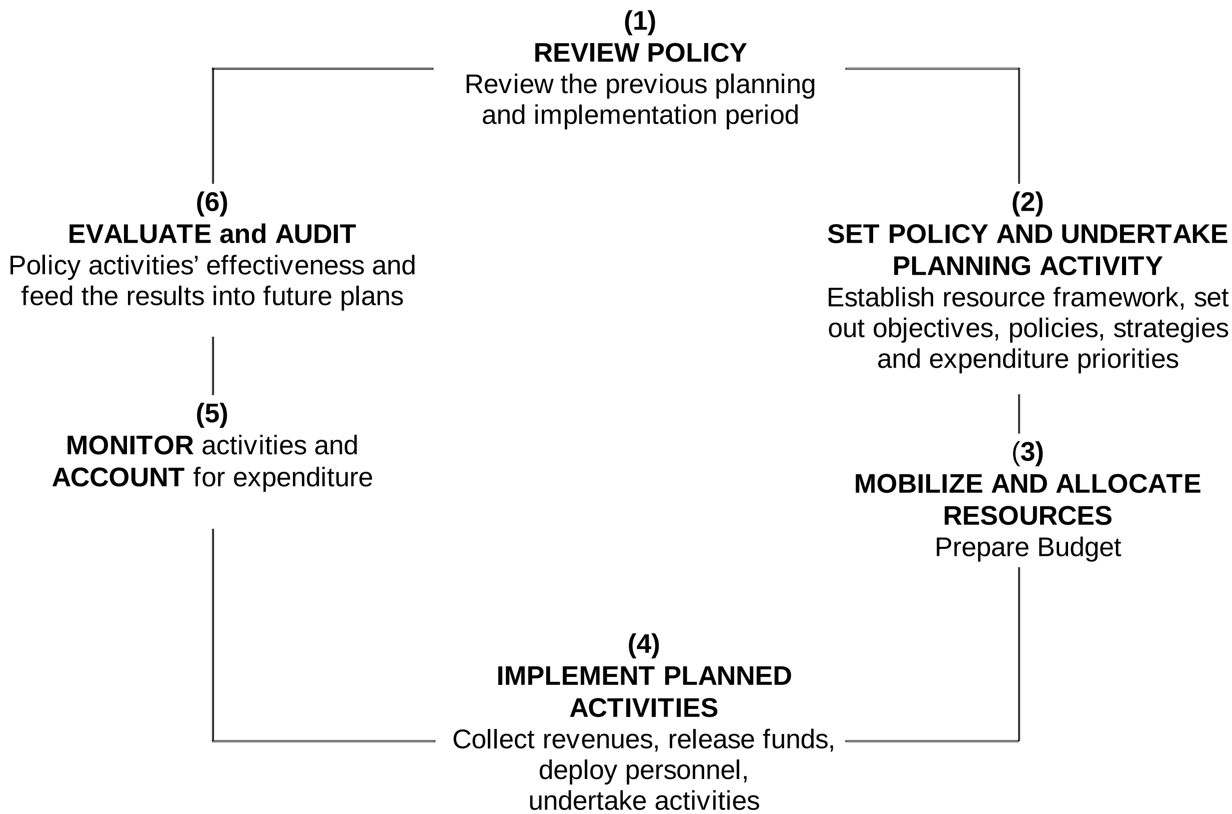
This chapter deals with linking policy, planning and budgeting across the whole of government and at a sectoral level. The chapter provides guidance on institutional mechanisms that facilitate the allocation of resources to achieve strategic objectives. Affordability must influence policy making and planning at the point when the decision is made. Where adjustment is required to deal with changing macroeconomic conditions and, even more particularly, changing priorities, that adjustment needs to take place through policy change to be sustainable. A medium-term approach that encompasses all expenditure provides a linking framework and facilitates the management of policies and budget realities to reduce pressure throughout the whole budget cycle. The result is better control of expenditure and greater efficiency and effectiveness in implementing policies, programs and projects. This chapter provides guidance on approaches to some of these issues and improving these linkages throughout the full cycle of policy, planning and budgeting (Figure 3.1).

WEAKNESSES THAT PRODUCE POOR BUDGETING OUTCOMES

Failure to link policy, planning and budgeting may be the single most important factor contributing to poor budgeting outcomes at the macro, strategic and operational levels in developing countries. In many countries, the systems are fragmented. Policy making, planning and budgeting take place independently of each other. Planning is often confined to investment activities, which in many developing countries refers to a series of donor-funded projects. Capital expenditures are already largely accounted for through the planning process, and a large portion of recurrent expenditures are pre-committed to the wage bill. For this reason, annual budgeting is reduced to allocating resources thinly across donor and domestically funded “investment” projects and to the nonwage portion of the recurrent budget. In addition, line agencies tend to budget and spend on an ad hoc basis because even small discretionary allocations are rarely predictable.

Unpredictability of funding, from one year to the next and within the budget year, is one of many factors that contribute to the poor operational (level 3) performance of public sectors. Others that are related to the budget are the failure to direct resources to policy priorities - in significant part because budgeting is treated as an annual funding exercise, not a policy-based exercise - and the lack of authority and responsibility given to line managers to manage resources at their disposal. Other weaknesses lie largely outside the budget. Box 5.8 in chapter 5 elaborates on the range of disincentives for sound operational performance.

Figure 3.1
LINKING POLICY, PLANNING AND BUDGETING IN THE PLANNING AND RESOURCE MANAGEMENT CYCLE



In the absence of effective decision-making processes, policy making and planning are disconnected from each other and from budgeting, and they are not constrained by resource availability or by strategic priorities. Overall, this leads to a massive mismatch between what is promised through government policies and what is affordable. The annual budgeting process therefore becomes more about scrambling to keep things afloat, rather than allocating resources on the basis of clear policy choices to achieve strategic objectives.

LINKING POLICY, PLANNING AND BUDGETING IN THE PLANNING AND RESOURCE MANAGEMENT CYCLE

Integrated policy, planning and budgeting is fundamentally about having expenditure programs that are driven by policy priorities and disciplined by budget realities. The challenge is to manage the tension between "needs" and "availabilities" more effectively (Box 3.1). A medium-term approach provides such a linking framework and facilitates the management of the tension between policy and budget realities to reduce pressure throughout the whole budget cycle.

BOX 3.1
NEEDS VERSUS AVAILABILITY

In many countries, budgeting has been undermined by the "needs" rather than "availability" psychology of the budget actors. While finance ministries stress "availability" (the revenues it expects to be forthcoming from domestic and external sources), line ministries persist in basing budget proposals on "needs." The result is a negative-sum budget process that undermines macroeconomic stability and program and project effectiveness.

These conflicting perspectives are understandable. The Finance Ministry is constantly battling weak domestic revenues, the debt servicing burden and mounting claims on budget resources. Since it has responsibility for the macroeconomic consequences of fiscal deficits, the MOF has no alternative but to preach the "availability" message through tight budget ceilings. If a satisfactory budget cannot be prepared, it remakes the budget during implementation through the release of funds mechanism, at a high cost to project and program efficiency. Line ministries build/inherit commitments they lack the resources to meet, yet must daily confront the consequences of inadequate allocations. Population growth, the running costs of newly completed projects, and unforeseen crises further pressure slender budgets. Budget bids are submitted two to three times over finance ministry ceilings. When requested to concentrate resources on priority programs, departments answer they have no mandate to cut service. Privately, they fear that to submit a lower bid within the ceiling would make them vulnerable to further cuts. The debate about "needs" makes no connection with using existing program allocations more efficiently.

In countries where the gap between commitments and resources is so large, a satisfactory reduction is unlikely to come within the tight perspective of the annual budget. A more fundamental restructuring of public expenditure has to take place engaging finance, planning, line ministries and Cabinet (because intersectoral trade-offs have to be faced) in a process that has a medium-term perspective. Donors, too, need to be involved because of their heavy contribution to budget financing. "Availability," both domestic and aid, must be projected beyond a single year, and indicative shares communicated to departments. "Needs" must be prioritized and made consistent with the resource framework. All this must happen in a manner that encourages departments to re-examine commitments and their resourcing with central ministries in a more cooperative framework.

Future resource allocations based on a specific policy mix will be more predictable where a medium-term framework enforces discipline. Predictability allows line departments to plan and manage resources more efficiently within the time frame of the annual budget cycle and over the longer term. The result is better control of public expenditures and better value for money within a hard constraint.

Increasing predictability of resource flows and the criteria by which funding decisions are made are the objective of the medium-term approach. In many developing countries, the resource allocation process is plagued by uncertainty, much of which is self-inflicted. The common tendency to make overly optimistic revenue projections is one example of how governments themselves increase the uncertainty of resource flows (Box 2.1 in Chapter 2). The complete mismatch between policy decisions and available resources is another source of uncertainty, again self-inflicted because it could be avoided by implementing a rigorous process that links policy making, planning and budgeting (Box 3.2).

BOX 3.2
MISMATCH BETWEEN POLICY GOALS AND EXPENDITURE ALLOCATIONS IN GUINEA

A 1996 public expenditure review in Guinea revealed a complete mismatch between the stated policy priorities of the government and actual priorities based on expenditure allocation. Although the government has designated primary education, public health and road maintenance as priorities, funds often end up being allocated to other areas instead. There is no system for costing out policy proposals or subjecting them to rigorous scrutiny. An exercise to cost out the policy mix needed to meet the government's stated priorities revealed that the share of priority programs in total spending would need to triple over the succeeding four years implying drastic cuts in other expenditures in order to remain within the budget constraint. Related to this finding, the report also showed that actual allocations to meet the recurrent costs of investment projects fell far short of what would be required for adequate operation and maintenance.

Based on the findings and recommendations of the PER, the Government of Guinea has recently launched an initiative to define affordable policies. Four line ministries are already revising their medium-term policies and costing out their implementation. Government is also working on preparing an MTEF for the four ministries (initially) in the context of its economic reform program, and central ministries are preparing a macroeconomic policy document to assist cabinet in intersectoral allocation decisions. Finally, the Ministry of Plan has taken steps to improve the predictability of the macroeconomic framework.

Source: World Development Report, 1997; and, "Findings," Africa Region, January 1998.

Key to increasing predictability and strengthening the links between policy, planning and budgeting is an effective forum at the center of government and associated institutional mechanisms that facilitate the making and enforcement of strategic resource allocation decisions. These central features of the MTEF were captured by the South African Minister for Finance in his l998 budget speech (Box 3.3).

BOX 3.3
SOUTH AFRICA'S MTEF

In his 1998 Budget Speech, the South African Finance Minister emphasized that the reasons for adopting a MTEF were numerous:

1. To facilitate political decision making,
2. To develop cooperative governance,
3. To improve the efficiency of the public sector,
4. To create a more predictable environment within which public sector organizations could raise the quality of their services to citizens.

Institutional Mechanisms to Facilitate Strategic Decision Making

Strategic resource allocation moves policy, planning and budgeting into the nexus of politics and administration. An important factor in ensuring that policy, planning and budgeting are linked is an effective forum at the center of government to make strategic decisions on the basis of budget realities. An effective decision making forum is not only more likely to produce fiscally sound resource allocation decisions, but also ensures that those decisons have legitimacy and are therefore more likely to be properly implemented. An effective decision making forum demands information to facilitate the decision-making process, which improves the quality of the decision and increases accountability for results and transparency. In most countries, this strategic decision making forum is the Cabinet or the Council of Ministers. Since decisions at this top level of government are made on the basis of political and administrative imperatives, it becomes a difficult level to constrain. Nevertheless, rigorous institutional mechanisms at the center of government can help to restrain policy making within the realm of the affordable by providing technical support and information, and establishing and enforcing a set of procedures that enhance the rigor of decision making. Similar institutional arrangements are needed at the sector level as well to restrain strategic decision making and to promote effective implementation at the operational level.

Key mechanisms that promote strategic decision making by core decision making bodies are those that:

- promote consultation and debate on policy issues;
- promote transparency and accountability;
- promote decision making that is underpinned by resource availability;
- help manage and sequence the process for policy considerations by Cabinet.

Box 3.4 describes how Australia has adopted some of these mechanisms to enhance the quality of policy making.

The key lessons from the Australian experience in the l980s are: policy change is the key to adjustment (not funding change as had been the practice in the past and continues to be the practice 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 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.

Mechanisms to promote consultation and debate. These mechanisms enhance strategic decision making by ensuring that all policy options are considered before choosing the most cost-effective option. They also ensure that policies are predictable and also contestable - an important principle of effective resource management. Furthermore, they help to improve quality at the policy design stage as well as effectiveness at the implementation stage. To develop such consultation mechanisms, technical consultation procedures need to be institutionalized (i.e., rules have to be established and enforced) to ensure that policy proposals have been adequately debated among all stakeholders prior to submission to the Cabinet.

Procedures must also be in place to ensure that all affected line ministries sign off on policy proposals and are fully aware of the implications of the decisions they are supporting. The administrative unit supporting the central decision making forum (e.g., a Cabinet secretariat supporting the Cabinet) can promote horizontal consultations by developing strong formal and informal linkages with line ministries and other central agencies through formal liaison officer

BOX 3.4
AUSTRALIA'S MECHANISMS FOR TRANSPARENT, COMPETITIVE, AND RESULTS-ORIENTED POLICY MAKING

One of the main objectives of Australia's public sector reforms has been to institute a process for disciplining and coordinating policies and exposing them to vigorous debate. Some of the challenges the Labor government faced when it came to power in the early 1980s were similar to those confronting many developing countries today. The new government had to manage both an immediate fiscal crisis and the unsustainable, long-term fiscal commitments of previous policies.

To discipline policy formulation and win political support for a resetting of national strategic priorities, the new administration decided to publish estimates of future spending under existing policies. These projections painted a bleak picture of unsustainable real growth in spending requirements, underscoring the need to scale back. Once the government had published these estimates, however, it became incumbent upon the government to continue to do so, and to illustrate continuous declines in future commitments that it had promised.

The reforms also required the government to publish reconciliation tables, showing how projections for existing policies differed from those for the new policies. These measures helped to make apparent the changes in the government's strategic priorities as well as in the medium-term costs of new commitments. In addition, the projections made resource flows to the line ministries more predictable, since the projected figures were automatically rolled over into the actual budget if no changes in policy intervened. This helped improve decision making and the operational efficiency of line agencies.

The reforms also required that line ministries proposing a new policy, or changes in existing policy that would increase spending, also proposed offsetting savings. This ensured that spending stayed within the resource envelope agreed to in the Cabinet. The Cabinet focused on changes in strategic priorities - which new policies to adopt and which existing ones to cut - to stay within macroeconomic constraints. Policy proposals were debated vigorously within the Cabinet, and all affected ministries and agencies were required to submit written comments on the sources of their agencies' proposals. This helped legitimize and build consensus on policy priorities. Finally, the reforms focused attention on results, through mandated periodic evaluation of new and existing policies and through reporting on performance and outcomes.

The results? Australia's deficit of four percent of GDP in 1983 became a surplus by the end of the decade. Accompanying this achievement were significant changes in the composition of public expenditures, reflecting both broad strategic shifts identified by the Cabinet and changes in priorities within ministries, often identified by the line agencies themselves.

Source: Adapted from *World Development Report 1997: The State in a Changing World*.

roles, establishment of intersectoral policy groups and informal networks. Box 3.5 shows how a Bank-supported initiative can grow into an institutionalized process for transparent consultation and consensus building with the wider civil society.

All parties need to understand the need for: (a) persistence through successive annual cycles; (b) a strengthening of the financial administration and information systems; and for parallel efforts to strengthen macro and sector analysis.

BOX 3.5
FROM JOURNEES DE REFLEXION TO AN INSTITUTIONALIZED CONSULTATION PROCESS

In February 1993, the World Bank's Sahel team undertook a four-day-long workshop, Journees de Reflexion, in Mali. It involved 75 participants on the Malian side (consisting of almost every minister, some deputies and assistants, union representatives and journalists) and 16 from the Bank side. Free discussion took place on a range of issues touching upon virtually every aspect of Mali's development. The basic idea of the workshop was to develop the building blocks of an agenda for reform, which was to be undertaken by the then newly elected government. The Prime Minister presided over the meeting, which was conducted in an atmosphere of openness on both sides. For the first time, a number of issues fundamental to the development agenda were, if not reconciled, at least brought to the knowledge of all participants. It became clear that Cabinet Ministers themselves were not in agreement either about the role of the state, or the best direction to take for reform. Nor, surprisingly, were most of them aware of the exact nature of the crisis facing their country. One important benefit of this first dialogue was that it improved communications (a first step towards building consensus) not only between the Bank and the government but equally within the government itself.

That first step has now turned into an institutionalized system of broad-based consultation conducted on an annual basis. The New York Times reported in a January 1998 article that Mali has instituted a public forum, held once a year, in which citizens from all walks of life are allowed to question the country's leadership on any subject. The proceedings are broadcast live (an important element of transparency) and listenership is reported to be nearly universal.

Source: Marshall, Katherine, "Mali: Journees de Reflexion" (Note) 1993; and, New York Times, January 4, 1998.

While the discussion so far has focused on policy making during the budget process, it is equally important (and often more important given the tendency to focus budgeting on funding not policy) to ensure that policy proposals that come up outside the budget context be subject to the same rigorous scrutiny discussed in this and the preceding two subsections. A characteristic of developing countries, particularly those heavily dependent on project aid, is that it is far easier to get new policies on the books than to remove old ones. As a minimum, how the policy will be funded within the aggregate resource constraint must be addressed. (Will offsetting savings be required, will funding be deferred until the next budget round, will it be an add-on, with the reallocations to be dealt with in the next budget round?) The Ministry of Finance (Budget Office) must be required to endorse the costing estimates over the medium term; and the proposal must indicate the expected impact and what success will look like.

Mechanisms to promote transparency and accountability. Availability of information is fundamental to promoting transparency and accountability. The institutional mechanisms surrounding core decisions should be set up so that the decision making forum demands timely and detailed information be brought to bear in decision making. For example, Cabinets can require submission of performance reviews of individual programs as key pieces of information to be considered in the resource allocation process for the next year. Improvements in accounting and auditing systems, specification and utilization of performance measures at the program and activity level, and enforcement of rules that require timely publication of information need to be in place for transparency and therefore to enhance accountability. Some rules emphasizing timely publication of information also help to enhance the accountability and credibility of the Cabinet. For example, Australia's rules mandating publication of reconciliation tables of forward estimates and actual appropriations provides information to hold government accountable for its decisions and, when divergence between the two is minimal, increases the credibility of Cabinet-approved forward estimates.

Mechanisms to restrain decision making by resource availability. This involves introducing mechanisms that help translate political vision into strategic policy choices within an affordable financial envelope. Countries such as New Zealand have legislation in place to ensure that this happens (Box 3.6). However, this involves introducing institutional mechanisms that make the costs and benefits of competing policies transparent. Much of this (e.g., costing out policies, etc.) involves the mechanics of developing MTEFs. With decision making, however, it is particularly important to ensure that Cabinet submissions are formally aligned with the budget and expenditure planning time frame and that financial consideration issues (cost of policy options, estimated cost of each option over the medium term and at maturity, already budgeted expenditure and additional requirements, possible savings, etc.) are explicitly addressed in the submission to Cabinet. Simultaneously, there must be capacity at the center to evaluate the policy options that come up from sector ministries to ensure that they fall within aggregate fiscal constraints.

BOX 3.6
NEW ZEALAND'S FISCAL RESPONSIBILITY ACT

The Fiscal Responsibility Act, enacted into law in 1994, offers a comprehensive legal framework for the formulation and conduct of fiscal policy, in general, and for incorporating a long-term orientation to the budget process, in particular. Many countries have similar practices, but New Zealand represents one of the few examples where these practices have been formalized into law.

The primary objective of the Act is to entrench sound fiscal policies and make it difficult for future governments to deviate from them. This is done through the two main provisions of the act.

The first main provision involves setting fiscal objectives in a two-step process by requiring adherence to "Principles of Responsible Fiscal Management" and mandating preparation of an annual Budget Policy Statement by government. The "Principles of Responsible Fiscal Management" mandate that debt, spending and taxation be maintained at "prudent" levels. Any deviation from the principles requires explanation by the Minister of Finance as well as an explanation as to how and when government will return to the principles. The Budget Policy Statement requirement, obligates government to make an annual statement of fiscal intentions for the next three years and their long-term fiscal objectives, as well as the consistency of fiscal intentions and objectives with the "Principles of Responsible Fiscal Management."

Source: PUMA, Budgeting for the Future, OECD, 1997.

Mechanisms to manage and sequence the process for policy consideration by the Cabinet. The sequence in which the Cabinet considers policies/expenditures is important and requires significant inputs from line ministers and several core agencies (e.g., finance, planning, cabinet secretariat) as well as effective coordination among them. Generally, there has to be a process to plan submissions to Cabinet to prevent overload and log-jams, to enforce use of an agreed format for Cabinet submissions and to monitor implementation of Cabinet decisions.

In addition, there must be a system in place to ensure that decisions on aggregate expenditure and revenue targets, and on broad principles of government policy precede the consideration of detailed expenditure proposals. Forward projections should be prepared at the policy and program level and should be reviewed by the Cabinet before the next annual budget is considered in detail. Once high levels agree upon broad allocations, lower levels can be entrusted with the details. Appropriate intervals must separate the stages.

Line agencies should receive broad guidelines in time to reflect them in their proposals. Otherwise, strategic issues are set aside in the rush to complete the detailed annual budget before the fiscal year ends. This situation arose recently in Malawi when, during the 1997-98 budget round, there were delays in communicating budget ceilings to sector ministries. This led ministries and agencies to revert to line-item-focused budget estimates.

The central agencies need to prepare the initial framework paper, which would review the economic and fiscal situation and prospects, propose aggregate fiscal targets for the planning/budget period, identify key strategic and policy issues, and propose sector allocations for line agencies to use in framing their own proposals. Coordination is needed where responsibilities are divided between finance and planning ministries to generate joint submission to Cabinet at the beginning of the cycle and to collaborate in the review of line agency proposals.

Developing and Implementing a Medium-Term Framework

Developing and implementing a medium-term framework for linking policy, planning and budgeting can be accomplished progressively at a pace that fits a country's capacities. Some countries (e.g., South Africa, Uganda) began by developing an overall medium-term framework for allocating resources between sectors through a top-down approach carried out by the Ministry of Finance. Others (e.g., Malawi) began with a more bottom-up approach, focusing first on developing MTEFs at the sector level to govern resource allocation within individual sectors.

Countries often choose to begin at the sector level because this represents a manageable change from the status quo. However, this approach should only be viewed as a building block to achieving a comprehensive medium-term approach. In the case of Pakistan, the sector approach has proven an important catalyst for focusing attention on government-wide systems and processes.

Many of the potential gains at the sector level, however, cannot be realized until the sector approach is combined with a central overall planning, resource allocation and budgeting system that supports a better balance between policies and resources at the intersectoral level. Furthermore, too much dependence on a sector focus can limit opportunities for responses that go beyond the sector. For example, the most effective health sector response might lie in the water sector, yet consideration of this could be excluded through a sector approach confined to health.

Similarly, a framework to allocate resources between sectors can only be fully effective when it is complemented by a similar system for resource allocation within sectors and by information generated by sector ministries themselves. The ideal, therefore, is to develop a medium-term approach to decision making and resource allocation across the whole of government that combines top-down and bottom-up decision making for expenditure allocation. Clearly, medium-term expenditure planning at the sector and government-wide level are linked. Necessary components of government-wide planning include sector (and program) information, a sense of what is affordable, and a mechanism to resolve the tension between the two and to set priorities inter- and intrasectorally. For either form of MTEF, development will take a number of years because the MTEF needs to encompass all expenditure.

The next two sections discuss sector and whole of government approaches to linking policy making, planning and budgeting in a medium-term framework.

LINKING SECTOR LEVEL POLICY, PLANNING AND BUDGETING

Years of short-term planning for annual budgets and hand-to-mouth adjustments during the budget year have led to accumulated overcommitments and inefficiencies at the operational level. The separation of policy making, planning and budgeting so often in evidence at the center of government is replicated at the sector level. The requirement, therefore, is to create enough certainty so that line ministries and agencies can plan ahead, have the incentives to do so, and have better information on which to base strategic and operational decisions. In other words, it requires, at its core, the development and effective implementation of a comprehensive MTEF. However, integrating planning, policy and budgeting at the sectoral level through sectoral MTEF's could result in significant gains and could be the foundation of a comprehensive MTEF. The example of Malawi (Box 3.7) is a case in point, where the reform process began with the implementation of MTEF's in selected pilot sectors and was then progressively expanded to become comprehensive. Defining and implementing a sectoral MTEF involves preparing estimates of overall resource availability, reviewing financing mechanisms, and preparing prioritized government spending plans. This is clearly not a one-off process. Rather it is iterative and must take into account, on a periodic basis, changes in sectoral needs and priorities and changes in the overall resource envelope.

Important Steps in Sector Level MTEFs

Conduct sector review and agree on sector objectives and policies. This is the first stage of developing a sectoral MTEF. At the outset, a clear vision for the sector has to be agreed. Ideally, this should be derived through a combined bottom-up/top-down process so that there is buy-in at the political level as well as across all technical levels. With the sector vision in hand, sectoral priorities need to be identified and/or revised. Sector reviews are helpful in this regard. They assess which activities are pertinent to the achievement of sector goals. The starting point of the sector review is to question whether government has a policy responsibility at all or whether a specific policy and associated activities should be left to the private sector and/or civil society. If government does have a policy responsibility, an important follow-up question is whether the appropriate instrument for implementing the policy is the budget. Next is the definition of the goal and objectives of the sectoral ministries and agencies, including the outputs to be produced and the specific activities to achieve the outputs and thus the objectives. Getting final agreement on sectoral priorities can, however, be a difficult task and needs to be handled carefully. Inevitably, each subsectoral grouping within the sector is likely to view its own activities as being as important as, if not more important than, others. Mechanisms therefore need to be in place to debate and resolve disagreements that arise among different sector players regarding relative priorities among sectoral activities. Fundamental questions about whether government has any particular role in a sector will almost certainly require a decision at the center of government. Figure 3.2 identifies the full range of decisions that government should consider on intervention and delivery mechanisms.

BOX 3.7
THE FIRST MTEF EXPERIENCE IN MALAWI

In 1995, the Government of Malawi decided to adopt a medium-term expenditure framework (MTEF) in response to increasing fiscal imbalances. The four largest spending ministries, education, health, works and agriculture, together with the police, piloted implementation of the MTEF in the 1996/97 budget year. The pilot was confined to the recurrent budget, and within that to nonwage and salary recurrent expenditure. The rationale for this was that the real test of the government's priorities was to be found in spending in this latter category. For the 1997/98 budget, the exercise was extended to 12 ministries and, at the sector level, there was an effort to integrate recurrent and development expenditure. For the 1998/99 budget, the MTEF will be extended to all remaining sectors. Recurrent and development expenditure will be integrated and estimates will be prepared for the budget year plus the three outer years.

The objectives of the Malawi MTEF are to link medium-term, or strategic, planning and the annual budget process in such a way as to restructure recurrent and development expenditures in line with clearly established priorities and available resources. Restructuring will be achieved through a top-down process of allocating resources between sectors based on relative priorities, and a bottom-up process of identifying the actual costs of policies and strategies in each sector.

So far, the participating ministries have taken an integrated sector approach to planning involving:

- reviewing and defining sectoral objectives and policies;
- identifying activities needed to implement sectoral policies (For some ministries, this involved a radical restructuring of budget classification. For example, the Ministry of Health and Population divided hospital services into several programs according to type of services or activities such as preventive and curative services.);
- estimating the actual costs of providing these services;
- identifying activities that can be scaled back or stopped to fit within expenditure ceilings.

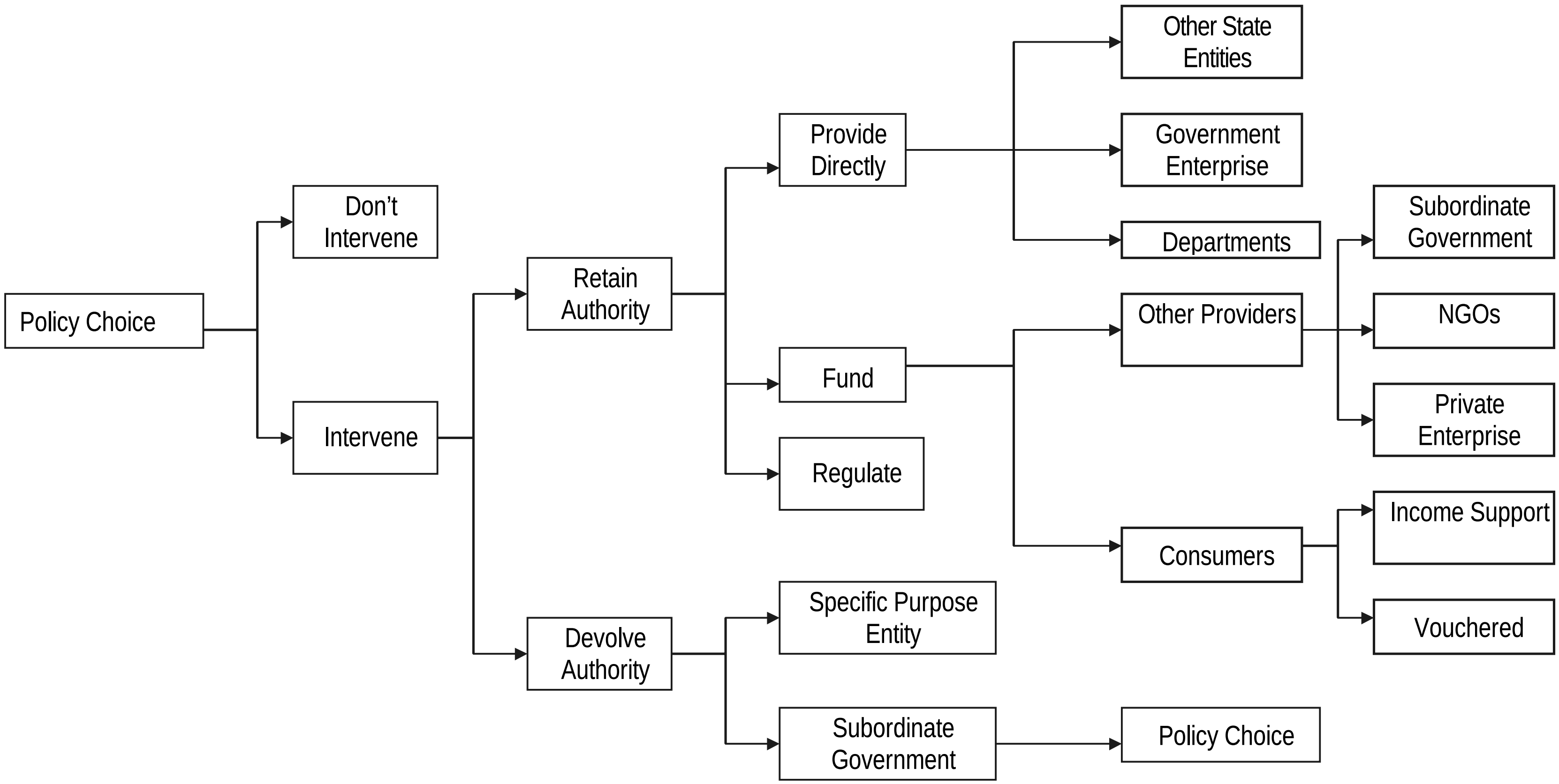
Progress at the sector level is already evident. Linking policy objectives and costings is underway although progress have been uneven across the pilot sectors. There is a clear understanding, particularly among the four initial pilot ministries, of the objectives of the MTEF and unanimous agreement that this is the way to move forward. The most obvious improvements are in the much clearer articulation of programs and their costs and in the start on re-prioritization and removal of unnecessary duplication.

Building on the initial progress, subsequent rounds of MTEF implementation will need to focus on issues:

- maintaining ownership of the MTEF process and building upon the involvement of budget managers to develop their sense of responsibility for budget implementation and management;

- developing a reliable medium-term resource framework so as to plan for macroeconomic stability;
- strengthening the links between the MTEF exercise and the annual budget process and embedding the MTEF in the work of the Ministry of Finance;
- incorporating aid into the MTEF exercise;
- addressing the need for institutional mechanisms at the center of government to discipline policy making by affordability and enhancing predictability of resource flows by preparing and abiding by forward estimates (This will help convince sector ministries of the usefulness of the MTEF.).

Figure 3.2
PUBLIC MANAGEMENT: INTERVENTION AND GOVERNANCE



Define sector resource envelope. Defining the total quantum of resources available to the sector should be as comprehensive as possible. Ideally, it should include resources available to the sector from tax revenue, donors, fee income, voluntary organizations, and private companies.[1] While there is uncertainty associated with making medium-term resource projections, efforts have to be made to eliminate self-inflicted uncertainties. This is where the sector approach is weakest. Without a whole-of-government MTEF that facilitates determination of intersectoral allocations, the uncertainties of the sector resource envelope are magnified.

Assess costs and expenditure implications of policies and develop a MTEF. Decision makers need to assess the possible expenditure implications of policies, using the sectoral policy priorities developed through the sector review process. In carrying out a cost assessment, a good starting point is to work out what existing policies would cost if fully funded, i.e., if facilities were adequately maintained, if staff were paid a reasonable minimum salary, and if essential complementary inputs were provided. This costing, aggregated across the sector, yields an estimate of the total requirements within each sector, based on actual costs rather than a percentage increase on the previous years' estimate. This cost analysis is then reviewed in relation to the policy priorities developed in the sector review and the overall resource envelope that was defined for the sector. Further adjustments may need to be made to ensure that the medium-term expenditure plan that results falls within the constraints of the resource framework.

Medium-term spending projections are useful for these reasons. First of all, they are necessary to demonstrate the desired direction of change. In the absence of a medium-term plan, rapid spending adjustments to reflect changing circumstances will tend to be across-the-board and ad hoc, focused on inputs and that which can be cut in the short term. If they 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 also enable governments to evaluate cost-effectiveness and to determine whether they are attempting more than they can afford. An MTEF also forces government to confront key organizational questions, e.g., should a service be contracted out to the private sector or civil society? devolved to a lower level of government? provided by central government?

Focus on overall expenditures for the whole sector. Sectoral MTEFs should cover all activities and organizations in the sector and focus should be on overall expenditures (not capital and recurrent expenditures separately). A coherent set of policies, programs and activities for the entire sector needs to be looked at together. In the education sector, for example, all three subsectors of primary, secondary and tertiary should have to compete for priority and, hence, resources. Emphasizing unity of the budget increases discipline in resource allocation decisions and injects greater realism and predictability into the budget process. In doing so, it helps to achieve greater conjunction between what is promised by government policies and what is affordable in the short run and over the medium term. The Government of Malawi developed an education simulation model in the first year of its MTEF to project the

[1] Other sources of resources should also be considered depending on the sector. For example, the health sector should attempt to assess the resource flow from different forms of health insurance.

financial resources (capital and recurrent) required to pursue objectives by implementing various education policies and programs.

Experience shows that tensions often arise when defining what constitutes the sector and drawing sector boundaries. Mechanisms must be introduced to resolve the issue early on and quickly because the sector approach requires focusing on the whole sector. Even where, for practical purposes, reviews are focused more narrowly, the wider sectoral policy issues must be addressed.

The role of foreign aid. In many aid-dependent countries, there is a high degree of separation between aid and domestic policy, and management and budgeting. Sector MTEF's seek to eliminate that separation by emphasizing all activities (regardless of source of financing) and overall expenditures. In heavily aid dependent countries, failure to include donor-financed activities under the sector MTEF will render the framework completely meaningless. Because of this, MTEFs are particularly relevant in the context of Sector Investment Programs (SIPs) or Sector Wide Approaches (SWAPs). SIPs/SWAPs are gaining increasing support from donors in part because of the mounting evidence of the fragmentation caused by multiple donor projects. Box 3.8 provides a general characterization of SIPs. SIPs have become particularly popular in Africa (Box 3.9) as a mechanism through which all government and donor funding for a given sector are brought together under one strategic resource allocation process.

BOX 3.8
SECTOR INVESTMENT PROGRAMS (SIPs)

Linking planning, policy and budgeting at the sector level is taking place across most regions of the world. In Africa, this approach is the basis upon which sector investment programs (SIP) are formulated. A SIP is the sum total of a country's medium-term public sector development activities in a given sector. It has the following main features:

- It must be sector wide.
- It must be based on a clear sector strategy and policy framework.
- Government must be fully in charge.
- All main donors must agree to and participate in financing.
- Implementation arrangements must if possible be common to all Financiers.
- Local capacity, not long-term technical assistance, must be relied on as much as possible.
- A SIP must move away from the distinction between recurrent and capital expenditure and focus on overall expenditures.

Donor acceptance of the discipline of a sector-wide approach will be crucial for success.

Develop mechanisms to facilitate resource shifts when priorities change. Mechanisms must also be in place to facilitate a shift in resources when policies change from lower to higher priorities or vice versa. Such mechanisms include decision making fora where strategic decisions are made as well as rules that ensure that full information is brought to bear on decision making. Sectoral decisions are made at a number of levels (the whole sector, individual ministries and agencies, etc.). Each is constrained by the decisions made at the higher level but should, at the same time, have the flexibility to make strategic choices within the limits of the imposed constraints. At the highest level, to repeat the earlier point about the centrality of the whole-of-government MTEF, broad sector priorities have to be determined and then reflected in resource allocation decisions within a sector ceiling that is imposed at the government-wide level (usually by the Cabinet or the Council of Ministers). Sector leaders making intrasectoral decisions have flexibility in the decisions they make, but they are also restrained by a hard budget constraint as well as by the need to ensure that sector spending priorities are consistent with the fiscal objectives of the government. Each subsequent level operates similarly to maximize strategic priorities within limits.

BOX 3.9
AN AGRICULTURAL SIP IN ZAMBIA

The 1995 Budget Brief of the Minister for Agriculture noted that, in the past, the government of Zambia was faced with a fragmented project approach to development in agriculture. There were over 180 ongoing projects and a large number of donors. Each of the projects had different objectives, often different from Zambia's overall sectoral objectives. Government has now moved to a more integrated program approach that provides a much more realistic link between policies and resources. All donor assistance will be coordinated with this program approach.

Government has developed a set of subprograms that encompass all subsectors of agriculture. The approach is called the Agricultural Sector Invest Program (ASIP). The ASIP reduces the fragmentation of donor-supported projects, thereby improving the effectiveness of development assistance. The reform aims to increase efficiency, ownership, capacity building and sustainability. The ASIP differs from the traditional project in several ways. The ASIP:

- covers the entire country's agricultural sector;
- has been prepared by a Zambian Task Force representing the public and private sectors;
- is being implemented within the ministry's existing institutional framework at the subprogram unit level;
- standardizes donor implementation procedures for procurement, reporting, accounting and auditing;
- uses long-term expatriate technical assistance only when requested by ASIP implementors;
- is embedded in individual public sector agricultural reforms aimed at decentralization and beneficiary participation.

Particular attention is being paid to building capacity and sustainability through a strong Zambian management team. What will need to be watched are the risks associated with complex project design and over reliance on long-term technical assistance.

The program emphasis is on high priority investment in the public and private sectors as well as on key policy and institutional reforms. Among government's long-term objectives is to significantly expand the sector's contribution to the national balance of payments by expanding agricultural exports.

When priorities change, decisions relating to associated resource shifts are made in such fora. For example, alternative service delivery arrangements, elimination of whole programs and activities as well as making "policy" adjustments such as higher pupil: teacher ratios could be considered. Annex E in Part II provides an example of an approach to education in Malawi where "policy" variables were manipulated.

LINKING POLICY, PLANNING AND BUDGETING AT THE GOVERNMENT-WIDE LEVEL: A COMPREHENSIVE MEDIUM-TERM EXPENDITURE FRAMEWORK

An MTEF is a whole-of-government strategic policy and expenditure framework within which ministers and line ministries are provided with greater responsibility for resource allocation decisions and resource use. The key to a successful MTEF is that institutional mechanisms assist and require relevant decision makers to balance what is affordable in aggregate against the policy priorities of the country. 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. Conservatively defining the medium-term aggregate resource envelope should help change the psychology of budgeting from a "needs" to an "availability" mentality as well as enhance the predictability of resource flows and policy over the medium and short term. The components of the Australian system are outlined in Annex F, Part II.

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 plan ahead and programs can be sustained;
- provide line agencies with a hard budget constraint and increased autonomy, thereby increasing incentives for efficient and effective use of funds.

The approach to building an MTEF will depend on the conditions in the particular country. The more unstable fiscal policy is, the more out of balance are available resources and policy, program and project demands. The less integrated policy making, planning, and budgeting are, the more budget making is focused on funding. The more unsustainable particular categories of expenditure are (e.g., wages and salaries, pension, interest payments) the longer it will take to put in place a credible MTEF. In fact, where these conditions exist, it is likely that a significant one-off adjustment of expenditures may be required before an MTEF can be expected to deliver.

Where significant imbalances exist, there is a case for aggressively employing top-down expenditure ceilings and providing such ceilings for the period covered by the MTEF. However, the very nature of the uncertainties confronting countries with such imbalances means that forward year ceilings will be, at best, indicative. Sector level managers must understand that the ceilings will be reset during each annual budget cycle to reflect changing macroeconomic conditions and policy priorities (and, more simply, better information). The contribution of an MTEF to improving budgetary outcomes will depend on the ceilings delivering greater predictability than the current arrangements. Therefore, ceilings should be set conservatively. Budget decision making must shift as quickly as possible to being policy driven and away from being funding driven. For the annual budget, sectoral ceilings should be set after key strategic policy decisions are made at the center of government (Cabinet, Council of Ministers, President). These ceilings, in turn, must be provided to sectors in sufficient time for the minister and officials to be able to reprioritize on a programmatic basis.

Serious and sustainable reprioritization and reallocation will not occur so long as the focus is on inputs by economic type (wages and salary bill, operations and maintenance, "development" investment, interest). To engage policy makers, the reconciliation of what is demanded with what is affordable must be increasingly policy and program based.

Where these imbalances are not so great or have been reduced, use of top-down ceilings should be confined to the budget year. Most importantly, there must be a medium-term aggregate expenditure constraint, medium-term costs of existing policy, and institutional mechanisms that facilitate reprioritization and reallocation of resources.

Stages of a Comprehensive MTEF

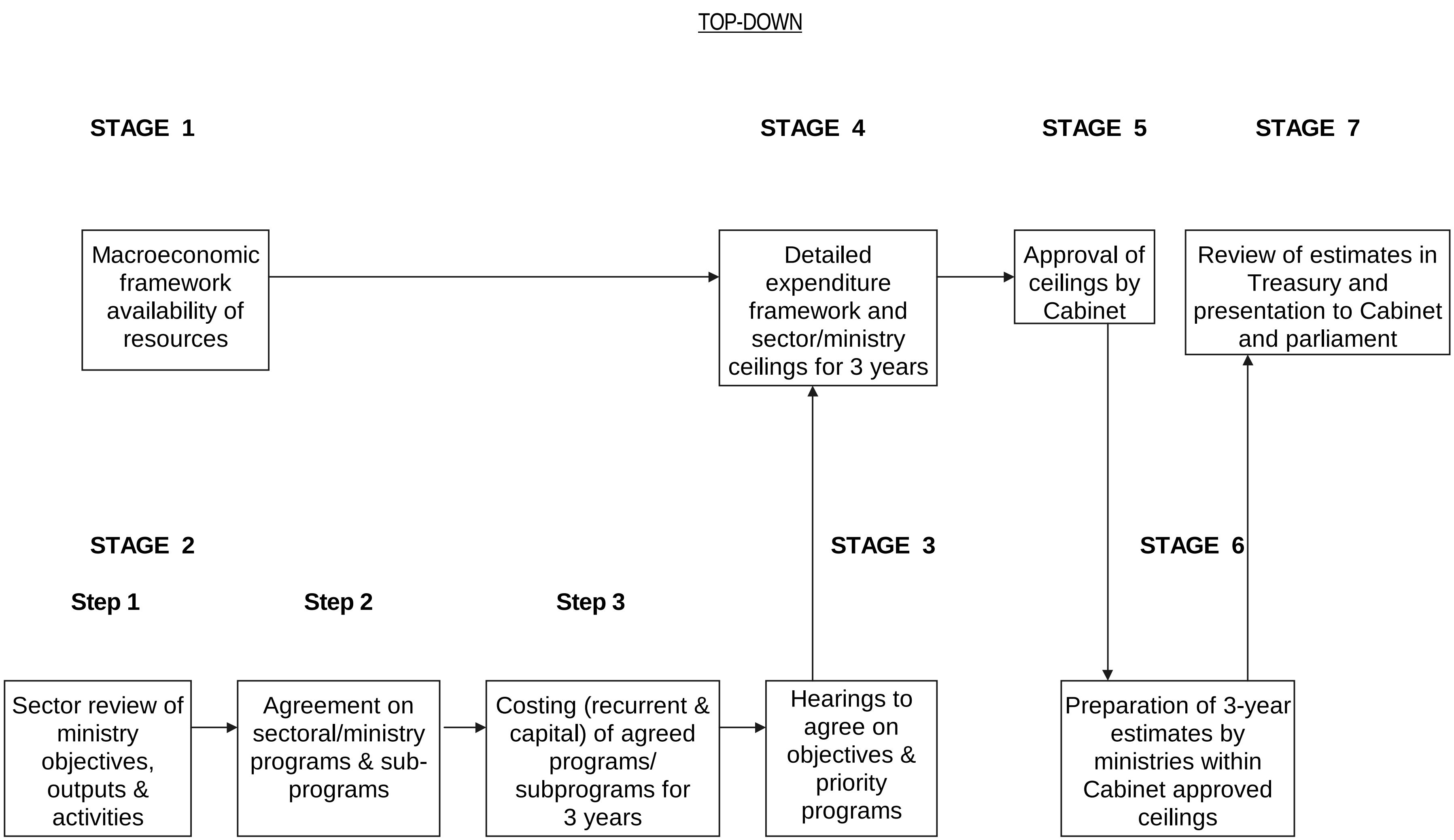
Preparation and implementation of an MTEF takes place through an integrated, bottom-up/top-down strategic planning process consisting of seven main steps, each of which feeds into the next. Figure 3.3 provides a schematic representation of the stages, drawing in particular on the Malawian experience.

Stage 1. This stage involves developing the macroeconomic framework, which will be used to make projections of revenues and expenditures for three years. The key activity here is macroanalysis and modeling, a necessary step in achieving aggregate fiscal discipline. Information on what is fiscally affordable and sound is required for restrained decision making. In this exercise, the importance of linking economic projections to fiscal targets and the requirements for constructing and using models must be kept in mind.

Linking economic projections to fiscal targets. The transition from planning to budgeting often suffers from inconsistencies such as overcommitment. This occurs when decisions do not take into consideration the aggregate resource constraint or their ongoing costs. Models can assist in identifying problems by checking the internal consistency of proposals and by generating accurate forecasts. Models can also illustrate trade-offs between alternative uses of resources and can make explicit the underlying assumptions about relationships and priorities. Constructing a model can expose differences in assumptions about what drives decisions or relationships and reveals deficiencies in data. Personal computers and software have increased the scope for using models for analysis and explanation.

Constructing and using models. The value of model building stems from involving the interested parties in reviewing data, discussing different perceptions about the relevant relationships, and identifying data requirements. A working group on a macroeconomic model may be the first occasion that technical staff of finance, planning and statistics agencies, together with the central bank, have collaborated directly. This coming together can be used as a basis for more systematic coordination in the future.

Figure 3.3
STAGES OF THE MTEF



Stage 2. This stage can proceed in parallel with stage one and involves a sector review process through which sector/ministry objectives and activities are agreed and then costed. The sector review process consists of three stages (Stage 2 is discussed in more detail at the beginning of this chapter.):

- agreeing on objectives, outputs and activities;
- reviewing/developing agreed programs and subprograms; and
- costing agreed programs.

Once ministries have reviewed and costed programs and subprograms, they also need to go through a process of prioritization to make program costs fit within available resources. This involves agreeing on which activities are to be scaled back, postponed until the following year or dropped altogether. The impact of these reductions on targets such as pupil-teacher ratios or kilometers of roads rehabilitated will also need to be identified. This information is provided to the Ministry of Finance and used to develop the expenditure framework and ceilings. During this stage, ministries can also develop performance indicators for agreed programs and subprograms so that, over time, there can be greater emphasis on what ministries are achieving with the resources they are given.

Stage 3. This stage involves a series of hearings between the Ministry of Finance and sector ministries to go over the outputs of the sector review (Stage 2).

Stage 4. With the macroeconomic framework and the sector review output in hand, the Ministry of Finance now develops a strategic expenditure framework. This framework enables the analysis of the trade-offs between and within sectors of certain funding decisions and is the basis for the establishment of sector expenditure ceilings for the upcoming budget year as well as the two outer years.

This framework should be used to guide the deliberations of the decision making body (usually Cabinet or the Council of Ministers) that makes strategic resource allocation decisions. The policy framework must enforce aggregate fiscal discipline, which demands a high-level of consensus among the key players. This consensus is essential to ensure that there is discipline in adhering to expenditure targets and to the procedures that have been agreed for adjusting them. The framework needs to cover a medium-term time frame (three to five years) and must include clear statements on the following:

- the broad objectives of policy and the role of 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 agencies.

The consensus that emerges must include political and technical levels and, where aid is significant, major donors as well. However, leadership must come from within the government if improvements in planning and budgeting are to be durable.

Stage 5. This is a crucial stage of the MTEF process and requires the main decision-making body in government (Cabinet or Council of Ministers) to make medium-term sectoral resources allocations on the basis of affordability and intersectoral priorities. This is done by defining sector resource envelopes (budget ceilings) for the next three years. The more out of balance are policies and resources, the more likely indicative resource envelopes beyond the budget year will be valuable. However, the poorer the balance, the more difficult it will be to deliver on these ceilings when the forward year becomes the budget year. The test of these envelopes is their credibility, i.e., they do not change so much during the cycle as to become meaningless. It would be expected that they would become tighter through the cycle, i.e., from indicative in the outer years, to reasonably firm for formulation of the annual budget, to very tight during budget execution.

Top-down sector resource envelopes with a medium-term horizon are a basis for predictability so that appropriate strategic and efficient operational decisions can be made and implemented. Restraint and discipline in defining the sector resource envelope increases predictability of resource flows, thereby increasing operational efficiency, and permits greater flexibility in the management of the resources that are defined by the sector envelope (e.g., by devolving authority for lower level resource allocation decisions within the tight aggregate constraint). Sector resource envelopes can be derived by establishing a sustainable macro ceiling for government expenditures over the medium term, then breaking it down. A division between discretionary and nondiscretionary expenditures should be made. A medium-term perspective increases the scope of effective discretion, e.g., over staffing levels and salary obligations. An unallocated contingency can be withheld to cope with uncertainties and to allow for adjustments for unanticipated expenditures, but this should be kept to a minimum as it can easily become a "slush" fund.

The political aspect of resource allocation makes it wise to reach agreement on the criteria to be applied to allocations. Agreement on criteria provides guidance on how to adjust to new or altered circumstances and can increase discipline and predictability. Box 3.10 identifies some criteria that can be applied in deriving broad expenditure allocations. The list is neither exhaustive nor prioritized, but merely provides examples of criteria that have been applied in different experiences with expenditure allocation. Sector envelopes reflect the inertia associated with existing policy and the dynamic of the changing priorities of government - political, economic and social. The envelopes should be defined in a way that provides incentives for trade-offs between policies and programs at the sector level. Aid and local domestic funding, and capital and recurrent expenditures should be incorporated within a single guideline. This comprehensive approach should result in pressure to unify the budget and to reduce bias in the choice between development and recurrent expenditure. This comprehensive approach will take time to implement especially at the government-wide level, as illustrated in the case of Malawi (Box 3.7).

BOX 3.10
EXAMPLES OF CRITERIA TO APPLY IN SETTING BROAD EXPENDITURE ALLOCATIONS

- Identify whole categories of public expenditure that should be phased out based on previously agreed policy priorities or role of government.
- Analyze the functional classification of expenditures to ascertain inconsistencies between actual resource allocations and agreed roles for the public sector.
- Check international comparisons for expenditure ratios for each sector.
- Analyze underfunding/overcommitment, including composition of expenditures, e.g., the balance between personnel and operating expenditures, trends in real levels of salaries and of aggregate funding, and the extent to which the development budget and aid projects have become disguised vehicles for recurrent expenditure.
- Consider cost recovery.
- Review recurrent cost implication of capital expenditures.
- Look for explicit or implied expenditure commitment not already factored into projections.

Stage 6. At this stage, ministries make revisions to the budget estimates to make them fit within the approved ceilings.

Stage 7. The revised ministerial budget estimates are reviewed again by the Ministry of Finance and presented to the Cabinet and the Parliament for final approval.

As illustrated above, implementing an MTEF is a complex task requiring a radical shift in perspective and the way in which business is done. Success hinges on a variety of factors, which include:

- political commitment and endorsement at the highest level to make and abide by the difficult decisions involved in the restructuring of expenditures (Some ministries may need to scale back their activities so that more resources can be directed to higher priority sectors.);

- strong management of donors to ensure that they operate within the framework of the MTEF;

- willingness to subject policy decisions with financial implications, made outside the budget process, to the discipline of the MTEF;

- understanding of, and commitment to, the difficult decisions at the sector ministry level;

- commitment at all levels to abide by the budget decision so that new expenditure decisions are not introduced during budget implementation that would require reallocation of resources (These new decisions mean that the priorities set when the budget is approved by Parliament are often overturned.);

- improvements in expenditure control so that the decisions are not undermined by overexpenditures and reallocation of funds during budget implementation;

- improved macroeconomic management and revenue collection so that revenue shortfalls do not necessitate adjustments to the budget estimates;

- briefings of politicians and senior management during implementation;

- improvements to expenditure reporting on results;

- development of a computerized accounting system.

PUBLIC INVESTMENT PROGRAMS (PIPS)

Public Investment Programs (PIPs) have long been a staple of developing countries. They attempt to provide a mechanism to manage investment projects more effectively both strategically and operationally. They have a parallel in capital works programs in developed countries. In developing countries, they have also played a role in managing external donor financing.

Despite these good intentions, PIPs have, in practice, been associated with many of the dysfunctional budgeting, resource allocation, and financial management practices around the world. In particular, PIPs are associated with dual budgeting - the separation of the capital budget from the regular recurrent budget (Box 3.11). Of even greater concern is that PIPs usually encourage countries to focus on projects, with policy and program often an after thought. The result is an expansionary thrust to spending, leading to unsustainable overcommitment of government funds and instability in all three levels of budgeting - macro, strategic and operational (Box 3.12).

In a well-performing system, policy would be constrained by budget realities, but it would be the driver of projects. There would be a fully integrated approach to the planning of capital and recurrent expenditures, and to aid and domestically financed activities. Consequently, linking planning, policy and budgeting within sectors and across government is likely, over time, to reduce the rationale for traditional government-wide PIPs.

The following are some good practice approaches to improve PIPs in contexts where they are deemed necessary and a shift to a medium-term framework is considered premature:

- Recognize that preparation of a PIP is a political as well as a technical process.

- Develop plans that are realistically cost constrained, by proceeding sequentially from the macro framework to sector resource envelopes and then to selection of priority policies and programs within sector constraints.

BOX 3.11
DUAL BUDGETING

The dual budget may well be the single most important culprit in the failure to link planning, policy and budgeting, and poor budgetary outcomes. The dual budget is misconceived because it is based on a false premise - that capital expenditure by government is more productive than current expenditure. Separating development and recurrent budgets usually leads to the development budget having a lower hurdle for entry. The result is that everyone seeks to redefine their expenditure as capital so it can be included in the development budget. Budget realities are left to the recurrent budget to deal with, and there is no pretension that expenditure proposals relate to policy priorities.

Many countries operate a dual budget system, comprising: (a) a recurrent or regular budget (RB); and (b) a capital, investment or development budget (DB). In Africa, DB's were convenient mechanisms in the first two decades of independence when governments were expanding beyond law and order. DB's were largely about public capital investment such as power supplies, public housing, roads and bridges, schools and universities, and hospitals and clinics, although even then they contained activities that were recurrent rather than capital projects, e.g., malaria eradication and crop research. Donors were willing to finance this expansion, and separate budgets facilitated the coordination of aid.

The DB was usually derived from the first year of the Public Investment Program (PIP), a phased five-year program of sectoral or organizational projects. A well-prepared PIP enabled government to: (a) prioritize future projects; and (b) track the outer year capital costs of development projects. In this way, they avoided the bunching of expenditures and programmed domestic resources for local costs. The total size of the PIP was limited by aid flows and by government's ability to finance recurrent costs. A project with high operating costs might be postponed or redesigned or cost recovery features introduced. PIPs and DB's were planned to stay in step with construction and management capacity.

Unlike the recurrent budget, development budgets covered individual projects. Donors could closely monitor the projects being financed and could identify future projects. Donors preferred the dual budget system. The recurrent budget, which was financed by domestic revenues, had tight ceilings; the development budget was open ended. The size of the development budget was determined by the availability of aid, at the margin an add-on exercise.

In recent years, the composition of the DB has gradually changed due to the growing inability of domestic budgets to shoulder recurrent costs and by the increasing "ring-fencing" of donor-aided projects. Expenditures go into the DB because they are aid-financed, not because they are capital investments. This blurs the capital/recurrent distinction. Nowadays, projects frequently contain three types of expenditure: (a) new investment; (b) rehabilitation of poorly maintained past investments (often aidfinanced); and (c) pure recurrent funding.

The international contradictions in the dual budget have come home to roost. The collapse is traceable to: (a) domestic governance failure that weakened budget discipline and financial management; (b) poor economic policies resulting in the collapse of domestic revenues; and (c) an overexpansion of the public sector, financed largely by aid in the case of Africa, but equally in evidence in Latin America. Recurrent budgets have become debt service and salary budgets, with limited ability to meet operation and maintenance costs of completed projects and ongoing programs.

In theory, the PIP/DB mechanism was not supposed to affect fiscal discipline. In practice, the large volumes of aid and donor preference for projects undermine fiscal discipline in most poor countries.

BOX 3.12
CONCERNS ABOUT PIPs

Over the years, PIPs have raised concerns. One frequent concern is that projects included in the PIP cannot be ranked by economic rates of return. When a project idea is first considered, there is insufficient data. But by the time the latter has been assembled, it is too late in the project cycle to deny the project a place in the PIP. A momentum has already built up. Even if rate of return ranking were possible, Internal Rates of Returns (IRR) are not comparable across sectors, and for many projects they cannot be calculated. Where they can be calculated and data are available, few developing countries could deploy enough economists to cover all project proposals. And if the gatepost for the PIP is a threshold IRR, line ministries will cook the figures. Furthermore, PIP planners never start with a clean sheet of paper. Up to 90 percent of the available space in the PIP may be preempted by ongoing projects.

Another concern is that the growth model underpinning the PIP is inappropriate. The essence of structural adjustment is change through policies that improve efficiency in use of resources. The PIP process does not necessarily support this approach.

Related to this is the concern that in the traditional PIP model, the capital side of the government budget leads the recurrent, giving an expansionary bias to government expenditure. Insufficient attention is paid to the financial costs the government will have to bear once external support has ended and to calculations of recurrent costs. This is particularly troubling since the role of government has changed substantially in many countries and an important task now is to create an "enabling environment" for the private sector. This means a mix of investment, recurrent spending and suitable policies.

Concerns have also been raised about the PIP being too much an instrument of central planning and control. This results in project decisions being made at the central government level rather than in the line ministries and agencies responsible for sectoral programs. A related point is that state enterprise investments should only be included in the PIP if they are funded through the government budget directly or with a guarantee. Concerns have been raised because they are often included in the PIP even when this is not the case, which then has negative implications for management autonomy and accountability.

Finally, because of the heavy influence of foreign aid in many countries that use PIPs, concerns have been raised that the PIP overemphasizes projects at the expense of programs and policies. Further complicating the issue, donor-funded projects are increasingly packages of recurrent and capital inputs, making the PIP no longer a true investment program.

- Utilize a two-stage screening process: passing selection criteria, followed by review at appraisal stage plus identification of funding for project completion.

- Ensure that objectives, policies and expenditures are linked in each sector.

- Build capacity locally for PIP preparation.

- Link the PIP with regular budget procedures and coordinate the PIP with ongoing budget and accounting reforms.

- Enforce discipline in the use of aid.

- Define PIP projects more broadly along program lines.

In developing countries, where development and recurrent budgets are separated, the focus should be on integrating policy and expenditure management. The above good practices are still relevant, but the problems may be more difficult to resolve. These include:

- ensuring that the PIP is comprehensive;

- estimating expenditure requirements for future years;

- evaluating relevance of existing projects to achieve full funding and completion of priority projects;

- developing joint analysis and planning of capital/recurrent expenditures.

A New Paradigm of the PIP

Thinking and practice on PIPs has shifted over the years as a reaction to inherent weaknesses. For example, the limitation of IRR's as a means of formulating the PIP is acknowledged. The role of economic analysis is now defined more as a test of the viability of controversial large projects and as a mechanism to facilitate choice between similar alternatives (i.e., clarifying policy and program choices) within a sector. Consequently, it is generally considered better practice to subject the 10 biggest projects in the PIP to economic analysis than attempt to cover the whole field.

There is also greater recognition that projects should be selected by reference to a range of criteria, both economic and noneconomic and, in particular, the chosen role of government within a sector. Get the latter clarified and good project choices will be more obvious.

This is particularly evident in the transition economies where PIPs especially emphasize two things: (a) ruthless screening out of hang-over projects from central planning using a mix of economic and noneconomic "role of government" criteria; and (b) where substantial capital investments are necessary to re-tool the public sector, mechanisms are put in place to ensure that the investments are firmly embedded in the changed role for the government. There is also a change in the transition economies in the type of projects in the PIP. Particularly, there is less reliance on technical parameters in determining new investments and more on efficiency considerations - changed management processes coupled with selected re-equipment at existing government facilities.

There is also greater emphasis now on the recurrent budget (RB) as the starting point. Related to this, there is recognition that the PIP, the DB and the RB should be integrated in some sort of medium-term financial framework in which the resource envelope is defined by the central government, not donors. This would give the PIP more of a top-down flavor, to counterbalance the bottom-up project driven nature of the traditional model. Put programs and policies first. This approach also puts more emphasis on the importance and benefits of sound aid management by the central government.

More emphasis tends to be placed now on clarifying what should and should not be in the PIP (e.g., decisions on whether to include: TA projects, direct donor-financed projects, entirely government-financed projects, local government projects, parastatal projects, etc.). In deciding what to include, the criteria have shifted from an economist's view of what constitutes public investment to a more managerial interpretation of the PIP as a tool to manage public expenditures and, in particular, external financing.

There are also increased efforts to limit the adverse central planning characteristics of PIPs, by a greater use of sector envelopes within which line ministries have discretion to select projects up to a specified share of the PIP. Large projects, however, still require central appraisal and collective decision. Boxes 3.13 and 3.14 give country examples of changes that are taking place in ongoing PIPs.

BOX 3.13
SHIFTING EMPHASIS IN PIPs

The shift from the traditional model of the PIP can be seen in a number of Public Investment Reviews (PIR's) and Public Expenditure Reviews (PER's) undertaken by the Bank in Central and Eastern Europe. The Poland Sector Investment Review contains robust criteria that can be applied to the PIP to screen out projects carried over from the central planning era. The Estonia PER places strong emphasis on getting the role of government clear. The Bulgaria PER focuses on screening and integrating Extra Budgetary Fund (EBF) funded projects into the PIP and better linking the PIP with the annual budget. The Albania PIP embraces many of the above approaches (e.g., the effort to clarify what should and should not be in the PIP).

Concerns have been raised about PIPs, but current thinking indicates that, with modification, the PIP can still be useful, provided it follows rather than drives policy and the budget. In a sense, a PIP is a reflection of external financing of the government budget. Thus the PIP is a tool for better managing donor aid that, for the most part, comes in project form. In industrialized countries, there is no PIP, nor a formal separation (in most cases) between a recurrent and capital budget. This partly reflects the fact that government programs are domestically financed and sources of funding are wholly fungible, and partly because, in an industrialized market economy, public investment tends to be a much smaller component of total government spending (which is primarily on entitlement programs). In addition to a different budget structure, budgets themselves are more stable, with much less shifting between different sectors than is the case in developing or transition countries. Over the very long term, these countries might be able to dispense with PIPs, but for the present they remain a useful tool for managing external aid and public expenditures generally.

Contexts very enormously, especially between the transition economies and developing countries. In the transition economies, Western budgeting systems and the principles of market economics are being applied from scratch. In developing countries, dual budget systems of external aid have become entrenched.

The transition economies should avoid dual budget systems. But PIP preparation may be a necessary initial exercise if the PIP is viewed in the context of public policy and expenditures as a whole, and the exercise is internally owned and combines the top-down, bottom-up approach. Box 3.13 illustrates this point with an example from Latvia, where a 1994 PER recommended introduction of a rolling three-year PIP.

BOX 3.14
PUBLIC INVESTMENT PROGRAMMING IN LATVIA

Based on the findings and recommendations of a 1994 Public Expenditure Review, the Government of Latvia decided to launch a rolling three-year Public Investment Program (PIP) as a measure to strengthen the management of public investment in the country and a first step towards developing a medium-term fiscal planning framework.

The public expenditure review indicated that as of 1994 there was no proper screening process to select projects for investment, no investment strategy or clearly defined investment priorities and, most importantly, no mechanisms to match investment decisions with long-term development objectives and available resources. To overcome these difficulties, a rolling PIP was proposed.

The PIP system proposed for Latvia focused on resolving the main issues in public investment:

1. development and adoption of a clear view of sectoral strategies and government priorities, which will drive the formulation of the PIP and the broad allocation of resources;
2. rigorous screening of all projects (including some ongoing projects) proposed for inclusion in the PIP (Specifically, it was recommended that cost-benefit and cost-efficiency analysis be applied to all projects financed from state and local projects as a means of prioritizing investments. At the time of review, this methodology was only applied to foreign financed projects.);
3. allocation of adequate resources for maintenance and depreciation of assets (The former would reduce the need for future investment to rehabilitate deteriorated assets, while the latter would be necessary to ensure adequate provision to replace obsolete assets.);
4. matching investment needs with availability of resources (Based on a preliminary ranking of high and medium priority projects and financial resource availability projections, the PER concluded that less than half of high- and medium-priority projects could be financed in the next three years. Thus, careful selection and screening mechanisms would have to be further utilized to restrict the range of priority projects and close the funding gap.);
5. improvements in the formulation and implementation of annual budgets, including linking preparation of the PIP to the annual budget cycle and requirements that the annual budget only finance investment projects included in the PIP.

Source: Latvia Public Expenditure Review, July 1994.

CHAPTER 4
FINANCIAL MANAGEMENT INFORMATION SYSTEMS

Information is the life blood of budogetary, resource allocation and financial management. Financial management information systems (FMIS) provide decision makers and public sector managers with a set of tools to support:

1. controlling aggregate spending and the deficit;

2. strategic prioritization of expenditure across policies, programs and projects for allocative efficiency and equity;

3. better use of budgeted resources, i.e., to achieve outcomes and produce outputs at the lowest possible cost.

Improving systems and processes requires an understanding of how these three levels interact. Particular attention needs to be given to the capacity to link the three levels through a set of commonly shared data bases. There is a need for vertical integration—through the planning, budgeting and financial management cycle—and horizontal integration—accounting, budgeting, cash management, and audit. This chapter discusses approaches to this integration.

Traditionally, control has been the dominant, if not the single, reason for developing FMIS. This control role will always be central. However, to deliver on the three levels of performance, FMIS's that support a results orientation at the strategic and operational level will be needed. Financial data that support informed decisions on policies and programs and that link information on costs, outputs and outcomes will be essential. The trend to decentralize within and between levels of government also underscores the importance of adequate FMIS.

This chapter is not advocating a big bang theory of FMIS. A modular approach will often be appropriate. Most of the elements of a comprehensive system exist in some form in every country. The nature and pace of integration of these elements will vary from country to country, but each step must take into account the end point - timely and reliable information for use throughout the resource allocation, budgeting, and financial management cycle. Some countries may be in a position to take advantage of developments in information technology to move relatively quickly from a currently disabled, manual system to an automated, integrated system. Automation will not, however, resolve problems associated with structure and a lack of discipline on the part of decision makers (Box 4.1).

BOX 4.1
BUDGETING AND ACCOUNTING REFORM IN TRANSITION ECONOMIES AND DEVELOPING COUNTRIES

For economies in transition, the strategy for building the budget and accounting system should focus at the outset on the careful control of budget execution and the management of cash and public debt. Major emphasis is therefore being given to establishing a framework and building a treasury system that would control release of funds to ministries, take over full accounting functions from the banking system, and manage cash and public debt. The treasury system, once established, will provide a good basis for developing the budgeting functions. Revenue uncertainties, combined with political pressures for social spending and resistance to expenditure reductions elsewhere, mean that the approved budget is often an unrealistic guide to a sustainable level of public spending. Simultaneously, therefore, it is important to address the budget preparation process because poor preparation will impose irresistible strains that interfere with control during budget execution.

In developing countries, core government budgeting and accounting systems will play a critical role in rebuilding and developing budgeting systems. In general, developing countries have inherited manual systems, which continue to provide a reasonable basis for control. Today's complex administrative processes have not been matched by the development of skills or the modernization of budgeting and accounting systems. Commonly, government accounts are not produced on time and are not comprehensive and reliable. The stand-alone systems that are in use often result in a further weakening of the central budgeting and accounting system. The most appropriate strategy would be to provide strong support for the central accounting system and to choose a flexible design that meets the needs that specialized stand-alone information systems now address. Alternately, the central and auxiliary systems could be integrated. For effective control, it is even more important that these countries confront the major dysfunction in their systems, which is the failure to link planning, policy and budgeting.

FMIS INADEQUACIES

Inadequacies in FMIS show up in all aspects of budgeting, resource allocation and financial management. From the perspective of the three levels, the most obvious symptoms of inadequate systems are:

1. at the macro level, assessment of the fiscal situation is derived from the books of the central bank;

2. at the strategic level, there is no costing information on policies and programs;

3. at the operational level, financial information is not available on time or in a form that facilitates effective expenditure control or management of agencies, programs or projects.

More generally, the symptoms include a lack of timely and appropriate financial information for decision making during planning and budget formulation; lack of timely and accurate financial management information during budget execution; and non-existent, or out-of-date financial reporting.

Some of the factors underlying these inadequacies include:

- gaps in the legal framework ;
- lack of a standard classification coding structure;
- poorly specified reporting requirements - external and internal;
- multiple ex ante controls on expenditure;
- multiple FMIS, often computer based, across government that do not communicate with each other;
- an inability to move data from one stage in the budgetary cycle to the next.

INSTITUTION BUILDING AND POLICY REFORMS

Implementing and improving information systems should be seen in the context of wider institution building and policy reform efforts. FMIS influence, and are influenced by, an overall regulatory framework that consists of:

a. the control structure that governs the use of government funds and are derived from the legislative framework;

b. accounts classification, which enables consistent recording of each financial transaction for expenditure control, costing, and economic and statistical analysis;

c. reporting requirements covering: (a) external reporting - to provide information to the legislature and the public, as well as to other countries, international organizations, overseas investors, and financial markets; and, (b) internal management reporting for government policy makers and managers.

Computerization is a key issue linked to any consideration of FMIS. As a minimum, the adequacy of the regulatory framework will need to be reviewed and modified as appropriate, and the institutional capacities of the responsible government agencies analyzed - inadequacies highlighted and corrective measures identified - before computer systems can be designed to support fiscal management. The benefits realized from computer systems will depend on the degree of success in strengthening basic functional processes, the regulatory framework, and the organizational structures responsible for them. Computerization is discussed later in this chapter.

DEVELOPING A CORE SYSTEM

The central premise of this chapter is that the broad technical requirements of government budgeting and accounting are similar for all countries, and a core system can be specified to meet these requirements. Such a system would meet basic needs for most countries, but aspects would need to be tailored to suit particular needs. The rate of implementation would depend on the capacity of individual countries. Better integration of the subsystems is the ultimate objective, so it is important to build in this capacity from the outset.

Many countries could start with a core accounting system that consists of modules for accounts payable, accounts receivable and the general ledger. An automated accounting system would ensure completeness of data capture. No transaction would be processed outside the system, and rigorous financial controls would be applied to all transactions processed by the system. With the core accounting system as a foundation, government could then expand the system as capacity developed.

Developing a system involves: (a) analyzing business processes involved in fiscal management; (b) defining a general information architecture, which is derived by an analysis of the strength of information linkages among the business processes; and (c) defining a general systems architecture, based on the information architecture. The general system architecture can be used for the design and development of application software, or for the selection of existing software packages that meet requirements.

The functional processes carried out by the central government in the areas of budgeting and accounting - and linkages to the control framework - are illustrated in Figure 4.1. As indicated, the functional processes can be categorized as those carried out by the central agencies and those carried out by the spending ministries and agencies. Those of the former group are most directly linked to the control framework. Indeed, one of the main functions of the central agencies is to ensure that the control framework is properly applied throughout government.

Figure 4.2 shows the core elements of the information systems network required to support government fiscal management and the main information flows between these elements. This information architecture has been derived by analyzing data from a number of countries on FM processes and the information systems required to support these processes. The Y-axis lists the main processes in FM; the X-axis lists the organizations normally responsible for these processes. Each box lies at the intersection of the functional process and the organization(s) normally responsible for the process and is the information support system for that process. Each system could comprise a number of subsystems. Figure 4.2 also shows the main information flows between the systems modules. Annexes G, H, and I supply details on how information systems assist during the budget process.

FIGURE 4.1
FUNCTIONAL ANALYSIS, CONTROL FRAMEWORK, AND FUNCTIONAL PROCESSES

FIGURE 4.2
INFORMATION SYSTEMS ARCHITECTURE FOR GOVERNMENT FISCAL MANAGEMENT

FMIS Support at Macro, Strategic and Operational Levels

Macroeconomic forecasting. This group of systems is normally used by the MOF, the Planning Organization, and the Central Bank to support the setting of fiscal policy. The systems assist with macro fiscal planning and the development of the macroeconomic framework. This is, in turn, used by the MOF to set aggregate budget parameters and guidelines for budget agencies to submit estimates. These systems require data from external economic data bases and the assumptions regarding GNP, inflation rates, and the deficit. Additionally, they require information on programs and projects the government intends to implement over the period of the program such as data on tax and non-tax revenues, and data on domestic and external borrowings, which are maintained by other components of the FMIS network.

Budget preparation and approval. These information systems support strategic priority setting by assisting with the preparation of budget estimates. The systems receive details of ongoing and planned programs and projects from line agencies, and consolidate and produce from them the documents that form the basis of the negotiations between the line agencies and the Ministry of Finance (MOF). After finalization of the budget, the systems produce the approved budget estimates.

The systems should be able to capture and maintain the budgetary proposals and income estimates of all government agencies and to capture subsequent changes during the budget preparation, approval and amendment processes. The evaluation of the budget proposals include an examination of the manpower component, maintenance and other operating expenses, and the evaluation of the capital outlays program, using baseline data from previous periods for comparison. Examination of the capital budget requires data on the physical and financial status of government-approved projects, both locally and foreign funded. The system should be able to access and generate the baseline data from the relevant past-year data bases.

Budget execution, core accounting and fiscal reporting. These systems support operations and are the primary repository of financial data that serve as the basis of the government's FMIS. These systems perform basic accounting functions, processes for budget execution, monitoring and control, and provide the information required for cash management and to implement cash limits 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 to enable them to better manage their work programs. These systems need to be comprehensive in coverage and a source of reliable and timely data to become a credible source of information for users.

These systems maintain data on:

a. approved (capital and recurrent) budgeted appropriations;
b. sources of financing for programs and projects;
c. budget transfers;
d. supplementary allocations;

e. fund releases (warrants) against budgetary allocations over the course of the year;

f. data on commitments and actual expenditures against budgeted allocations.

The budget execution systems normally operate at two levels - at the line agencies and at the MOF. The line agencies' systems, operated by their finance departments, enable managers to track the budget implementation process and implement expenditure controls at the agency level. The central systems track the budget execution process for the government as a whole.

At the start of the fiscal year, the legislature-approved budget is entered into the system. Budget transfers such as supplementary authorizations and warrants are also entered during the year they are issued. As commitment and expenditure transactions take place at the line agencies, these systems: (a) check for budget authorization and the existence of a prior commitment; (b) record information verifying receipt of goods; (c) authorize payment; and (d) update the total amounts committed and spent. They operate on the basis of commitment, verification and payment request transactions received from the line agencies, either electronically or on paper.

Subsystems

There are a number of subsidiary systems that are essential to a well-performing public sector.

Subsidiary payment systems. These systems cater to payments such as payroll and pension. The systems post summaries to and interface with the core accounting system.

Cash management system. This system maintains an up-to-date picture of the government's liquidity position and cash requirements. This system 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. This information is obtained either from the general ledger or from the systems for these areas, e.g., the debt management system. Government can use this information to decide on: (a) budget ceilings and fund releases to line agencies; and (b) the timing of the issues and redemptions of government securities to provide short-term financing for shortfalls.

Debt management system. 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, these systems also provide important information required in the formulation of fiscal policy such as forecasts of draw down and debt servicing liabilities, and debt implications of fiscal and deficit financing policies.

Civil service management systems. This system assists in aspects of civil service management that are relevant to FM. These are processes associated with post management and payroll and pension payments. The corresponding systems modules therefore form important elements in the FMIS network.

Revenue administration. This group of systems assist the government in: (a) the processes for the formulation of tax and tariff policies; and (b) the collection of tax and non-tax revenue. The tax revenue administration systems provide summary information on revenue collections to the core accounting systems.
Auditing. These systems assist the internal and external audit functions. Auditing takes place at two levels: internal audit at the line ministries during the course of the FY, and external audit by the auditor general through random checks and on the final accounts for the FY.

INTEGRATING INFORMATION SYSTEMS

Integration of the different elements of the FMIS network will not happen without conscious effort and the involvement of all stakeholders. More often than not, information systems are implemented as components of separate projects, responding to specific needs, with little thought given to requirements in other areas and or to critical interrelationships. The resulting information systems are often disparate and segmented with little or no capacity for sharing data. These systems have overlapping and sometimes conflicting functions and provide incomplete coverage, particularly for managerial information requirements, which normally span several areas.

The failure to integrate financial management information results in:

- fragmented and unreliable data;
- duplications of data difficult to reconcile;
- failure to use actual results in planning and budgeting;
- failure to fully and publicly report financial and operational results;
- undue emphasis upon one of the component subsystems, usually budgeting, which tends to dominate, duplicate and crowd out the others.

The investments required to set up modern computer-based information systems covering the major areas of FMIS are sizable and can span several years. Investments could easily range from US$10 to 50 million over five years. Integration is a requirement, not an option, for these large investments to yield expected benefits. Incompatible or duplicative systems would be wasteful and inefficient and would not provide the information that governments require for economic management.

Components of an Integrated Financial Management System

An integrated financial management system (IFMS) consists of an interrelated set of subsystems that plan, process and report upon resources, quantifying them in financial terms. The basic subsystems normally are accounting, budgeting, cash management, debt management, and related internal controls. An important element of modern internal control throughout government is a professional internal audit function that is an integral part of an IFMS.

The factor that "integrates" the system is a set of commonly shared, reliable data bases to and from which all data expressed in financial terms flows. All of the subsystems and users of financial data must participate in common data sharing. The validation, classification and recording of data in the accounting subsystem produces timely reports of classified data for users. The common data base may be manually maintained, but an electronic data base is much more flexible and accessible.

An IFMS can be developed regardless of the organizational structure, but it is likely to function better where the four basic subsystems are closely related under a common, professionally qualified financial management executive.

In integrated networks, the component elements are able to exchange information with ease and to share commonly used data. Integrated systems must be structured along functional rather than organizational lines. The system needs to support a functional area across all organizations being integrated. This enables the creation of systems and data bases in which the agency responsible for a function provides a subset of data. However, the data bases are accessible by relevant core agencies, subject to appropriate security controls. All agencies work with the same set of data, eliminating duplicative data gathering and data inconsistencies.

Framework for Integration

The first step towards achieving integration is to develop a framework that provides an overview of the systems network required to support FM. The framework is developed by analyzing: (a) basic functional processes and information requirements; (b) responsibilities of agencies in charge of the processes; (c) information flows between the processes, including the nature, volume and frequency of these flows; and (d) data characteristics of the information used and created by the processes. This framework would address questions such as:

a. which information systems modules are required to support FM;
b. what is the scope, scale and type of a particular systems component;
c. how do these systems interrelate?

The framework would consist of:

a. a systems architecture that identifies the major component modules of the network required to support FM, the type of information maintained by each module, and the information flows between modules;

b. a technology architecture that identifies the appropriate technology choices for the hardware and software to set up the modules.

The integration of systems modules can be achieved incrementally once the framework has been set up and the prerequisites and criteria for integration have been spelled out and incorporated in the implementation plan. The framework will serve as a road map for implementation.

Automation

Fiscal management processes are transaction intensive. Retrieving information from manual records and reclassifying it in an appropriate format or classification can be extremely time consuming and labor intensive. Automated systems speed up the process and provide the accurate data required for economic and fiscal management.

Three aspects of computer-based information systems are particularly important:

a. the rapid compilation of data on transactions from widespread locations and timely generation of information in formats prescribed by the legislature or for internal control;

b. ensuring that prescribed controls and procedures are adhered to at the point of origin of a transaction;

c. the integration of the posting and classification of transactions with the functional process in such a way that performance (e.g., authorizing a payment) simultaneously ensures that all transactions are classified and posted. This in turn will ensure complete and timely data.

Technological Recommendations

Three important technological improvements for a well-performing information system are: (a) multi-tiered networks; (b) systems portability and scalability; and (c) application-specific technology.

Multi-tiered networks. Several elements of the FMIS network 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. Government-wide FMIS require a multi-tiered network. This could consist of stand-alone microcomputers, local area network (LANs), or minicomputers, located at the nodes (MOF, other core agencies, the line agencies and subordinate/regional treasury offices) and connected by telecommunication lines.

The transaction processing and data base management at each node are carried out by 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 for two reasons: (a) computing power is distributed commensurate with node requirements, making this system less vulnerable to malfunctions at the central site; and (b) end users at the line agencies have more control of 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 (daily, weekly or monthly, depending on the application system) in an off-line/batch node. The size of each node's computers would depend on the amount of data and number of 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.

Systems portability and scalability. For systems modules implemented at multiple levels, the software at each node should be able to be run on small or large computers without major changes. These properties can be achieved by choosing compatible computers that offer multiple size configurations. However, this would restrict 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 portable software that can operate on machines of different sizes offered by several vendors.

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 it can be used on a different vendor's machine; however, time and effort involved in making these changes would be small compared to rewriting the applications.

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 to increases application development productivity, therefore reducing development time.

These tools also enable end users to access the data bases and to program simple reports.

Application-specific technological requirements. The technology required for the system modules would depend on the modules' functional characteristics, including the amount of data handled, the size of the data bases, the number and rates of transactions, and the volume of the information flow between modules. The distribution of information processing, either centrally or among widely separate locations, is important. If distributed among widely separate locations, the following factors should also be taken into account: how frequently the information needs to be aggregated at the center; and the requirements for output facilities such as graphics, report writing and desktop publishing, and for analytical facilities.

Off-the-shelf commercial packages are capable of filling many of the financial management needs of government - general ledger, accounts payable and receivable. For all currently known configurations, however, such packages will require substantial additional work to meet the complex central budgeting and accounting needs. There is a great body of evidence that each country will have its own idiosyncrasies that will produce a design that is unique to that country.

MANAGING IMPLEMENTATION

Implementation of budget and accounting system reforms is a long-term process. Such programs have been evolving in the OECD economies for several decades. A similar or longer-term timetable will be necessary in countries with less developed administrative processes.

For effective resource allocation, budget and financial management, systems must be developed around the core functions described in the preceding sections. Moreover, since the underlying requirements are similar, it may be feasible to draw on the growing number of off-the-shelf software packages to develop a core government budgeting and accounting system (CGBAS) that could (a) provide the basic transaction processing and data base management functions needed for fiscal management in any country; and (b) allow the tailoring of controls, data entry and reporting functions to any country's needs. However, off-the-shelf software packages should not be regarded as the "off-the-shelf solution." As a minimum, they will require significant modification to accommodate the unique demands of a government system of resource allocation, budgeting and financial management. In fact, experience has shown that because of the unique set of institutional arrangements in each country, the design of the FMIS is unique to that country.

The case for developing a core system or identifying suitable software packages is strongest for the EITs. Development of the appropriate institutions to manage a market-oriented economy is of strategic importance to these economies. They are all starting from a similar administration base, so a core system should be readily applicable to all. Development of a CGBAS should greatly reduce the implementation time for all such systems.

The CGBAS should provide a sharper focus for much of the technical assistance provided by international bilateral agencies. The IMF, the World Bank, the regional development banks, and the UNDP have provided assistance to improve various aspects of budgeting and accounting. The need for continuing efforts in this area is widely recognized. If a CGBAS were available, its features could be tailored to meet specific needs, and the implementation time would be much reduced from the broader approaches now being used. General support would continue to be needed. In each country, there would need to be a comprehensive review of systems requirements, administrative constraints, and an appropriate phasing of implementation in light of these factors.

Centering the efforts on a CGBAS, however, should avoid the difficulties that arise from piecemeal development of systems. Clearly defined requirements would enable the systems to be designed to accommodate all budgeting and accounting objectives, whereas computerization of existing accounting systems would only meet the limited objectives of ensuring financial compliance. Information systems development could then play a pivotal role in improving budgeting and accounting, providing that the policy and administrative environment is supportive.

Successful implementation of an integrated network of information systems is crucially dependent on cooperation among diverse users. Project preparation and implementation in a multi agency environment is complex. Key requirements are securing sponsorship at the highest levels of government and participation by the widest range of users in all phases of the project. A necessary condition for sustainability of systems reforms is for key decision makers to see information as critical to their work (Box 4.2). A steering group with representatives from all major stakeholders should ensure that all of the needs of participating agencies are taken into account during systems design.

Agencies will then not have to resort to independent and duplicative initiatives. Cooperation among users would also establish systematic data sharing arrangements, protocols, and schedules between the various systems so that all agencies have access to financial data as needed. The organization in charge of a functional process for the component modules will be responsible for that process.

The number of technical staff and skills required to set up such systems are considerable. To ensure sustainability, an information systems organization should be established, or existing organizational units strengthened, to incorporate and retain the skills and to manage planning, development and operation. The following skills are required: (a) high-level project design and planning skills; (b) project management skills; (c) technical implementation skills - to operate and use the hardware and software; and (d) user support skills - to develop user and technical documentation and to set up training and a hot line for end users.

BOX 4.2
INFORMED DECISION MAKING IN BURKINA FASO

Recent reform efforts in Burkina Faso illustrate successful management of implementation. The success results from the efforts: (a) being part of broader institutional reform; (b) engaging stakeholders; and (c) focusing on information management rather than on computerization.

As part of a structural adjustment program, the government had three interrelated objectives for the public sector:

1. to improve financial management capacity through better control and use of information, particularly financial information, which was not used as a basis for decision making until introduction of democratic rule (This was expected to lead to: (a) better budget preparation and execution; (b) improved public accounting, in line with a new budget structure; (c) improved Treasury operation; and (d) the delegation/decentralization of management responsibilities.);

2. to introduce accountability as a major tool of management through clearly defined rules and procedures of operation of the government, involving the rewriting of the administrative laws;

3. to improve the efficiency and cost-effectiveness of the civil service through a reform based on the introduction of job descriptions, a new salary structure and new rules for promotion and training geared to administrative needs.

A particularly significant achievement was that, for the first time, line managers started thinking together about each other's problems. Before, managers had a ready solution for their own problems, but those solutions, until then, did not take into account the problems of other people and other segments of the administration. These exchanges were kept alive all the way through the implementation of the project.

Behind all of this was the fact that the Minister of Finance had become convinced of the importance of quality information at all stages in the resource allocation, budgeting and financial management cycle. More than a year was spent on the definition of an information structure (not computerization). This is the most important element of the reform and also the most innovative. The one and only long-term technical assistant is a data administrator, not an economist or a public finance specialist. This person is in charge of managing the information system (not the computers), the data dictionary, and information flow, integrity and timeliness. The computerization plan was developed only after an evaluation of information needs of the different entities of the MOF.

Once the data structure was selected and choices were made about what to computerize and at what pace, a data management platform was selected, administrative and computerized procedures were drawn up and the computerization plan (the network) completed. The structure and procedures were then translated into programs. The financial management system came on line early 1996, after three years' preparation. The emphasis during this initial stage is on budget execution.

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 are put in place for managing data and systems across government. The standards should cover: (a) the protocols for communications; (b) data entry; (c) editing and updating screen input and output formats; (d) back-up and recovery; (e) security, contingency and disaster planning; and (f) technical and user documentation.

Project planning methodologies should be used to design, implement and monitor the FMIS, and project management responsibilities should be clearly identified. Phased implementation would ensure that the system can be easily absorbed by organizations.

Hardware and software chosen must be supported locally. Vendors represented locally can provide training and technical support needed during the life of the system.

The Links of Integration

Several "links" are necessary to achieve true integration of the financial management system: training, coordination, harmonization, communication, and collaboration. Most financial management systems fail due to the absence of these links.

A comprehensive training program covering all aspects of the IFMS is essential to ensure that all individuals involved in the subsystems understand the role, need, and underlying concepts involved in each subsystem. All too frequently FM systems fail because budget personnel know nothing about cash management or debt management staff fail to consider accounting requirements. Training staff in each subsystem and other aspects of the system, e.g., internal controls and management principles, would contribute to the success of the system.

The coordination and harmonization of the IFMS component subsystems are necessary to achieve "integration." Harmonization is achieved by means of consistent provisions and standards governing application of each of the subsystems. The principles, policies, standards, manuals, and procedures must be harmonized to avoid conflicts and inconsistencies between one subsystem and the others. Internal provisions for each subsystem must be coordinated with the other subsystems before being completed and issued in final form.

Collaboration among individuals is also important. Communication among staff in the subsystems must be open. Periodic meetings, conferences or round table discussions should be held to discuss problems, areas of possible friction or duplication, and common measures to be taken to achieve more operational efficiency.

Information systems normally have a direct effect on the way people do their day-to-day work. Appropriate change management procedures and training need to be carried out to ensure that staff feel comfortable in the new work environment and, in particular, do not feel insecure about their jobs.

Information systems may also lead to redefinition of the relative authority and power relationships of individuals and groups within organizations. Change management exercises need to cater to these complex effects also.

Partial Integration

Full integration, like full computerization, may not be cost-beneficial in some countries. Varying degrees of partial integration are viable options. The most important element in any partially integrated approach is the integration of the budgeting and accounting systems so as to assure a commonly used data base for managerial decision making and for budget formulation. System design should allow for the remaining systems to be integrated and expanded without redesign.

Each government can decide on a system after evaluating: the success of existing systems, the need to improve the systems, and the opportunity to initiate integration as a part of improvement. The governments can then determine what degree of FMIS integration is reasonable to expect, what expertise will be required and what financing is available.

Figure 4.1:
Functional Analysis, Control Framework, and Functional Processes

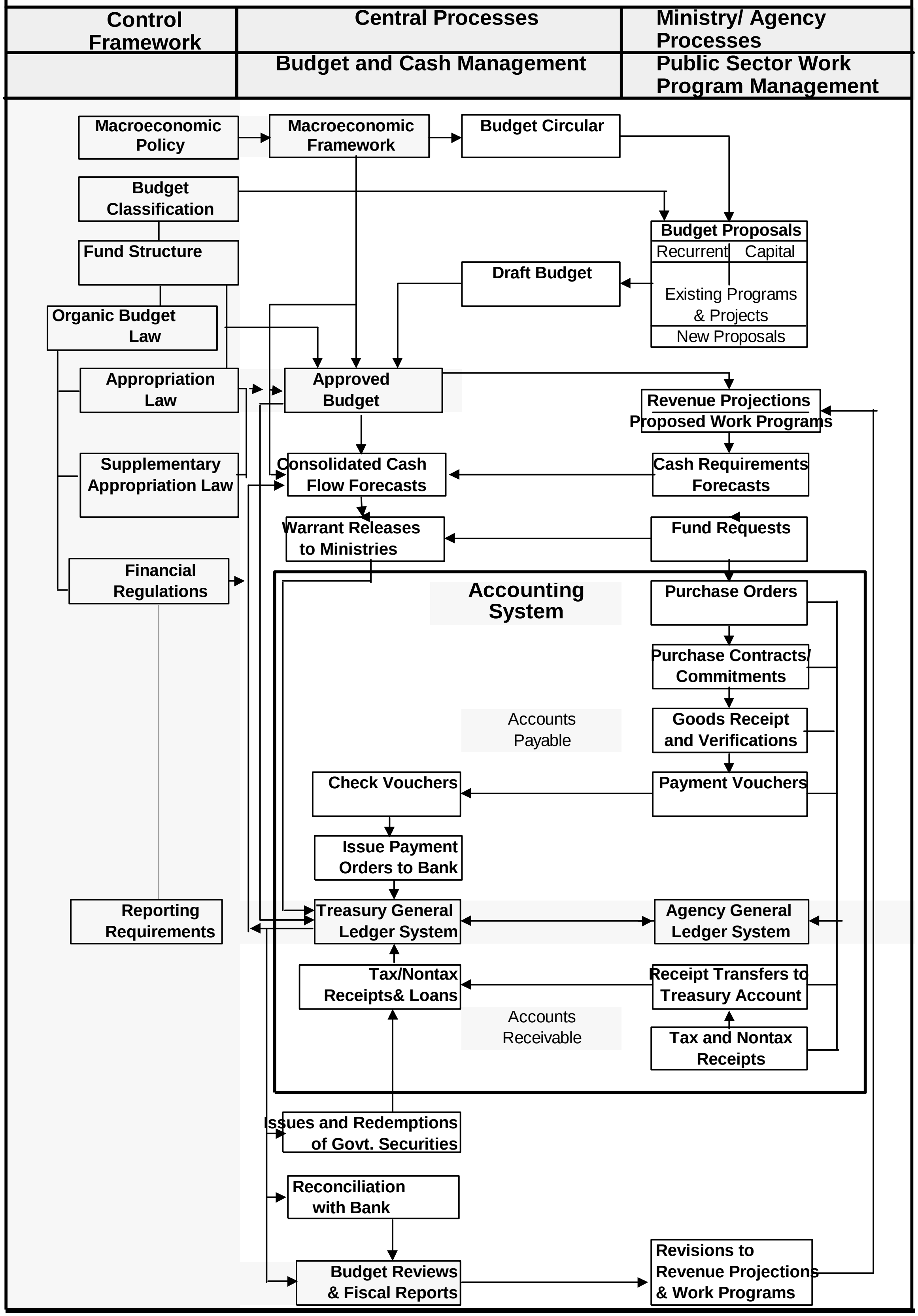
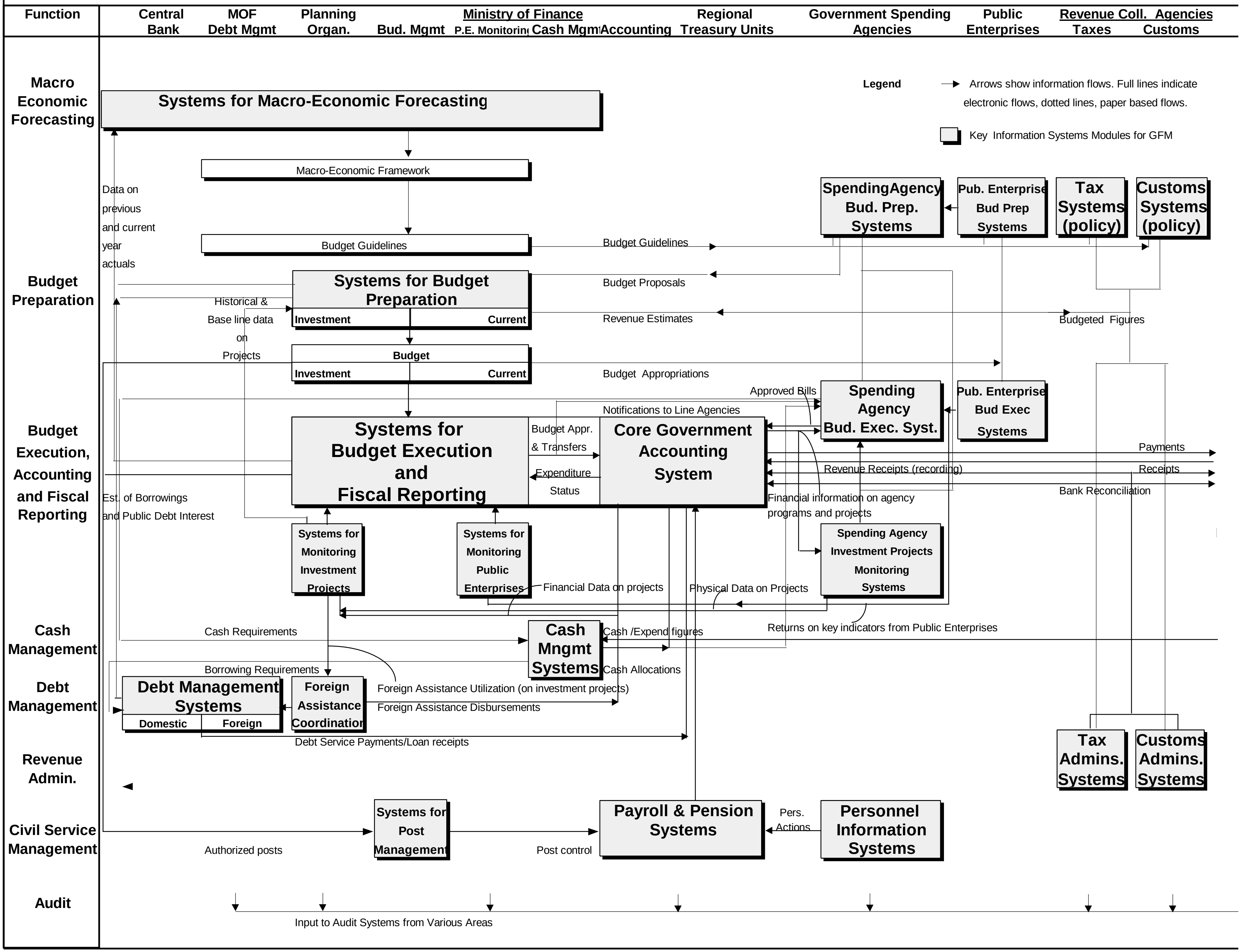
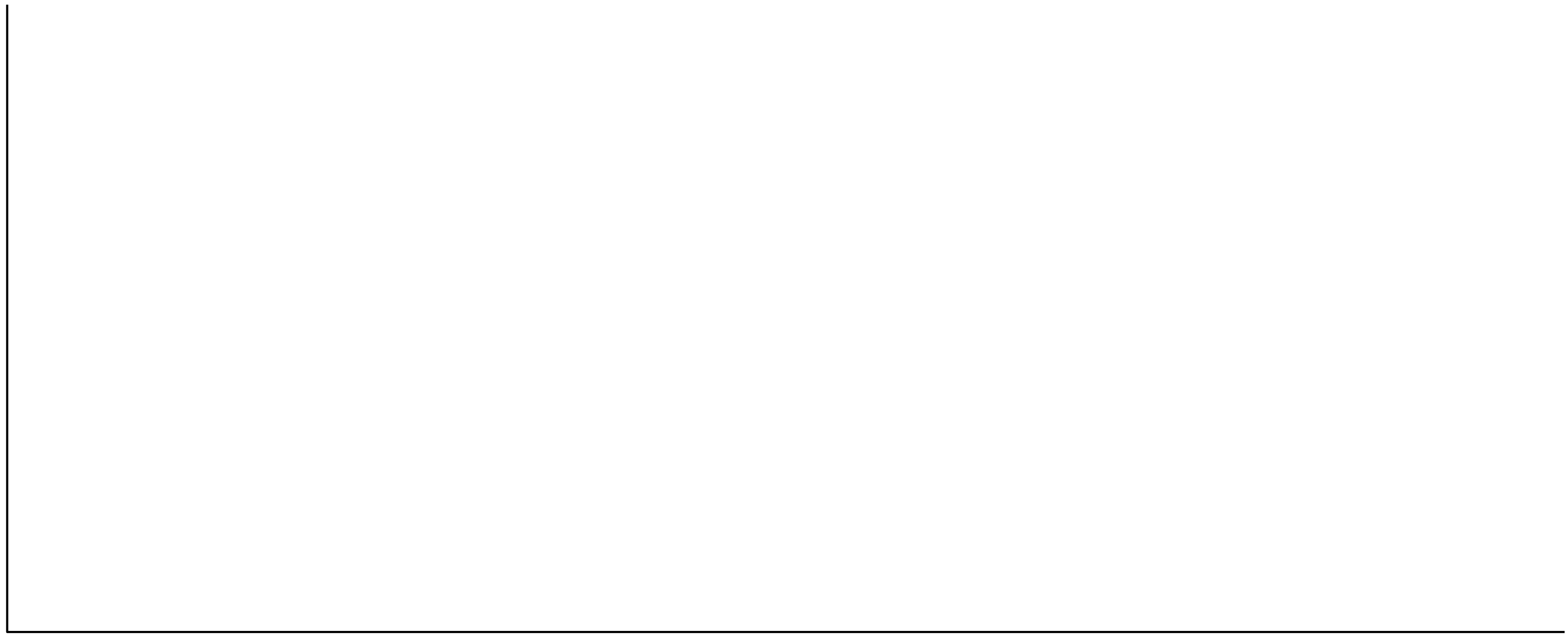
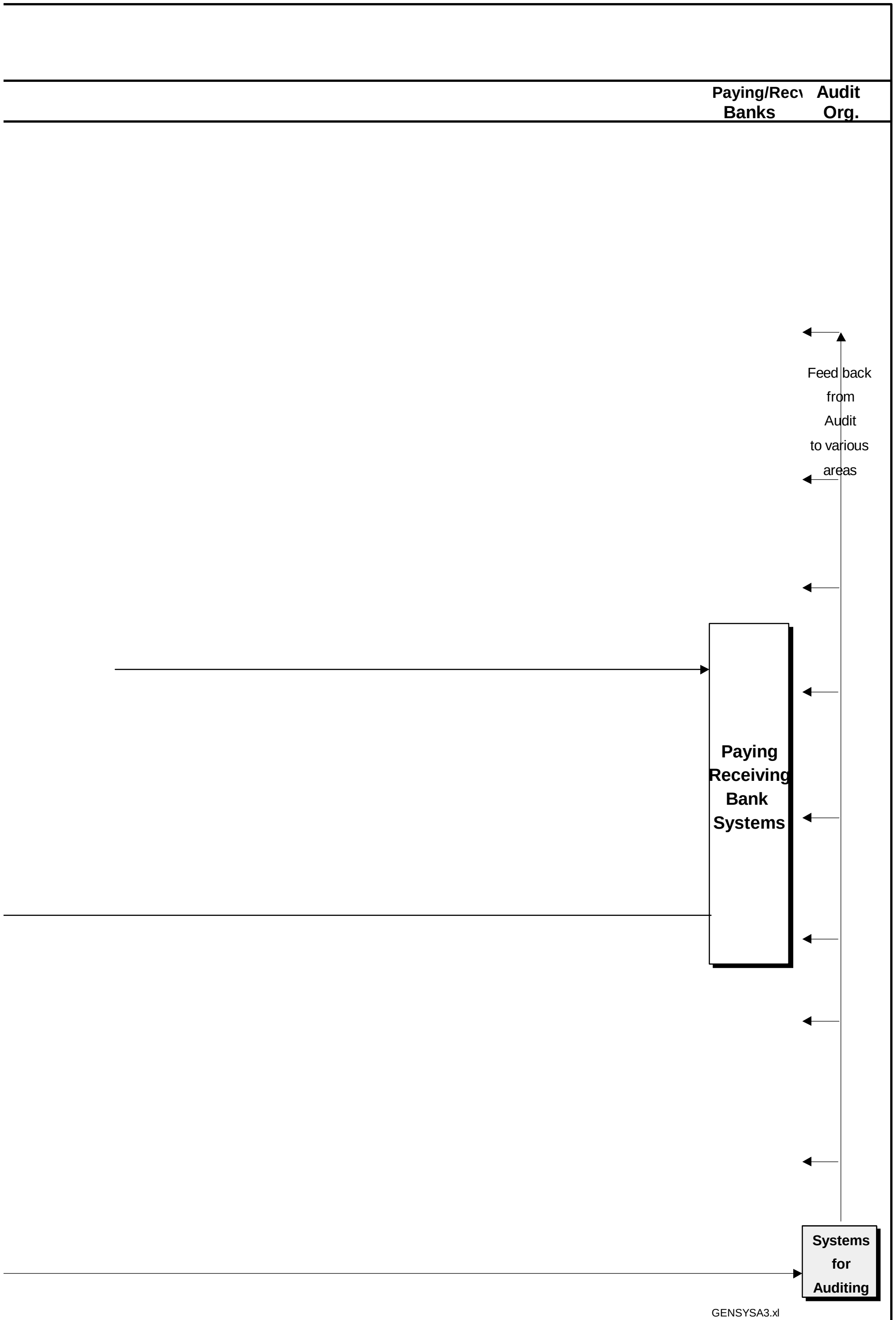


Figure 4.2: Information Systems Architecture for Government Fiscal Management






Paying/Recv Banks
Audit Org.
Feed back from Audit to various areas
Paying Receiving Bank Systems
Systems for Auditing
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CHAPTER 5
APPROACHES TO BUDGET REFORM

Chapter 1 suggests that approaches to budgeting, resource allocation, and financial management are constantly changing to reflect which of the three functions of budgeting is in the ascendancy - control of public resources, planning for the future allocation of resources, or management of resources. A key message was that reform efforts usually failed because they were incomplete. Chapter 2 reformulated these three functions into three levels of budgetary outcome: aggregate fiscal discipline, strategic prioritization and efficient and effective service delivery. This is the basis of a conceptual framework for thinking about what constitutes an effective system of Public Expenditure Management (PEM). Chapters 3 and 4 provide guidance on key components of a PEM system. This chapter discusses approaches to, and sequencing of, improvements.

The original concern of control - to ensure that taxes were spent in accordance with the wishes of Parliament - has since been supplemented by a concern to control aggregate expenditure for macroeconomic stability. Chapter 1 notes that more recent reform efforts incorporate improved approaches to allocation and management of resources. Chapters 2, 3, and 4 point out that budgetary reforms of recent years can develop systems and processes that simultaneously improve performance of all three functions and levels.

This chapter builds on the proposition that reform efforts fail not only because they are incomplete, but also because they are often designed to solve a technical problem when the problem lies in the institutional framework. The next step is to confront the fact that it is often difficult to generate enthusiasm for budgetary reform, notably among politicians. The handbook argues for engaging all potential beneficiaries in reform efforts; for putting the focus on performance; and for defining performance broadly, i.e., in terms of the three levels. With this broader definition of budgetary performance, constituencies with an interest in a well-performing budget have a vehicle for pushing for reform.

Too many countries have been distracted and too many scarce resources wasted by the latest budgetary tool or technique. Specific tools and techniques do have a contribution to make, and they are prominent in most current reform efforts. However, they cannot solve the problem of a budget system and process that is not performance oriented and that does not have the basics right.

CONTEXT AND ISSUES IN BUDGET REFORM

The best examples of current reform efforts represent a substantial departure from past efforts. The new wave recognizes the key weaknesses of past reform efforts, in particular the failure to address the relationship between control and performance and the incentives for performance in the full range of formal and informal budgeting, decision making, and management rules (restraints and flexibilities). Just as budget reform cannot by itself be the sole driver of improved performance - the budget is embedded in the decision making and management practices of government - neither will performance improve sustainably in an environment where the budget system gets in the way of the broader reform effort.

Key lessons about the what and how of budget reform can be derived from the experience of over 100 years of reform across the full spectrum of countries. They are as follows:

1. It is important to consider at the outset the deficiencies of the particular budget system. In what sense is it performing below expectations?

2. Within the basic functions of budgeting - control of public resources, planning for the future allocation of resources, management of public resources - budget systems involve many subfunctions, all of which influence the three levels of budgetary outcome. These subfunctions include policy making, conflict resolution, communicating, accounting, macroeconomic direction, program selection, evaluation, and aid management. A reform program may address one or more of these issues, but it must take account of the linkages between all of them. Particular dimensions require attention:

   a. Budget systems cannot be bought fully assembled off the shelf. They are processes that continue to develop, not solutions for all time. They are also systems linked to other systems, particularly political and managerial. If these systems are deficient, it is unlikely that the budget systems will deliver sound budget outcomes, particularly at levels 2 and 3.

   b. Budgetary basics have to be understood. Budget systems include a wide range of basic supporting services, including accounting, budget examination, estimating, forecasting, monitoring, and evaluating. If these components are not adequate, the budget system is unlikely to perform well. Poor performance occurs when budgets do not come out in time to influence events, contain unrealistic assumptions, are made and remade throughout the year (implicitly or explicitly), contain flagrant opportunities for corruption, or are simply fictions. Such circumstances require patient diagnosis, detailed analysis of how moneys are released, spent and accounted for, restructuring of organizations, institution building, and careful consideration of objectives and methods. The fault will more often lie not with the basic budget systems themselves, but with the environment in which they operate.

   c. Budget systems face certain intrinsic problems, including:

      - the relationship between macro and micro levels;

      - the balance between long- and medium-term commitments and flexibility to meet exigencies;

      - differences in outlook between budget personnel and program and planning staffs related to background, values and functions.

   d. Budget systems are communication systems, conveying signals about behavior, prices, priorities, intentions, and commitments. Budget reforms should take particular account of effective communication, a two-way process that facilitates bringing the full range of stakeholders into the reform process. Particular attention needs to be paid to donor relationships.

e. Where foreign aid is significant, particular attention needs to be paid to aligning donor practices with the reform effort. As a minimum, all donor support to government should be incorporated in the budget.

3. Budget reforms do not implement themselves. A detailed implementation strategy needs to be built into their design, but it must build in flexibility to learn and adapt. No known reform effort has specified at the outset all the elements of the ultimate reform program.

4. Budget systems, however capable, are not self-contained. In particular, they are adversely affected by multiple, converging uncertainties, political instability, vulnerable regimes, wars, entrenched patterns of expenditure, donors, severe inflation, and structural imbalances between expectations and resources. The budget system must be built to cope with these realities, but be aware of self-inflicted uncertainties or rigidities (including those associated with donor practices).

5. Improving the information base to aid decision making is a crucial ingredient of reform, but incorporating more analysis into budgetary decision making does not automatically lead to better decisions. Apart from the problems of quantifying and measuring performance, such information rarely leads to a single clear policy choice. Policy choice is essentially political, and strengthening decision making requires a recognition of the multitude of factors that bear on decisions.

6. Building a greater performance orientation into a budget system is not simply a matter of implementing the latest tool or technique. Excessive expectations are often raised about the capacity of these tools and techniques to contribute to, even replace, central resource allocation decisions. Such costs and techniques are much more likely to contribute to improvement in resource use at the line agency level. In the end, performance-oriented tools and techniques will only deliver where the central processes of resource allocation, budgeting, and financial management change to support and require a performance orientation at the agency level. Equally important are personnel management and structure of government that provide incentives for improved performance.

7. Budget reform is not a choice between leaving the unreformed system in place or adopting a new budgeting approach lock, stock and barrel. Many of the concepts of zero-based, performance, or program budgeting can be incorporated slowly into a traditional budgeting system. Performance depends on a proper balance between restraint and flexibility. This means that reform must work towards putting in place hard, but predictable, budget constraints while providing decision makers with the authority they require to do their jobs.

Specific tools, techniques, structures, and subsystems must support these basic institutional arrangements. Concerns with these apply equally to the tools and techniques targeted in chapter 1 (program, performance and zero-based budgeting) and to current techniques and tools such as output budgeting, performance measurement and, even, accrual accounting. The current tools and techniques have been shown to work in a number of developed countries (although unqualified success with comprehensive performance management systems remains elusive). New Zealand has had significant success with these particular tools and techniques, but as Allen Schick has noted, the lesson for other countries is "Getting the Basics Right," not universal applicability (Box 4 in Introduction).

8. Reform takes time and persistent effort - it is more a pilgrimage than a destination. The important factor is not so much the specific tool that is used for budget reform; it is the institutionalization of the principles underlying the tool.

CURRENT INITIATIVES IN BUDGET REFORM

The 1980s and 1990s have seen a new wave of budget reform. Reformers in OECD countries and, in increasing numbers, in middle income, developing countries and economies in transition, are stressing changes in budget systems that contribute to better public sector performance. A key message of this handbook is that sustainable reform, whether it be comprehensive or concerned only with one component of the system, will be built by considering all three levels of budgetary outcomes and the broader political, social and economic environment. This change in emphasis is illustrated in the current guidelines on Public Expenditure Reviews for the Africa Region (Box 5.1).

Reform designed to put in place an effective PEM system and process along the lines discussed in this handbook conjures up visions of comprehensive and broad-based reform initiatives. However, resistance to comprehensive approaches is common. This concern needs to be addressed when discussing approaches to implementing budget reforms. Skeptics argue that a disadvantage of the comprehensive approach is that it involves a longer time horizon than more narrowly focused initiatives. They also argue that governments (and donors) are often unable to sustain an initiative of comprehensive scope and extensive length. In addition, they cite environmental weaknesses such as closed financial markets and uncertainty of resource flows over the medium term. For these reasons, they claim aggregate fiscal discipline cannot be achieved, or a short-term focus to budget decision making has to be continued.

However, these are not valid reasons. A sailor who wants to get from Cairo to Punta Arenas does not give up on his medium-term objective because a sudden storm hits him. He will have built a boat to withstand violent storms and will have taken on board extra provisions.

Evidence shows that there are many more examples of failed reform efforts where the approach has not been comprehensive, and the initiative has addressed only parts of the problem. Where comprehensive reform efforts have failed, it has mainly been because of poor analysis of the underlying problem. But, comprehensive reform will involve a longer time horizon than will component reforms.

Much of the skepticism about comprehensiveness might lie in a misconception of what is meant by the term. Comprehensiveness is not about trying to do everything at once. Rather, it is about taking a holistic approach to diagnosing the problems, understanding all the interlinkages and evaluating the institutional impediments to performance, and then finding the most appropriate entry point to launch a phased reform process. Phasing can be fast or slow, depending on country conditions, and could eventually expand to become comprehensive.

BOX 5.1
GUIDANCE FOR STRENGTHENING PUBLIC EXPENDITURE MANAGEMENT (PEM)

In the Africa Region, public expenditure reviews (PER's) are seen as having a role in improving PEM. However, weaknesses in past PER exercises need to be corrected. These guidelines therefore recommend an approach that aims to achieve:

- strengthened budget formulation and implementation processes,
- enhanced government capacity for efficient public expenditure management and monitoring;
- appropriate and transparent allocation of public expenditures among competing priorities;
- fuller integration of PER processes with regular budget processes and internalization of the results of such exercises; and
- improved consultation with donors on the composition, management and financing of public expenditure.

PERs need to contribute to developing a government expenditure management system that can:

- prepare, implement, and annually roll forward a medium-term framework for a comprehensive public expenditure budget, which is consistent with the macroeconomic reform program, and which indicates main spending programs and how the overall budget will be financed. Such a framework could include alternative future scenarios and should take full account of debt servicing and the possible impact of rescheduling and debt reduction;
- achieve sound standards of in-year expenditure management and accountability, including transparency vis-à-vis the public and donors;
- generate expenditure priorities and arbitrate between competing needs for scarce resources and reflect government policy objectives;
- ensure that actual expenditure reflects the budgeted priorities and is carried out in time with budget regulations; and
- include all government expenditures, including those financed by donors, and provide value for money.

Source: Africa Web Site.

Budgetary reform, because of its role in resource allocation, is a powerful driver of wider public sector reform. Making performance information available to inform strategic resource allocations is important. This information, however, will be only one input to the decision-making process. Significant strides can be made short of transforming the resource allocation process. Establishing performance-focused accountability for the better use of resources by line ministries is extremely important. New performance budgeting stresses that the most substantial strides can be made when performance information is used for management purposes, i.e., in the implementation phase rather than for resource allocation.

A report from The Second Commonwealth Advanced Seminar on strategies for public service reform, held in New Zealand in l997, noted that "certain aspects of the New Zealand reform (Box 5.2) appear to have wider applicability than others." The report suggested that "certain techniques (sic) appear to be highly transportable:

- a specific legislative basis for reform;

- the creation of an overall government strategy, with linked departmental strategies and individual targets;

- the focus on accountability for outputs and outcomes, rather than for inputs and processes."

BOX 5.2
NEW ZEALAND REFORMS FOCUS ON VALUES AND RELATIONSHIPS

The 1997 report, "Strategies for Public Service Reform," presented at the Commonwealth Advanced Seminar stated "New Zealand reformers wanted to hold on to some key values, and principles, that provide the core of the public service such as equality for citizens, an apolitical public service and honesty. Virtually everything else was examined and changed. New values needed to be developed such as transparency, openness, trust and customer responsiveness." Key relationships were reviewed and changed.

The private sector. Government focused on providing public goods and services not supplied by the market economy. Government-owned enterprises were opened up to competition and, where they did not serve an important policy goal, eventually privatized.

Government agencies. Agencies that remained in government were given the same freedom to manage employees and budgets as their counterparts in the private sector: to purchase directly from the private sector, rather than routing requests through central agencies; to sell directly to the private sector; and to compete with similar private sector businesses (such as weather forecasting). Petty central regulation was removed. In one case, 147 pages of travel regulations were reduced to "reasonable expenses will be paid."

Directions for services are more clearly focused on outputs and outcomes. The government integrated agency goals within an overall strategy, spanning agency boundaries. The strategy gives agencies clear performance objectives, defined in terms of outputs and related closely to costs. The chief executives of government departments have been made clearly and personally accountable to their ministers for the performance of agencies. Performance expectations are specified through performance contracts, including key measurables based on outputs. Reporting is transparent. There is two-way feedback, and there are consequences for performance (positive and negative). Government accounting is aligned with the private sector's generally accepted accounting principles, with full accrual accounting and balance sheets.

At the start of the reform movement, managers tended to see the public sector as distinct from the private sector in terms of relevant management techniques. They also saw their particular country as unique, more influenced by local than global factors. Now, there is a growing recognition that, while the two sectors are distinct, especially in the core functions of government, there is much that public sector managers can learn from general management practice.

Citizens and customers. Agencies were encouraged to develop customer service standards and incorporate them in performance measures. An orientation towards service for citizens was reinforced by institutions like the Ombudsmen and an Official Information Act.

Staff. Focus moved from the traditional bureaucratic low pay, limited challenges, lifetime employment, good pension, and becoming skilled in a narrow silo, to a focus on pay and pension competitive with the private sector, growth and challenge on the job, and mobility laterally within the public and private sectors. The relationship became more like the relationship between private sector employers and employees.

Source: Report, Second Commonwealth Advanced Seminar, New Zealand, 1997.

Given the growing debate about the relevance of "The New Zealand Model," particularly to developing countries and economies in transition, the decision of the Mongolian Government to adopt the New Zealand Model will be followed with keen interest (Box 5.3).

There is a great deal to be learned from the New Zealand approach and experience. However, it is the argument of this handbook that the "New Zealand Model" is not the appropriate starting point for most developing countries (Mongolia may well be one of the exceptions, with its relatively small and homogeneous population, minimal corruption, and strong commitment to reform at the highest political level). Driving a performance orientation must be the centerpiece of any reform program, but it will only succeed if it is built on, or builds in, the basics. As discussed below, this can be achieved by pursuing parallel, and reinforcing, reform agendas in the central systems and processes of government and at the sector and agency level.

SEQUENCING OF REFORM

There is no single best way to approach the sequencing of reform. There are too many factors that influence sequencing, notably the extent to which the basics are in place, the particular set of institutional arrangements, and the sources supporting and opposing reform. This final section will discuss issues that need to be addressed and links the issues back to the preceding chapters. It also includes an approach to sequencing where a performance orientation, focusing on all three levels, is the driver of reform.

Too often interventions focus on reallocating expenditure to priority sectors, on across-the-board cuts to reduce aggregate expenditure, or on reforms that are procedural or technical. These include: tightening of expenditure controls, installing a new accounting system that produces timely, reliable information, and introducing program budgeting. Some clear messages in this handbook that bear on sequencing include:

a. Analyze and keep focused on the problem.

b. Be opportunistic.

c. Get the basics right.

d. Understand the rules of the game (the institutional arrangements).

e. Focus on rules that undermine performance on the three levels (Introduction and chapter 2).

f. Pay attention to building systems and processes that effectively link policy, planning and budgeting (chapter 3).

g. A sound FMIS is a basic building block of any reform (chapter 4).

h. Enlist the support of those who have something to gain from reform, address the concerns of those who might be losers, and explain to those who are not interested in reform, but may be important to success, why reform is necessary, drawing on the three levels as appropriate. A Minister of Finance may be more interested in aggregate fiscal restraint, while a line manager will be more interested in how reform might lead to a more predictable flow of budgeted resources.

i. Effective reform requires country ownership and champions, but political commitment is often importantly influenced by the quality of the advice given.

j. Push for comprehensive and transparent budgets.

BOX 5.3
PUBLIC SECTOR REFORM IN MONGOLIA ADOPTS NEW ZEALAND MODEL

The government's strategy for public sector management is embedded in a draft, "Public Sector Management and Finance Act," which establishes the new policy framework. Key components of the reform include:

a. the adoption of output-based budgeting, management and reporting by ministers, ministries, agencies, and parliamentary bodies;

b. the adoption of accrual budgeting and accounting by ministries, agencies, parliamentary bodies, and the government as a whole;

c. the delegation of input management decisions to state secretaries and chief executives;

d. the preparation of strategic business plans by ministries, agencies, and parliamentary bodies for which state secretaries and chief executives will be held accountable at the end of the year;

e. the integration of current and capital budgeting through the appropriation process in the form of appropriations to ministries and agencies for investments (on behalf of the state as well as on their own behalf) as well as for expenses of producing outputs, transfer payments, etc.;

f. the preparation of appropriation estimates and annual reports by portfolio ministers; and

g. the preparation of forecast accrual financial statements and annual accrual financial statements for the government as a whole.

Source: Project Appraisal Document on A Proposed Credit to Mongolia for a Technical Assistance Project, Report No. 17460-MOG, Annex 11, 1998.

A Two-pronged Approach

One broad approach, which has many variations within it, involves parallel reforms at the center of government and at the sector level.

Central agencies focus on reforming the policy, planning and budgeting systems so that they are more supportive and demanding of a performance orientation. This might well include the gradual implementation of an MTEF (chapter 3), which provides an umbrella under which policy, planning and budgeting can be more effectively linked to produce improved outcomes on the three levels. A key element of this approach is to strengthen the capacity at the center of government to make strategic choices and to provide the lead on financial and policy discipline. The key is to ensure that whoever has the legitimacy in the country has these capacities, including the capacity for enforcement. In many countries, this will mean Cabinet or the Council of Ministers.

From the World Bank's perspective, an obvious instrument to support this approach is the SWAP/SIP (chapter 3), which is simply a sector MTEF. The new lending instrument, the Public Expenditure Reform Loan (PERL), appears to have potential to support the reform efforts discussed in the handbook. Since PERL advocates argue that it is in many respects a government-wide SIP, and this handbook argues that a SIP is a sector MTEF, there is reason to see the PERL supporting some form of government-wide MTEF.

In parallel with these reforms at the center, sector and agency level bodies focus on developing outcome and output information, supported by cost information. Many OECD countries are making effective use of performance information in managing programs and, in a smaller number, it is being linked into budgeting. As a 1997 IMF report notes, however, there is a need for caution (Box 5.4).

There should be no pressure to integrate these two parallel efforts at an early stage. The center should be exerting pressure by requiring that performance information accompany new policy proposals to Cabinet and that this information be progressively introduced into budget and other published documentation. The sector and line level should be exerting pressure on the center to improve predictability and to "get out of the detail." Work should proceed on providing greater programmatic and managerial autonomy to individual ministers and organizations accompanied by appropriate accountability mechanism. Box 5.5 describes how Uganda is using this parallel approach to reform its budgeting system.

Despite the arguments of some, a move to output budgeting is not the first step in reform. For many countries, output budgeting may be inappropriate, particularly at the national level. In this regard, there is much to be learned from the experience with program budgeting. Too often it has been introduced into a disabling environment, including one where the basics are not "right." Efforts to integrate it too quickly into central budgetary processes that are unprepared, and where sectors and agencies are suspicious of its use, have contributed to inevitable failure.

BOX 5.4
PERFORMANCE INDICATORS AND BUDGETING

Performance indicators can play an important role in improving public expenditure management but the links are not always obvious, particularly when it comes to outcome and impact indicators. To date, that role has been most visible in improved efficiency in budget execution, i.e., in the delivery of publicly financed projects and programs. The evolution of performance indicators and other associated managerial reforms in several OECD countries have led to a much greater focus on performance and improvements in service delivery. Sweden, for example, requires all ministries and agencies to include performance indicators in their annual report, along with the financial statements. In Finland, significant financial devolution to agencies has been accompanied by a requirement that performance indicators be developed both for inclusion in an annual report and as part of “results oriented budgeting.” The UK approach stresses annual performance agreements between ministers and the chief executives of agencies.

In addition to contributing to improvements in budget execution, performance indicators are also being used in improving the resource allocation process. At an informal level, performance indicators help budget analysts in central budget agencies challenge spending proposals more effectively than in the absence of such information while, at the same time, providing line agencies with evidence to justify their budget requests. In New Zealand, this process has been formalized and performance information plays an important role in resource allocation decisions in the annual budget process. Most budget allocations in New Zealand are based on a purchase agreement between the minister and the chief executive of each ministry or agency. The agreement covers the provision of an agreed type, volume, timing, quality, and cost of outputs in return for the specified appropriation. The budget review system provides for a review of why actual outputs may have differed from that specified in the agreement.

While performance indicators provide very useful information that can lead to substantial improvements in efficiency and effectiveness, OECD experience suggests that caution must be exercised both in recognizing the inherent limitation of performance indicators in the public sector (e.g., they may involve considerable elements of subjectivity and assumptions and should assist in decision making rather than make decisions) and in ensuring that the “right” indicator is used. For example, the performance of a taxation office might be measured (as an efficiency measure) by cost per unit of revenue collected. But, on its own, this measure could encourage managers to set aside any cases that might increase their current unit costs, i.e., leave alone the difficult cases that may in time encourage tax evasion.

Source: “The Role of Performance Indicators in Public Expenditure Management,” Fiscal Affairs Department, IMF, 1997.

BOX 5.5
TOWARDS AN OUTCOME-ORIENTED BUDGETING SYSTEM IN UGANDA

Public services in Uganda are financed through three budgets - the recurrent budget of central government ministries and agencies, the budgets of local government, and the development budget. Because of the three-way division, it is difficult to determine resource allocations for key public services. The problem is accentuated by budget practices that concentrate on the detailed budgeting of inputs or expenditures, rather than on the level and type of service to be provided. An action plan for budgetary reform to be supported under the World Bank financed SAC III program has been developed to overcome these difficulties and make the budget process more strategic and outcome oriented.

The action plan builds on the successful government initiative to introduce a medium-term expenditure framework for resource allocation and consists of three elements:

1. strengthening the strategic focus of the expenditure planning and budgeting cycle, by developing the role of the MTEF and the Budget Framework Paper in reviewing and setting sectoral and program level resource allocations;

2. improvement to budget presentation and budget procedures to increase strategic focus and discipline and improve the efficiency and operation of budget processes (Here, efforts will center around improvements in budget classification and increasing discipline and certainty in resource flows by instituting a greater outcome focus to the budget. Demand for output and outcome information will increase due to a greater emphasis on budgetary monitoring and analysis.);

3. improvements to the content of the budgeting process through the development of integrated sectoral programs, beginning initially in three pilot sectors (The introduction of results-oriented management will lead to definition of ministry missions and objectives, the definition of key result areas against which achievement of objectives can be measured, establishment of specific performance targets, and preparation of costed action plans for achieving performance targets. Annual national service delivery surveys will be conducted to assess actual performance against stated objectives and targets and monitor progress in increased effectiveness of service delivery. Particular emphasis is being placed on the role of citizen surveys in instilling a greater performance in the public sector.)

The Uganda example illustrates how a two-pronged approach can be developed simultaneously. The first and second elements of the reform program focus on the strategic level and are concerned with reforming the overall budgeting system and setting in place the mechanisms to instill greater discipline and predictability in the budgeting process, and generate demand for a stronger performance orientation from implementing agencies. The third element focusing on generating performance information at the ministerial/agency level to respond to this demand by using a client survey mechanism to measure service delivery performance by agencies.

Singapore provides a contrasting case study to Uganda, with the evolution over many years to a current budget system focusing on the three levels of performance. This has been a 25-year odyssey that continues today (Box 5.6).

BOX 5.6
SINGAPORE: MILESTONES IN BUDGETING

Pre 1978 - Line Item Budgeting: The emphasis during this period was on inputs and input control. There was no mechanism within the system to link resource allocations to goals and objectives. Civil service wages were low and misappropriation of funds was not uncommon.

1978 to 1989 - Program Budgeting: This represented an improvement from the past in that it emphasized what had to be done and helped link missions, goals, objectives, and resources. The program approach also provided more flexibility to move resources around within programs. Notwithstanding the improvements, it became evident over time that further enhancements were needed, particularly with respect to providing flexibility to move resources between programs if priorities shifted.

1989 to 1996 - Block Vote Budgeting: Block vote budgeting provided greater flexibility in resource reallocation. Under block voting, line agencies were given larger blocks of appropriations within which they had the flexibility to reallocate without seeking central approval. However, many constraints still remained such as the inability to shift funds between years, the absence of output and outcome information, and the persistence of too many controls on financial and personnel decisions.

1996 Onwards - Budgeting for Results (BFR): This is the most recent development in the evolution of Singapore's budgeting system. The emphasis now is on outputs and deliverables, and the management philosophy is based on devolving more authority to public sector managers to improve performance in exchange for increased accountability. Public organizations are to be managed as autonomous agencies. Resource agreements will specify the outputs and performance targets that these agencies will deliver in exchange for allocated resources. The resource agreement will be used as an accountability tool for performance evaluation and resource allocation, and details will be agreed between the agency, the parent ministry, the minister, and the budget division. Resources will be allocated on the basis of outputs.

Source: Singapore, Ministry of Finance, 1997.

The client survey is a powerful tool that can create incentives for a greater performance orientation at the agency level. Combine this with pressure from the center to provide performance information and the potential for improvements in performance rises. The strength of the client survey is that it taps stakeholders who have an interest in sound operational performance (level 3 outcomes). Box 5.7 describes situations where client survey data has been used effectively to improve public sector performance.

Examples of approaches to leveraging a performance orientation can be found in Ecuador and Colombia. In Ecuador, agencies were provided with increased budgetary (and other) flexibilities in return for restructuring and downsizing. In Colombia, the constitutional requirement to evaluate development programs was followed by a contract between the center and agencies, whereby the center committed itself to providing greater predictability in funding in return for the development of performance information by the agencies.

BOX 5.7
CLIENT SURVEYS ENHANCE PERFORMANCE ORIENTATION OF PUBLIC AGENCIES

Client surveys have helped improve public sector performance in many countries. The surveys have tapped user experience and preferences to identify performance improvement measures such as better ways for delivering service, suggestions for design improvements and quality enhancements. Benchmark and follow-up surveys have helped ensure steady improvements in the desired direction.

In Bangalore, India, "report cards" administered by the Public Affairs Center, a local NGO, ask citizens and businesses to grade the public agencies with which they have to deal to solve a problem or get a service. The report cards grade both quality and cost (including transaction costs a.k.a. "speed money") of service delivery. Wide dissemination of the most salient results is achieved by publishing easy-to-read graphs on the front page of newspapers. In the first round of report cards, the Bangalore Development Authority (BDA) scored the lowest in a number of categories including staff behavior, quality of service and information provided. The head of BDA used the results as an opportunity to introduce improvements in his agency. A citizen-government initiative to address service delivery problems was launched as were corrective mechanisms to improve targeting of resources and to enhance staff performance. Inspired by the approach, other agencies in Bangalore have taken action to improve their performance, and five other Indian cities have launched their own report card system based on the Bangalore experiment.

In Nicaragua, service delivery surveys are being used to measure progress of reforming organizations in the context of the national public sector reform program. For example, the Ministry of Construction and Transportation (MCT) has been spurred on to undertake innovative actions based on the findings of two rounds of surveys. The initial survey of bus riders indicated that quality of service was poor. For bus riders, security was an important aspect of quality and 14 percent of riders indicated that they had been assaulted on the bus in the last year. The initial survey also indicated that bus drivers rarely respected the official fare of 85 cordobas - 90 percent did not return the 15 cordoba change when a 100 cordoba note was presented. The survey also showed that riders would be willing to pay a higher fare if quality of service improved. The ministry responded by raising the official fare and taking steps to enhance public awareness of the problem. A year later a follow-up survey was conducted. In contrast to the previous year, 90 percent of riders reported that the new fare was being respected. However, quality of service had deteriorated. There was a 60 percent increase in assaults from the previous year. This brought the MCT, the National Police, the Managua Mayor's Office, and the bus companies together to discuss actions to improve security on buses. A number of recommendations followed, including the introduction of plainclothes policemen on buses, and establishment of an adequate reward system for good performance.

All of this tends to confirm the lessons from successful reforms in a number of OECD countries. Instilling fiscal discipline and improving the links between strategic priorities and resource allocation turn out to have multiple benefits for public sector performance. One of these is that they underpin an enabling environment for operational performance. Box 5.8 highlights the fact that improving operational performance requires attention to a wide range of incentives, which may or may not be directly linked to the budget system.

BOX 5.8
DISINCENTIVES TO SOUND OPERATIONAL PERFORMANCE

Unpredictability of funding, from one year to the next and within the budget year, is one of many factors that contribute to the poor operational (level 3) performance of public sectors. Other weaknesses lie largely outside the budget. One of the most significant of these is the erosion of pay and the associated growth in public sector employment in many countries, which governments and donors persist in seeing as a funding, not a policy, issue. In Africa, evidence shows that the limited resources available for nonwage operations are increasingly being used as wage and salary supplements. This reflects the myriad other weaknesses in the incentive structure such as the lack of:

(a) clear objectives and tasks;

(b) merit-based personnel policies;

(c) ex ante performance specification;

(d) performance information;

(e) evaluation;

(f) transparency (notably reporting on performance);

(g) accountability;

(h) competition;

(i) voice.

Add to these the lack of flexibility in the management of nonfinancial resources and the externalizing of accountability that is associated with aid, and it is surprising that any services get delivered.

Entry Points

There is no single entry point for budgetary reform. In fact, the process can begin in a variety of ways. Every reform effort has to begin somewhere, and it is important to be able to identify opportunities when they arise.

- A president demands better information for decision making. This presents an opportunity to improve the financial management information system and should be taken, as should the opportunity to develop more evaluative information on outputs and outcomes. At the same time, support provided to the Cabinet for decision making could also be reviewed and strengthened.

- An anti-corruption program provides a good opportunity to focus attention on some of the basics of a sound financial management system:

  – accounting systems that deliver data on expenditure on time, effective monitoring of expenditure;

  - financial auditing (Note that sound financial audit is key to building the confidence of central controllers to give managerial autonomy.).

- A country is implementing a series of Sector Investment Programs. Take the opportunity to test the programs' compatibility with central budgetary processes and to begin linking policy, planning and budgeting at the center within a medium-term framework.

- Take opportunities to encourage the development of performance information at the agency level by trading increased flexibility.

- A country has introduced a rule requiring that government programs be evaluated. Take opportunities to review the budget rules for their impact on performance.

- A country has to achieve certain targets to be eligible, for example, for EU accession. Take the opportunity to reform the budget system.

As a further aid to assessing where the entry points for reform may be, the following set of questions, which concern incentives, need to be answered:

1. What has to occur for the specific budgetary problem to be solved?

   What specific outcomes would constitute success?

   How will beneficiaries have to behave - or which of their behaviors will have to change - for success?

2. What critical actions have to be taken to secure the desired outcomes and by whom?

   What key actions do which stakeholders have to take to realize desired outcomes?

   What critical actions does the state have to take to realize desired outcomes?

   What laws, rules, regulations have to be changed or created? By whom?

   What responsibilities and authority have to be established, aligned, clarified, redistributed?

   What data and knowledge have to be obtained and which feedback mechanisms have to be set up?

   Who can prevent action from being taken?

3. What are the formal and informal rules that determine whether and how:

- players who control resources, and have the authority to take actions, make resources available?

- players who are responsible for taking critical actions try to obtain the resources they need and effectively deploy those that they get?

What incentives affect the players who control the resources required for critical action? The players responsible for taking the action? (monetary rewards, factors that affect personal wealth, authority, intangible rewards such as status or recognition, support of those outside the organization such as kin groups)
What are the consequences for a player who fails to play by the rules of the game?

A central objective in reform must be the shift of focus to managing resources "that players get." Early gains can be made from performance information at the level of managing resources.

CONCLUSION

This chapter has argued that there is no single best way to approach budget reform. Reflecting this, the chapter provides a variety of perspectives on reform and points to a broad range of issues to be taken into account. Developing a more coherent approach to the sequencing of budget reform will be a major focus of Public Expenditure work in the World Bank in 1998. This work will build on the characteristics of a well-performing budget system set out below.

Aggregate, binding fiscal targets. Many of the countries engaged in reform efforts are committed to particular fiscal targets and have instituted mechanisms that enforce achievement of the targets; the openness of the media and financial markets provides an added source of discipline. This involves a medium-term perspective and means that policy making and planning is always confronted with aggregate constraint.

Incentives for better allocation and use of resources. Within the aggregate constraint, there are institutional mechanisms (Cabinet, committee of ministers, legislature) within which the hard allocation choices that are made have legitimacy and hence are implementable. Transparency and accountability, and associated information, are keys to improving allocation decisions and resource use. In New Zealand, chief executives have contracts that specify levels and quality of output, and budgetary appropriations are based on outputs purchased. There is a multiyear perspective to resource allocation and budgeting, which emphasizes the future implications of policies and provides more predictability for recipients of government funds.

Autonomy of line agencies. A key tenet of reform in the 1990s is that line managers have greater autonomy over managing their budgets to achieve desired outputs and pursue outcomes, including the right to hire and fire. Part of this devolution involves the replacement of detailed line item budgeting with an aggregated line item (lump sum budgeting). This provides managers with greater flexibility in the allocation of costs across different types of inputs such as staffing. As is noted in the discussion of the evolution of budgeting in Singapore (Box 5.6), lump sum budgeting needs to be accompanied by information that identifies the links between inputs and outputs and, ultimately, outcomes. As noted earlier, New Zealand appropriates on an output basis (Boxes 5.2 and 5.3), and many countries have some form of program appropriation.

Accountability of line managers. A traditional line item system stresses ex ante accountability for the detailed use of inputs. An important characteristic of new performance budgeting is that it switches the accountability to ex post accountability for results. This implies that governments have the ability to measure progress toward achieving their objectives.

It is important to understand that these four elements are not capable of delivering sustainable improvements on the three levels of budgetary performance separately. They are interdependent. Current approaches also recognize that budget reform is not enough - it is part of an integrated strategy for better public sector performance. Accounting systems need to be revised to provide real cost information by program. Civil service systems need to introduce greater concern for merit and a greater public service ethos. The budget system needs to provide greater predictability and flexibility to create an enabling environment for performance.

Box 5.9 outlines components of results-oriented public management that are receiving priority attention in OECD countries. Three fundamental principles underpin these particular components: clarity in who has the authority to make what decisions, the matching of authority (flexibility) and accountability, and the capacity and willingness to reprioritize and reallocate resources.

BOX 5.9
RESULTS-ORIENTED PUBLIC MANAGEMENT

OECD country practices indicate that the following helped improve performance:

Performance reporting. This practice entails the regular, systematic publication of data on results to citizens or clients. Being systematic means that key measures are selected in advance and reports on performance distributed. These reports examine results from the perspective of those who pay for or are impacted by public services.

Performance objectives. This involves specifying in advance the short- or long-term results expected. The aim of performance objectives is to encourage government to use resources for priority activities. The objectives should be limited to a few high priority items and should be quantified. Publication of the objectives emphasizes the importance of the goals and government commitment.

Benchmarking. This practice involves mapping operational processes, identifying crucial processes and key performance indicators, and searching for best practice for those indicators. Benchmarks are performance objectives that represent the best practices or results found in organizations facing similar situations, e.g., admission practices in one hospital compared with another hospital or a hotel. Benchmarking may spur agencies to identify "role models" whose performance they try to match or surpass.

Performance auditing. This practice subjects the performance of government or agencies to review by auditors. This form of auditing is relatively new, but financial auditing may be the model used in performance auditing. The task of auditors would be to review specifications of performance objectives and reports on results by management to determine reliability and accuracy. Auditors will need performance principles and standards similar to those applied in financial management.

Performance "contracts." This practice specifies the output or results that an agency or a manager is committed to produce with agreed resources from the ministry or budget office. The contract may run for a year or longer, during which performance is monitored to ensure that the terms are being met.

Performance budgeting. This approach links resources provided to outputs or, less frequently, outcomes promised. The linkage can range from a "lockstep" relationship in which a marginal unit of resources produces a marginal unit of output, to one in which the budget lists the expected results associated with the budgeted volume of resources.

No OECD country practices a form of budgeting in which quantified performance is the sole basis for allocations. Typically, performance measurement is more useful in determining how to make best use of resources rather than what the allocation should be. Practical considerations deter governments from making a strict link between resources and performance. Budgets and performance interact, and focusing excessively on the link from performance measurement to budgets may undermine performance. Performance measurement aims to change management style and behavior, not just to improve the budget process.

Source: PUMA, "Budgeting for Results," OECD, 1995.

DIAGNOSING THE WEAKNESSES AND IMPROVING BUDGETARY AND FINANCIAL MANAGEMENT IN THE PUBLIC SECTOR

The two most important rules to follow when dealing with developing countries or countries in transition are: (a) do no harm and (b) know your country. A task manager who is advising a government on improvements to the budget and financial management must first collect information on the current performance of budgetary and financial management systems in that country.

This section focuses on critical points that a task manager must look for to be able to analyze the country situation and to make informed recommendations. The points relate to factors that impinge upon the budget and financial management. These are:

- law
- budget coverage/structure
- budget planning
- budget preparation
- budget execution
- aid management
- accounting systems
- auditing
- evaluation
- integrated financial management information systems
- performance measurement

A task manager might find the checklists of practices in the following pages useful in assessing a country's strengths and weaknesses. Task managers may also find it helpful to distribute copies of these checklists to stakeholders for their evaluation of the quality of public sector budgeting and financial management systems and processes.

THE FRAMEWORK OF FORMAL AND INFORMAL RULES

Laws form the basis for the strategic focus of reforms that follow. The institutional arrangements determine the rules of the game, both formal and informal, for resource allocation and resource use. The formal rules are embodied in the legal framework - the constitution, the organic budget law, the appropriation bills and legislation generally, the finance regulations - and in the procedures of the legislature and the executive.

The informal rules tend to be reflected in what actually happens. A country may have an exemplary set of formal rules, but they are meaningless if they cannot be enforced because of the more powerful informal rules. Trust throughout the system is crucial for efficient and effective resource use. This depends on the confidence of the players that all other players will play by the rules (formal and/or informal). The key point is that any assessment of the institutional arrangements requires that both the formal and informal rules - and the nature of their enforcement - be understood.

Points to look for in assessing the effectiveness of the legal framework and in understanding the informal rules follow.

CHECKLIST OF PRACTICES ON LAW AND RULES

Points to Look For	Adequate	Inadequate	Improvements Needed
There are checks and balances in the system (e.g., executive and legislative, committing and spending, external and internal audit).			
There is a requirement that tax revenue be paid into consolidated revenue fund and funds can only be spent by appropriation of the legislature.			
Formal rules require minimum ex ante controls on expenditure, and rules require attention be given to efficiency and effectiveness.			
Rules do not unnecessarily circumscribe managerial capacity at the point of service delivery.			
Laws require a comprehensive budget.			
Extrabudgetary funds are transparent and valid.			
The budget is executed as legislated.			
Rules govern whether the legislated budget can be adjusted during execution.			
There are incentives for working with the best possible estimates of resources.			
Next year's budget is not based primarily on what was spent in, or appropriated for, this year.			
The central budget agency does not relentlessly pursue fortuitous savings and efficiencies at the sector agency level for return to the treasury.			
Rules require timely publication of information for transparency and to enhance accountability and credibility.			
There are sanctions for overspending and poor program and project performance.			

BUDGET COVERAGE AND STRUCTURE

The basis for sound government finances is generally a single central fund into which revenues are received and out of which public activities for citizens are paid. For good macroeconomic management, controls need to be exercised over all revenues and expenditures. Activities placed outside the official "budget" are not subject to the discipline of the resource allocation process. A comprehensive budget process promotes allocative efficiency because it forces trade-offs between the different ways a government uses financial resources.

Budget coverage that results in efficient use of resources consists of:

- total revenues and all budgeted expenditures, including funds that usually are not reported such as extrabudgetary;

Budget structure that results in efficient use of resources consists of:

- capital and recurrent (or operating) spending;
- country-financed and aid-financed spending.

Points to look for in assessing the effectiveness of budget coverage and structure follow.

CHECKLIST OF PRACTICES ON BUDGET COVERAGE/STRUCTURE

Points to Look For	Adequate	Inadequate	Improvements Needed
The budget covers total revenue and expenditure.			
No funds or financial mechanisms are excluded.			
Donor finance is channeled into the budget.			
Earmarking is limited.			
Laws on earmarking can be modified or limited.			
Special funds and separate or supplementary budgets are limited.			
State enterprise investments financed from budget are included in the capital budget.			
Measures are being taken to improve coordination of autonomous agency investment without full incorporation into the government budget.			
An attempt is made to calculate and forecast recurrent cost implications of investments, and results are incorporated in the annual and forward budgets.			

BUDGET POLICY AND PLANNING

A policy and planning system should force governments to understand better the realities of what is affordable over the medium term and to address sectoral priorities strategically. The system needs to provide:

- a medium-term framework for public expenditure by identifying the resources that are to be available and the sectoral priorities that will drive resource use;

- political ratification (legitimacy) to the policies and programs that will be the basis of subsequent public expenditure proposals.

Points to look for in assessing the effectiveness of the planning process follow.

CHECKLIST OF BUDGET POLICY AND PLANNING PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
Policy and planning provides a realistic resource framework for public expenditure rather than encourage a "wish list" approach.			
It links macroeconomic and revenue projections with public expenditure proposals.			
The planning framework is made public and widely disseminated.			
The planning framework is updated regularly (annual economic review, mid-term plan review).			
Government's policies are accessible and clearly articulated in each sector.			
The policy process drives any PIP.			
The policy and planning process is tightly linked to the annual budget. Affordability influences policies and decisions.			
Conflicts between resource needs and availability are resolved in appropriate decision making arena.			
Needs, as perceived by Departments/Agencies, are prioritized and made consistent with available resources.			
A decision making forum at the center demands information to facilitate decision making and to increase transparency and accountability for results. Similar arrangements at the sector level restrain strategic decision making and promote effective implementation at the operational level.			
Decision makers at all levels are held accountable for authority (flexibility) provided them.			

BUDGET PREPARATION

The process of annual budget preparation should be derived from the MTEF and ideally consists of the following stages:

- assessment of overall resource availability and the adoption of aggregate expenditure and revenue targets;
- disaggregation of aggregate targets into ministry ceilings;
- preparation and distribution of budget guidelines, including ministry ceilings, and their distribution to spending ministries (the "budget call circular");
- preparation of submissions by spending ministries and departments;
- review of submissions by the Finance Ministry;
- preparation of draft estimates;
- submission to and approval by Parliament of draft estimates.

The determination of aggregate resource availability and ministry expenditure ceilings are crucial stages for the budget process to be credible. Aggregate targets must be explained and agreed upon at the political level before the elaboration of the budget proceeds. In practice, most budgets are incremental, taking last year's allocation as base, adding a small percentage for inflation and, perhaps, a little real growth. Incremental budgeting usually reflects a mismatch between policies and resources and excessive focus on funding, at the expense of policy, in budget deliberations.

Points to look for when assessing the effectiveness of budget preparation follow.

CHECKLIST OF BUDGET PREPARATION PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
The budget preparation cycle has logical sequence and timing.			
The macroeconomic and revenue forecasts and budget ceilings are linked.			
The budget circular is timely and provides a clear set of rules for the budget process.			
Budget ceilings are determined for sector ministries. Ceilings are not subject to substantial reduction.			
They cover both recurrent and capital components of the budget.			
They are communicated prior to the preparation of the sector submissions.			
Mechanisms require a medium-term perspective to decision making.			
The estimates for the capital budget reflect total costs of projects, not only the costs for a single budget year.			
Earmarking does not play a significant role in the allocations of funds and is not distortionary.			
No arbitrary cuts are made.			
Budgeted costs reflect realistic O&M.			
Sector ministries are consulted before budget finalization.			
Sufficient time is devoted to debating funding for existing policy.			
There is a well-defined process for considering new policy proposals.			
All relevant issues, information and stakeholder perspectives are available to decision makers.			

BUDGET EXECUTION

Constrictions in the "plumbing" of the budget are a major cause of poor program and project implementation, of failure to translate strategic priorities into results on the ground and of inefficient resource use. Even when there is provision in the estimates, Finance Ministries may still make tactical budget cuts by authorizing expenditure levels well below those provided for in the estimates. Cuts tend to fall heavily on non-staff O&M costs, thereby compounding the effect on the operation of government services. Another likely candidate is capital spending. Outlays on salaries, however, are rarely touched.

Even where expenditure has been authorized, there can still be problems caused by delays in authorizations, by insufficient funds in Ministry or District bank accounts, or by the requirements of government tendering procedures. These problems are often compounded in the Development Budget by the multiplicity of donor disbursement procedures.

Another issue relates to the use of funds. Expenditures may reflect budget categories but may be applied to purposes different from those originally intended. For example, vehicle operating costs intended for an agricultural extension staff service may be used by Ministry headquarters. This will often be the case where expenditure items are undercosted in the estimates. Funds may be misappropriated either directly or indirectly, e.g., where a government vehicle is used for private activities.

Points to look for in assessing the effectiveness of budget execution follow.

CHECKLIST OF BUDGET EXECUTION PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
Estimates are approved by Parliament and distributed to spending departments in time for the start of the FY.			
Annual cash requirements for each agency are forecast. Government cash flow is efficient and backs up authorizations.			
Line ministries manage recurrent budgets/development projects well.			
There is a process of rationing out releases over the year and for accommodating major expenditures occurring one time in the year.			
The MOF has the authority to change allocations to line agencies during year.			
It is easy for agencies to obtain supplements to their original budget.			
Decentralized payments do not undermine expenditure control.			
Information on actual expenditure is available on time for monitoring tasks.			
Arrears are not significant as a proportion of total expenditure.			
Agencies have a system of commitment for planning and control that ensures that expenditure does not exceed budget.			
All stakeholders - the community, private sector and line agencies - make decisions they are best placed to make.			
Tender boards meet with sufficient regularity and are respected.			
The payments system is centralized and payments are made on time. In a decentralized system, payments do not exceed appropriation limit. There are sanctions for overspending.			

AID MANAGEMENT

External aid impacts on several phases of the budget process. Coordination problems occur such as:

- maintaining consistency between donor and government priorities (Some projects are funded because of the availability of funds rather than consistency with government priorities.);
- keeping track of how much donors have spent, what the funds have been spent on, and whether government obtained value for the money.

Points to look for in the effectiveness of aid management follow.

CHECKLIST OF AID MANAGEMENT PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
All aid is incorporated in the budget.			
Aid funded projects are derived from the policy and program priorities, not from the priorities of donors.			
There is adequate aid coordination--roles are clearly defined. Ministry responsibilities do not overlap.			
Aid pledges are well coordinated. Government prepares sufficiently for meetings with aid agencies.			
There are adequate procedures for matching projects to aid agencies.			
The government takes the lead role in discussions with aid agencies and in the subsequent project preparation stage.			
In the case of direct disbursement, government is involved in sanctioning expenditure.			
Government receives expenditure statements from aid agencies, and expenditures are then recorded in the government accounts.			
Separate arrangements are not made for providing aid agencies with progress reports and statements on expenditure incurred by government. They are a by-product of the country's own systems. These arrangements operate adequately.			
Aid management is facilitated by a coordinating medium - this may be one useful role for PIP.			

ACCOUNTING SUBSYSTEM

The accounting subsystem is at the heart of an integrated financial management system because other subsystems depend upon it for useful, timely and reliable data necessary for the full range of decisions made as part of the resource allocation, budgeting, and financial management system and process.

A well-performing accounting system enables inputs to be tracked and costs to be attributed to specific government interventions. A sound system also:

- provides information to managers for use in making informed decisions;
- permits faith in the ability to substantiate financial transactions where necessary based upon well-organized supporting documentation;
- makes it possible to report results in financial terms and, where performance data is maintained, to report costs;
- permits controlling current year budgetary execution as disbursements are made and preparing future year budgets based upon actual expenditures;
- provides periodic financial reporting and auditability, lending credibility to governmental operations and strengthening accountability.

Points to look for in the effectiveness of accounting systems follow.

CHECKLIST OF ACCOUNTING SUBSYSTEM PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
All accounting and budgeting classification or coding schemes are fully integrated into a single common classification that remains constant over several years.			
The chart of accounts is comprehensive. It integrates accounts containing assets, liabilities, government equity, revenues and expenditures to facilitate the preparation of financial statements.			
Financial statements/ public accounts are prepared in accordance with a recognized set of accounting standards.			
The accounting system (cash, modified cash, modified accrual, full accrual) works well.			
There are manuals setting out the procedures and regulations for the accounting system.			
Budget execution data (revenue and expenditures) are classified and recorded normally in the same manner as all other transactions, not segregated into a separate data subsystem.			
Expenditure statements are produced during the FY. They are frequently distributed to stakeholders and cover total expenditures.			
Annual expenditure statements are produced and appear shortly after the end of the FY. They are accurate in recording expenditure, and outturns do not differ from budget estimates.			
The accounts include aid expenditures undertaken directly by aid agencies.			

AUDITING SYSTEM

The focus of auditing is to determine whether public funds have been spent for the purposes for which they were designated. The scope of auditing should be sufficiently broad. The objectives of an audit should include: (a) compliance with budget appropriations; and (b) whether public funds purchased value for money.

Three general recommendations to improve internal and external auditing are:

- build staff capacity to the extent that constraints allow;
- establish and abide by uniform and transparent standards and procedural norms for basic financial accounting and management (In-house training in basic and more advanced programs in government financial management might be a useful starting point.);
- standardize and centralize control of a financial information system.

Points to look for in the effectiveness of internal and external auditing follow.

CHECKLIST OF AUDITING SYSTEM PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
Government accounts are audited on time.			
Audit queries are responded to swiftly.			
The Auditor General is independent. When the AG issues an adverse report, appropriate action is taken.			
Government decides on the audit priorities.			
An auditor's report was issued for the last FY.			
Reports of the AG are made public.			
The legislature has established mechanisms for pursuing reports of the AG.			
The AG follows certain standards in carrying out audits. There is a manual setting out the standards that are applied in the AG's office.			
The AG undergoes external quality control reviews. Findings and system improvement methods are provided.			
Audit Office has a capacity to do systems unit.			
Financial auditing is sufficiently effective to move to performance auditing.			
Auditors review specifications of performance objectives and reports on results, using performance principles and standards, to determine reliability and accuracy.			
The AG employs private sector auditors to carry out public sector audits on his behalf. There is a rule against engaging the firm of auditors as consultants to the same client.			
There are requirements for internal audit within line ministries. Internal audit is directly responsible to the head of the agency.			

EVALUATION

A well-functioning evaluation system permits managers to determine how the use of resources is contributing to the achievement of objectives. A rule of thumb is that no major new program should be launched without either an extensive evaluation of similar earlier programs or a pilot program. Close monitoring followed by an interim evaluation could provide valuable information for decision making on expansion, modification or termination of a program.

Evaluation can be ex ante, during implementation and ex post. Well-focused and properly timed evaluation can: (a) provide the information needed to bring about mid-course corrections in programs and projects; (b) allow for the analysis and resolution of systemic or policy issues; (c) improve the design of future operations; and (d) contribute to strategic policy and program decisions.

Regular evaluation is most effective and should include staff involved in implementing the program. Regular independent evaluations should also be carried out. Evaluation skills within a Ministry of Finance are needed so that budget proposals can be rigorously scrutinized based on cost-effectiveness or cost-benefit analysis.

Points to look for in assessing the effectiveness of evaluations follow.

CHECKLIST OF EVALUATION PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
There is a requirement for carrying out evaluations of programs/projects by central agencies, line agencies or by independent external agencies for a certain percentage of programs/projects (100%, 50-99%, 20-49%, less than 20%).			
The results are used in budget decision making.			
The results of ex post evaluations are published.			
Client surveys are routinely and frequently carried out as part of these evaluations for ministries and services. The results are published.			
There are incentives in the resource allocation and budgetary system for line agencies to undertake evaluation of existing policies.			
There is a requirement that new policy proposals are accompanied by evaluation strategy.			

INTEGRATED FINANCIAL MANAGEMENT INFORMATION SYSTEM

Computerized information systems are essential to support expenditure management activities. However, the information systems of many countries have little capacity for data sharing and may have overlapping or conflicting functions. An integrated system would strengthen the government's core financial systems: budgeting, accounting, and treasury/cash management systems.

Summary data from computerized modules for similar transactions must be transferable and usable within the system. Equally important is the way people relate. People must speak the same technical and legal language across the organization and program structures to make an integrated system work.

Points to look for in assessing the effectiveness of an integrated financial management information system follow.

CHECKLIST OF INTEGRATED FMIS PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
Accounting system is sufficiently reliable to move to an integrated FMIS.			
All national level financial regulations, standards, rules and guidelines are in a common language.			
Budgeting and accounting categories at the national level have a common classification.			
Operating unit and agency-produced financial data, centrally produced data and regionally produced data in a single financial data base can be accessed by all systems.			
There is a uniform flow of information-based decisions throughout the management cycle.			
There is clear interlinkage of data flow, accumulation and reporting throughout the agencies and the government.			
The basic subsystems of financial management within each agency (budgeting, accounting, cash and debt management systems) are fully compatible, consistent and coordinated under a single head.			
The basic subsystems of financial management at the national level have a unified direction and control including full coordination and agreement on all changes.			
The methods of processing financial management staff are based on unified professional criteria.			
Nonfinancial data are accumulated and processed for purposes of performance measurement and reporting consistent cost-measurement criteria.			

PERFORMANCE MEASUREMENT

Performance measurement refers to measuring the performance of a program, service or function. Annex C contains definitions for a number of key performance measurement terms. The various categories of what can be measured are listed under performance indicators. Performance indicators are signs to help a manager answer the question, "How will we know when we have been successful?" Performance indicators refer to what specifically is to be measured for each aspect of performance, that is, the specific numerical measurement that is to be made such as the "number of customer complaints" or "percentage of customers that report being satisfied with the service they received."

In an education program, e.g., the outputs may be measured by test scores and the percentage of students advancing to a certain level of proficiency in mathematics. The outcomes may be measured by the percentage of students completing elementary school or advancing to higher education. In drawing this distinction, governments typically assign responsibility for outputs to program managers and responsibility for outcomes to elected politicians. A key point is that, whatever the accountability relationships, managers collect both output and outcome information.

Ideal characteristics for performance measures and indicators are:

- they are consistent over time and between units, and comparisons are made only with similar programs;

- they should be simple, well defined and easily understood, emphasizing aspects important to decision making;

- emphasis should be given to a limited number of key measures or indicators that reflect the program's purpose or objective or signal whether the program is worth continuing;

- managers' performance are measured for areas under their control.

Measurements should include quality of services. This includes: timeliness, responsiveness to consumer needs and manner of delivery. Quality may be measured via consumer surveys or by objective techniques such as results achieved. Performance measurement should be seen as a tool primarily for use in improving performance once resources have been allocated. For the exercise to be worthwhile, collected data should be analyzed and then used in decision making. Increasing attention is being given to performance in Bank projects.

Points to look for in an assessment of the effectiveness of performance measurements follow.

CHECKLIST OF PERFORMANCE MEASUREMENT PRACTICES

Points to Look For	Adequate	Inadequate	Improvements Needed
Government fosters an environment that supports and demands performance.			
Managers have clear short - and long-term performance targets.			
There are feedback mechanisms to supply data on performance, and data are published.			
The managerial accounting system ties costs to performance, and the system regularly measures workload, outputs and outcomes.			
There is a systematic collection, analysis and reporting of performance information to verify compliance with strategic goals and to provide a sound basis for future policy making and implementation.			
Agencies use benchmarking - finding best practices or results in organizations with similar challenges whose performance they try to match or surpass.			
Agencies or managers contract, explicitly or implicitly, to produce outputs or results with agreed resources.			

ANNEX A

DIAGNOSTIC QUESTIONNAIRE

1. AGGREGATE FISCAL DISCIPLINE

A. Budget preparation and approval

1a. Are there formal constraints (constitutional or legislatively mandated) on aggregate spending and/or deficits?

1b. Is the government required to publish actual figures relative to these constraints?

1c. Are these constraints imposed and monitored by donors?

2a. Are there formal constraints (constitutional or legislatively mandated) on public debt and domestic/external borrowing by (i) central government; (ii) subnational governments; and (iii) public enterprises?

2b. Is this monitored by the Central Bank?

2c. Are these constraints imposed and monitored by donors?

2d. Is the government required to publish actual figures relative to these borrowing constraints?

3a. Is there a medium-term expenditure framework which projects an aggregate expenditure ceiling over a three- to five-year horizon, consistent with the macroeconomic targets?

3b. Is this published?

3c. What is the percent difference between the aggregate spending in the medium-term projection and that in the annual budget?

4a. What is the percent deviation between the aggregate spending in the budget as proposed by the central agencies (i.e., Minister of Finance in the Budget Call Circular) and that approved by cabinet at the end of budget discussions?

4b. What is the percent deviation between aggregate spending proposed by the cabinet and the legislature?

B. Budget execution and monitoring

1a. Are there formal rules that guard against overspending by agencies 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)?

1b. Is there a published reconciliation of actual expenditures versus budgeted amounts?

1c. Is there punitive action taken against overspending agencies?

2a. Is there a formal or informal requirement to report on aggregate fiscal outcomes relative to targets?

2b. Are these published?

2c. If so, with what lags?

2d. What is the percent deviation between the aggregate spending in the annual budget and the total amount actually spent at the end of the fiscal year?

2. EXPENDITURE PRIORITIZATION AND ALLOCATIVE EFFICIENCY

A. Budget preparation and approval breadth of consultations

1a. What percent of expenditures are allocated by the central government (as opposed to subnational governments)?

1b. Which of these activities do subnational governments have constitutional responsibility for in allocating their budgetary expenditures: (i) primary education; (ii) secondary education; (iii) university education; (iv) hospitals; (v) health clinics? Check only those which apply.

2a. Are there explicit pre-budget consultations about budgetary priorities between government and the following groups in the private sector: (i) business community; (ii) public interest groups (e.g., NGOs); (iii) labor unions; (iv) farmers' associations? Check only those which apply.

2b. How large a change vis-a-vis existing priorities in the current budget have emerged from such consultations: negligible, modest or large?

2c. Are there post-budget consultations with the same group which attempt to reconcile pre-budget understandings with actual allocations?

3a. At the start of budget preparation, is there a session in the legislature about budget priorities?

3b. How large a change vis-a-vis existing priorities in the current budget have emerged from such a session: negligible, modest or large?

4a. Rank the following in terms of their relative influence of the following in deciding upon broad priorities for the composition of expenditures: (i) Ministry of Finance/Planning; (ii) the Cabinet; (iii) the Legislature; (iv) Donors; (v) private sector-government consultation committees.

4b. What is the average percent deviation in the allocation for major sectors and programs: (i) between the budget as proposed by the central ministries and that by the cabinet; and (ii) between the budget as proposed by cabinet and that approved by the legislature? Range: negligible (0-10%), modest (10-30%), high (more than 30%).

5a. Does the government publish expenditure priorities corresponding to the following levels of disaggregation: (i) sector expenditures; (ii) programs; (iii) projects? Check only those that apply.

5b. If so, are these expressed in terms of outcomes (i.e., impact on beneficiaries e.g., infant mortality) or outputs (i.e., goods and services produced e.g., number of health clinics or immunizations provided)?

5c. Are actual achievements of sectoral expenditures published?

5d. If so, is there a public or published reconciliation with the targets?

6a. What percentage of public spending is financed by donors?

6b. Is there a prior agreement among donors about the composition of expenditures that are being collectively financed?

6c. If so, is this agreement induced by the leadership of a central donor?

B. Budget preparation and approval allocation rules and criteria

1a. Are expenditure allocations across ministries and programs increased or decreased in the same proportion across-the-board?

1b. Are there formulae or rules which earmark funds for specific expenditures? What proportion of total expenditures do they constitute?

2a. Is there a formal or informal rule which requires an explicit consideration of whether individual programs or projects that are to be funded by the budget can be undertaken by the private sector?

2b. For which sectors is this done? For what percentage of programs/projects is this actually done (100%, 50-99%, 20-49%, less than 20%)?

3a. Is there a requirement to conduct an *ex ante* quantitative analysis of costs and benefits before a new program/project is initiated?

3b. For which sectors is this done? Indicate the percentage of programs/projects for which this is actually done (100%, 50-99%, 20-49%, less than 20%)?

4a. Is the distributional impact of public spending explicitly quantified and considered in allocating resources among programs and projects?

4b. For which sectors is this done? Indicate the percentage of programs/projects for which this is actually done (100%, 50-99%, 20-49%, less than 20%)?

C. Budgeting preparation and approval norms

1a. Is there a system of forward estimates which projects the future cost implications of existing and proposed programs and projects?

1b. Are these automatically rolled over into the next budget, adjusted only for key national parameters such as inflation rate?

1c. Are these forward estimates published?

1d. Does the government publish a reconciliation statement explaining any significant deviations in the composition of expenditures between the original forward estimates and the annual budget?

2a. Are line agencies required to identify cuts in their existing programs to match new spending proposals?

2b. Are various new spending proposals and offsetting cuts discussed systematically at a Cabinet or sub-Cabinet level?

D. Budgeting preparation and approval capital/recurrent budgeting

1a. Are there separate budgets for capital and recurrent expenditures?

1b. Is there a requirement to estimate the recurrent cost implications of new capital investments?

1c. Are there different ministries responsible for preparing capital budgets (e.g., Ministry of Planning) and recurrent budgets (e.g., Ministry of Finance)?

1d. What percent of public investments is donor financed?

E. Budgeting preparation and approval donor rules

1a. Is there donor conditionality on the overall composition of expenditures?

1b. Has expenditure composition been changed in accordance with this conditionality?

1c. What percent of donor financed expenditures are earmarked for particular programs and projects?

F. Budget execution and monitoring

1a. What is the average percent deviation between the composition of expenditures as approved in the annual budget and the actual allocation at the end of the budget year?

1b. On what basis was the composition changed: (i) arbitrary/*ad hoc*; (ii) related to specific problems?

1c. What was the relative role of the following in inducing these changes: (i) Ministry of Finance/Planning; (ii) the Cabinet; (iii) the Legislature; (iv) private sector-government consultation committees? Rank these in order of importance, with 1 for the least influence and 4 the most.

2a. Is there a requirement for carrying out *ex post* evaluation of programs/projects? By whom: central agencies, line agencies, or by independent external agencies? Check all those that apply.

2b. For what percentage of programs/projects (100%, 50-99%, 20-49%, less than 20%)?

2c. Are the results used in expenditure allocations for the next budget?

2d. Are the results of *ex post* evaluations published?

3a. Are client surveys routinely carried out as part of these evaluations?

3b. For which ministries or services?

3c. With what frequency?

3d. Are the results published?

3. TECHNICAL EFFICIENCY

A. Autonomy

1a. What is the percent and type of expenditure items over which line agencies have flexibility in allocating budgetary resources during budget preparation?

2a. During budget implementation, what percent of budgeted allocations are automatically released to line agencies?

2b. What percentage of items require additional documentation and approval from the central agencies?

2c. How much time (in weeks) does it take on average to secure approval for these items?

3a. What is the frequency of turnover over the last 15 years of heads of agencies for health, education and transport?

3b. Whenever there is a change in government, is there a corresponding change in personnel in line agencies? If so, how deep do these personnel changes go? Check all those that apply.

B. Accountability

1a. Is there a clear specification of the output to be produced by: (i) a ministry; (ii) a department within a ministry; and (iii) a division, program or project unit within a department?

1b. If so, are these outputs published?

2a. Are performance indicators specifically linked to senior managers' (i) tenure; (ii) promotion; and (iii) compensation?

2b. Are these performance indicators based on the achievement of outputs (i.e., goods and services produced, e.g., number of immunizations or health clinics) or outcomes (i.e., impact on beneficiaries e.g., lower infant mortality). Check all that apply.

2c. Have chief executives been fired on account of nonperformance?

3a. What is the percentage deviation between public and private pay for different grade levels?

3b. Is there an explicit link between pay and performance?

4a. Is competitive bidding required for the procurement of major expenditure items?

4b. Are the rules for bidding made public?

5a. When are financial accounts of line agencies prepared: (i) quarterly during the budget year; (ii) semestral during the budget year; (iii) within six months from the end of the fiscal year; (iv) more than six months but less than one year; (v) between one and three years; (vi) more than three years.

5b. Are there punitive actions taken against (i) delays; and (ii) discrepancies?

5c. Are these accounts tabled before a separate session of the Legislature?

5d. Are they made public?

6a. Are the agency accounts audited?

6b. If so, by whom: internal agency auditor, the government auditor within the Executive, independent auditor? Check all that apply.

6c. When are audits of agency accounts undertaken : (i) quarterly during the budget year; (ii) semestral during the budget year; (iii) within six months from the end of the fiscal year; (iv) more than six months but less than one year; (v) between one and three years; (vi) more than three years.

6d. What percent of programs have been audited in the last five years?

6e. What percent are financial audits as opposed to performance audits?

6f. Are the results published?

6g. Has there been punitive action or promotion based on these audits?

7a. Are there client surveys undertaken?

7b. How frequently?

7c. Are the results published?

7d. Do these surveys measure satisfaction with service delivery (i.e., outputs), or with success of the program (i.e., outcomes), or both? Check all that apply.

8a. How many major donors provide project financing? Indicate the number.

8b. Do these projects specify the amount and type of expenditures on which project resources will be spent?

8c. Does each donor have its own rules about disbursement, procurement, accounting and auditing of project funds?

8d. Do these rules match those of the government?

ANNEX B

CHECKLIST OF BUDGET/FINANCIAL MANAGEMENT PRACTICES

I. The following matrix contains practices that are relevant to assessing a country's strengths and weaknesses in budgeting and financial management.

Instructions**:** For each practice listed below, circle a number which represents your country's stage of development.

	Country:									
	Stage of Development									
Budget and Financial Management Practices	**1-Inadequate 5-Adequate 10-Excellent**									
Budget:										
Comprehensive	1	2	3	4	5	6	7	8	9	10
Based on reliable data and estimates	1	2	3	4	5	6	7	8	9	10
Has medium-term perspective	1	2	3	4	5	6	7	8	9	10
Linked to macroeconomic policy	1	2	3	4	5	6	7	8	9	10
Links planning & resource allocation	1	2	3	4	5	6	7	8	9	10
Capital and recurrent expenditure well integrated	1	2	3	4	5	6	7	8	9	10
Links between policy and resources are transparent	1	2	3	4	5	6	7	8	9	10
Trade-offs within spending constraints	1	2	3	4	5	6	7	8	9	10
Effectively controls spending aggregates	1	2	3	4	5	6	7	8	9	10
Is implemented as authorized	1	2	3	4	5	6	7	8	9	10
Is adopted on timely basis	1	2	3	4	5	6	7	8	9	10
Controls items of expenditure	1	2	3	4	5	6	7	8	9	10
Provides incentives for efficiency	1	2	3	4	5	6	7	8	9	10
Uses performance measures	1	2	3	4	5	6	7	8	9	10
Financial Management:										
Based on accounting standards	1	2	3	4	5	6	7	8	9	10
Efficient cash management	1	2	3	4	5	6	7	8	9	10
Timely disbursement of budgeted funds	1	2	3	4	5	6	7	8	9	10
Accountability for expenditure	1	2	3	4	5	6	7	8	9	10
Internal control systems	1	2	3	4	5	6	7	8	9	10
Audit of expenditure (professional, timely reporting)	1	2	3	4	5	6	7	8	9	10
The FMIS links planning, budgeting, accounting	1	2	3	4	5	6	7	8	9	10
Budget/Accounting is consistent	1	2	3	4	5	6	7	8	9	10
Procurement is transparent and competitive	1	2	3	4	5	6	7	8	9	10

II. The following matrix is designed to focus attention on the planning and decision-making processes within a country.

Instructions: Since two or more players will usually be involved at each level, indicate the relative importance of each player with the total adding to 100.

Who makes the following decisions?	**Legis-lature**	**Pres.**	**Prime Minister**	**Cabinet**	**FM***	**PM***	**LM**	**MOF**	**MOP**	**Line Ministry**	**Donors**
The macro setting											
Allocations between sectors											
Allocations within sectors											
Changes to program and project allocations during the budget year											
Allocation of adminis-trative resources during the year											

*FM = Finance Minister
*PM = Planning Minister
*LM = Line Minister
*MOF = Ministry of Finance
*MOP = Ministry of Planning

(If any player is not covered, please include as appropriate.)

III. Comment on key challenges in the field of budgetary and financial management [if you need more space, please add additional sheets]:

IV. Describe key features of recent and current budget and financial management reform efforts [if you need more space, please add additional sheets]:

ANNEX C

DEFINITION OF KEY PERFORMANCE MEASUREMENT TERMS

Below are suggested definitions for a number of key terms relating to performance measurement and the National Evaluation System:

1. **Mission** is the reason that an organization or a program exists, a broad statement of purpose.

2. **Program** is an organized endeavor of an agency that has measurable objectives that have a direct relationship to the agency's mission a defined budget and staffing, and an identifiable target population.

3. **Activities** are the "means to the end" actions, with specific objectives, that make up a program and lead to the attainment of that program's goals and objectives.

4. **Performance.** This covers the work an organization performs in converting inputs, through a process, to outputs, to outcomes. Inputs, process outputs and outcomes can be considered to fall along a "performance continuum."

5. **Performance Measurement.** This refers to measuring the performance of a program, a service, or function. The various categories of what can be measured are listed below under "Performance Indicators."

6. **Performance Indicators** are signs to help a manager answer the question, "How will we know when we have been successful?" They refer to what specifically is to be measured for each aspect of performance, that is, the specific numerical measurement that is to be made such as the "number of customer complaints" or "percentage of customers that report bring satisfied with the service they received." The various categories of performance indicators are as follows:

   a. **Inputs.** The resources used to produce outputs or outcomes. Inputs are usually expressed as amount of expenditures or amount of staff time (such as number of employee hours or days).

   b. **Outputs.** The products and services produced by a program or activity. Outputs results from internal activity or effort. Outputs are important for measuring internal work performance, but do not in themselves indicate the extent to which progress has occurred toward achieving the program's purpose.

   c. **Outcomes.** Events, occurrences, or conditions that indicate progress toward achievement of the purposes of the program. Outcomes can be measured in terms of the extent to which these occur. Outcome indicators can also reflect the quality of the service delivered or customer satisfaction with different aspects of service delivery.

It is useful to distinguish "intermediate outcomes" from "end outcomes." Programs usually have both types of outcomes.

c-1 **End Outcomes.** The desired end or ultimate results that the program's activities aim to achieve. These results are directly related to the agency's mission. Examples: clients whose condition improved, reduced crime, clean air or water.

c-2 **Intermediate Outcomes.** Events, behavior, conditions, etc. that are effects of government agencies and are expected to lead to the ends desired, but are not themselves "ends." Intermediate outcomes have several advantages for program managers. These outcomes often (but not always) occur earlier in time than end outcomes, and thus, may provide more timely feedback. Using intermediate outcome indicators can ensure that programs (and managers) receive credit for early events, especially it if takes a long time before the end outcomes of program activities can be measured. End outcomes, however, should not be neglected.

Intermediate outcomes are usually more under the control of programs than are end outcomes. End outcomes are more likely to be influenced by factors that are outside program control. Program managers should be encouraged to identify the sequence of outcomes sought and to distinguish intermediate from end outcomes.

c-3 **Quality.** Refers to characteristics of how a product or service is delivered, not the results of the service. Quality characteristics that might be measured include timeliness, accessibility (of customers to a service), accuracy, and conformance to requirements. Quality, as defined here, is an intermediate outcome.

Examples:

- Percentage of cases in which the time from request for service to when it was provided was within two days.

- Percentage of laboratory tests that correctly identified the water pollutants.

c-4 **Customer Satisfaction.** Refers to the level, of satisfaction expressed by customers on some aspect of the provision of a service to them such as timeliness, accessibility and pleasantness with which the service is delivered. Customer satisfaction is usually an intermediate outcome but sometimes is an end outcome such as customer overall satisfaction with their experiences in national parks.

d. **Impacts.** These indicators are those that show the extent to which a program actually produced effects on client populations (usually based on more in-depth program evaluations).

e. **Efficiency and Productivity**. These terms describe ratios of inputs to outputs or to outcomes. Efficiency and productivity are essentially equivalent, differing only in the way in which the ratio is expressed. Efficiency is defined as the ratio of inputs to outputs (or outcomes) and is usually expressed as the number of employees or amount of employees time per unit of output (or outcome). It is sometimes referred to as "unit cost." Productivity is the ratio of the amount of output or outcome to inputs, traditionally expressed as the amount of output (or outcome) per unit of input.

Output Examples:

- Number of persons or days expended per repair made. (Efficiency)
- Number of prisoners transported divided by the cost of transportation. (Productivity)

Outcome Examples:

- Repair cost per kilometer of roads that were repaired to satisfactory condition. (Efficiency)
- Number of criminals convicted per number of prosecutor-days. (Productivity)

7. **Target Population.** This term refers to the specific categories of the population that a program affects. (Such population groups might be categorized by geographical location of residence, by age group, by ethnicity, gender, by income group, by type of handicap, etc.).

8. **Performance Targets.** These are numerical target levels of performance against which actual achievements can be compared. Targets probably should be set by each program for each indicator for each future reporting period. For example, the statement to achieve an 85 percent success rate in helping clients in 1997 includes the target of 85 percent.

9. **Program Evaluations.** This term refers to in-depth examinations of particular programs to estimate the effects of those programs on outcomes. These evaluations usually involve various technical procedures such as statistical analyses. These are usually expensive, and an agency is only likely to be able to sponsor a few each year.

ANNEX D

PERFORMANCE INDICATORS FOR PUBLIC FINANCIAL MANAGEMENT

The principal components of public financial management (PFM) are: financial planning, budget preparation/implementation, accounting, internal/external auditing, cash management, debt management, tax administration and financial management information systems. The Bank's adjustment lending and economic and sector work support building capacity in these areas. Much of this work has focused on innovations or improvements in key systems, e.g., accounting and auditing, which are essential for sound financial management.

Currently, however, the Bank is paying increasing attention to reform of the strategic aspects of Public Sector Management (PSM) by focusing on the institutional mechanisms that support:

- aggregate fiscal discipline
- strategic prioritization of expenditures across programs and projects, and
- technical efficiency in the use of budgeted resources.

Aggregate fiscal discipline refers to managing competing, often excessive, claims on limited public resources for macroeconomic stability, i.e., without incurring large, unsustainable fiscal deficits. Strategic prioritization refers to ranking competing claims on scarce resources through institutional arrangements that build consensus on development outcomes and link them with the composition of budgeted expenditures. Technical efficiency refers to the capacity of line agencies (or any private sector or NGO contracted to deliver a service) to use allocated resources to ensure the efficient delivery of public goods and services.

Task managers are confronted with two interrelated jobs: (a) to assess whether the building blocks of PFM (technical skills, management and information systems) are in place and working; and (b) to ascertain whether the system of PFM has institutional arrangements to ensure the outcomes of fiscal discipline, prioritization and technical efficiency. The PFM building blocks alone are not sufficient to achieve these outcomes; institutional arrangements are also required. It should also be noted that reform of budgeting and financial management systems cannot be carried out independently of other service-wide systems and processes of government.

Current Bank practice emphasizes input, process and output monitoring at the project level with little attention to the strategic factors most likely to produce desired PFM outcomes. Greater balance in evaluation of PFM operations may be attained by incorporating measures of these strategic dimensions.

INPUT/PROCESS INDICATORS

Nominal scaling (yes/no/date) figures prominently in Bank audits of all components of PFM operations to document whether a borrower has complied with the terms of an agreement with the

Bank to take a time-bound action such as the adoption of a policy, installation of a system, incorporation of a management innovation or new technology or achievement of an efficiency objective. This scaling may be supplemented by quantitative indicators of actions taken to improve budget preparation/implementation and revenue/expenditure control. The Bank often finances the proposed innovations in a parallel technical assistance loan.

The components of input and process indicators drawn from PFM operations follow.

Financial Planning:

- capacity for macroeconomic analysis improved
- training program in economic forecasting conducted
- alternate methodologies for macroeconomic policies generated
- integrated sectoral strategy papers produced
- medium-term expenditure framework formulated
- system for projecting revenues/expenditures established
- system of forward budgeting implemented
- finance/operating ministries' planning coordinated
- public investment program rationalized
- public services user survey conducted as input to resource allocation.

Budget Preparation/Implementation:

- training program in budget preparation conducted
- public investment budgeting capacity developed
- all revenues and expenditures included in budget
- budget structure unified
- revenue/expenditure composition & public investment program reconciled
- budget execution verified within 15 days of set closing date
- budget over/underestimation reduced by %.

Financial Management Systems:

- integrated financial management system installed
- financial commitment/expenditure controls strengthened
- auditing/accounting functions strengthened
- financial management decentralized
- fiscal monitoring mechanism established in # ministries.

Nominal indicators are of limited use in assessing whether reforms in PFM have been carried out. Apart from the transfer of technologies, e.g., computerization of financial information systems, much of the Bank's input to reforms is the less tangible advice and training, which may only have an effect over the long term.

Evaluation practice suggests that excessive measurement of inputs and processes can have diminishing returns. On-going process monitoring is needed for accounting and auditing systems. Many borrowers attach insufficient importance to timely and accurate accounting data, especially for the costing of policy and the efficient implementation of programs and projects. Sustained improvements in performance in these areas may be indicators that governments have accepted the transparency and discipline of modern financial management systems.

Nominal indicators may also be insufficient to generate data of evaluative importance for the operation of a medium-term expenditure framework, which reveals the longer-term costs of policies and programs and provides a mechanism for forcing policy trade-offs within a medium-term context. Process monitoring might segment and document over time three key operational components:

- formulation/publication of budget estimates from departments and agencies
- degree of convergence/divergence between planned/actual budget estimates
- publication/reconciliation of discretionary changes between estimated/actual spending.

Measures of the timeliness and accuracy of these operations serve as indicators of government commitment to a medium-term expenditure framework and of the technical capacity for budget preparation/implementation. Measuring budgetary capacity alone may not necessarily indicate capacity for fiscal discipline. But doing so as part of the evaluation of medium-term expenditure planning may show that the internal conditions for achieving fiscal discipline have been met. These indicators, however, measure only the process of medium-term expenditure planning, not outputs.

Task managers can decide whether to use process monitoring based on the need for additional data to evaluate long-term outputs and impacts. The Bank normally restricts monitoring to the technical and administrative processes of financial management and does not monitor the broader institutional framework within which these processes operate.

OUTPUT INDICATORS

The output indicators currently used to assess the Bank's PFM operations vary considerably in rigor and utility. Indicators for financial planning and management are softest because they deal with intangibles such as transparency and accountability, which are measured qualitatively. Indicators dealing with the mechanics of the budget are stronger because they use quantifiable data to measure changes in financial performance and administrative efficiency. However, quantitative measures are not necessarily superior if qualitative measures permit systematic comparisons.

The components of output indicators drawn from PFM operations follow.

Financial Planning:

- public investment projects based on strategic macro/sectoral policy considerations
- share of expenditure on social sectors improved [$ or % increased/maintained]
- more efficient/effective management of public debt

Budget Preparation/Implementation:

- precise/timely information available for economic, financial, statistical analysis
- budget presented to parliament on time
- delays in appropriation releases reduced [no./time]
- budget deficit ratio reduced [targeted % of GDP]
- budget allocation/disbursement disparities reduced [$/$ ratio]
- extra budgetary funds incorporated into budget [$$$]
- verified budget information available daily
- improved accuracy/timeliness of public expenditure information
- improved PIP execution rate [% of projects/time-period].

In PFM operations, the Bank emphasizes improvements in tax and budgetary procedures. The outputs are greater efficiency, timeliness and accuracy, which result in better financial ratios, turnaround times, compliance rates and related variables. The intended effects of these outputs are aggregate improvements in fiscal savings and deficit reduction.

However, for the key outputs transparency and accountability, no metrics are used. The sheer volume of the above input, process and output indicators, with their complex interactions, and the softness or absence of indicators for transparency and accountability call for an evaluation framework that captures both the technical and institutional dimensions of PFM.

OUTCOME INDICATORS

Outcomes may be measured by verifying that key outputs have been produced. Table 1, at the end of this paper, displays the nominal linkages between PFM outputs and outcomes. The matrix provides a framework for linking institutional arrangements and accountability/transparency mechanisms to strategic outcomes.

The matrix assumes that: (a) a medium-term expenditure framework, strong central spending controls, reconciliation of planned/actual expenditures and publication of fiscal results ensure fiscal discipline; (b) a consultative process for reconciling competing claims on the budget, line agency flexibility to allocate resources within centrally determined ceilings and public scrutiny of these processes support strategic prioritization; and (c) line agency capacity and autonomy to deliver the public services for which resources have been allocated, predictable flow of resources to intended purposes and public disclosure of financial and program performance promote technical efficiency.

Most of the above indicators are nominal and would need to be specified with more precision for measurement purposes. Task managers can weigh the effects of statutory spending and borrowing constraints by measuring how much line agencies exceed limits and how frequently sanctions are used to enforce limits.

Other PFM indicators can be measured quantitatively. In some cases, only rough proxies for the actions or processes being probed may be possible. The validity of data generated must be treated cautiously, particularly if aggregated into mathematical coefficients of performance.

For example:

- strength of central ministries over budgetary planning: percentage of deviation between total spending proposed by central ministries vs. amount approved;
- flexibility of line agencies to allocate resources within a fixed ceiling: percentage of expenditures over which line agencies have discretionary authority;
- technical efficiency of line agency civil servants: percentage differential between private and public sector compensation;
- predictability of annual/medium-term allocation flows to line ministries: percentage of allocated funds line agencies actually receive;
- efficiency of financial auditing: time lag in months/years between auditing deadline and submission of report;
- responsiveness of line agencies to client populations: time lag in months/years between conduct of client surveys and publication of results.

Institutional dimensions of PFM, e.g., priority setting and devolution of authority, are particularly difficult to measure and evaluate. For example, "bottom line" indicators narrowly focused on expenditure differentials and resource flows, while more easily quantifiable, do not reflect whether a decision-making process for choosing between policy alternatives is purposive, informed and consensual. These attributes would indicate whether resource allocation is goal oriented, reconciles and integrates competing agency budgetary claims, and promotes management for results. Nevertheless, task managers should incorporate systematic measures of attributes in PFM evaluation designs considering the impact of the less tangible dimensions of PFM on expenditure outcomes.

Indicators of efficiency and effectiveness of the budgetary process may be reflected in the timeliness of budget formulation and adoption, the consensus/dissensus engendered by budgetary decision making and the deliberative process used to make decisions. The three indicators may be interrelated: the promptness of budget decision making reflects the degree of consensus on the strategic goals for which resources are being allocated; this in turn depends on the extent to which the deliberative process is broadly consultative and participatory.

Timeliness is commonly used in the Bank's performance audits as an output indicator of the efficiency of budget preparation/implementation. The resulting nominal data could be made more useful to evaluating performance by probing the antecedent institutional dimensions of consensus and deliberation, which may significantly affect efficiency. For example, the degree of consensus on strategic priorities may be estimated by noting the percentage of policies/programs not subject to budgetary contention, thereby permitting debate to take place at the margin over new priorities that might be expected to engender controversy. Characterizing the deliberative dimensions of budgetary decision making would require a more complex set of indicators that vary by case. At a minimum, these might include measures of:

- concentration of budgetary authority in central ministries as reflected in constitutional/statutory provisions)
- substantive input to budget formulation from sectoral agencies
- sectoral scope of budgetary planning
- openness of channels of communication (transparency)
- stakeholder input/participation (voice)
- contestability of policy advice
- devolution of implementation to line agencies.

Most of these indicators are qualitative and would require data descriptive of the formal and informal "rules of the game" governing budgetary decision making. However, several indicators may be quantified. For example, the sectoral scope of budgetary planning may be documented by observing the number of line agencies substantively contributing to policy development outside their sectors. The degree of stakeholder participation in budgetary planning may be gauged by the number/frequency of public debates on policies. The contestability of policy advice may be documented by determining the number of competing sources of advice that feed into policy development.

Measures of outcomes vary in directness and rigor. Fiscal discipline is usually measured by the deficit to GDP ratio expressed as a percentage. The degree of sustainability of the deficit may be measured by the ratio of the deficit to GDP growth rate. Strategic prioritization is measured by the degree of correspondence between planned/actual composition of expenditures by sector, usually against a baseline pattern of allocation that is being changed, e.g., increases in social sector spending/decreases in subsidies to state-owned enterprises. Technical efficiency is measured by estimating the average unit costs of selected activities within a sample of ministries/agencies.

Improved fiscal and expenditure outcomes should result in improvements in welfare, particularly for groups targeted for increased social spending. However, documenting causality may be problematic due to externalities. For PFM, Operations Evaluation Department’s guidance to use service delivery and beneficiary response as proxies for direct measurement of impact might be appropriate.

Public sector management operations have begun to incorporate service delivery surveys (SDS) into project designs to measure qualitative dimensions of public services such as: accessibility, standards, timeliness, quality, and convenience. Performance data generated by these surveys can serve as proxies for impact measurement and can provide feedback to line agencies for improved future management.

Table D1
Public Financial Management:
Output-Outcome Matrix

	PFM Outputs	PFM Outcomes
Fiscal Discipline		
Institutional Arrangements	medium-term expenditure framework central expenditure controls/sanctions hard budget constraint budget comprehensiveness	target revenue/expenditure ratio achieved
Accountability	ex post reconciliation of expenditures sanctions applied for agency over-expenditures	reduction in agency overspending
Transparency	publication of fiscal results	
Strategic Prioritization		
Institutional Arrangements	budgetary planning consultative allocations/strategic targets linked line agency allocation discretion	budget expenditures/strategic goals matched
Accountability	outcomes reported ex post evaluation of results	
Transparency	stakeholder voice mechanisms outcome performance published	
Technical Efficiency		
Institutional Arrangements	civil service reformed relative line agency autonomy	service delivery efficiency maximized
Accountability	accounts audited personnel policies performance-based service delivery standards customer satisfaction surveys	
Transparency	program performance publicized client voice mechanisms	

ANNEX E

EDUCATION FINANCING IN MALAWI

The Education Sector Policy and Investment Framework (PIF) highlights the goals and objectives that the Government of Malawi wishes to pursue in the next 10 years, and the programs and policies that will enable Government to attain these objectives. The ability to implement these policies and programs, however, will be constrained by the availability of public finance within the country and the human resource capacity within the Ministry of Education. This annex focuses on the first of these constraints and the potential effect that limited public resources will have on policy formation.

The approach that this annex follows is to formulate three scenarios, each representing different macroeconomic conditions and public enthusiasm and will for education. These scenarios are:

- **Low Scenario.** The macroeconomic environment deteriorates and economic growth stagnates or declines. With high inflation, real government expenditure on education cannot be maintained at current levels and education policies and programs are cut back.

- **Medium Scenario.** The macroeconomic environment is stable and economic growth rises steadily. While education is a high priority of Government, its program of fiscal austerity and increasing demands from other sectors creates a situation where education expenditure rises only gradually. Education programs are generally maintained, but prioritization is essential and contributions from the private sector and parents must increase.

- **High Scenario.** The macroeconomic environment is stable and economic growth rises steadily. Consensus exists within the country, and among top levels of Government, that education should be the country's uppermost priority and should receive a steadily increasing share of public expenditure. As a result, education programs and policies are expanded significantly.

The note examines how each scenario, representing different levels of resource availability, affects the mix of education policies and programs that are possible. It is hoped that the note can be used by MOE to revisit the PIF to ensure that the policies and programs outlined therein are consistent and sustainable with the level of funding that MOE and MOF Planners predict over the years 1994/95 to 2009/10.

SIMULATION MODEL

An education simulation model, based on the structure and characteristics of Malawi's education sector, has been developed that projects the financial resources required to pursue various objectives and implement various education policies and programs. The model's flexibility permits parameters to be changed to reflect prevailing situations and alternative scenarios through the period 1994/95 to 2009/10. The simulation model consists of four modules:

1. Projections of enrollment, by level of education, based on school age population, and drop out, repetition and promotion rates. Using the enrollment projections and desired teacher to pupil ratios, the demand for teachers is estimated.

2. Unit costs, by level of education, calculated as the annual average public expenditure per pupil. Unit costs are derived for both recurrent and investment expenditure. Initial unit costs are based on the reference year 1994/95 and, as different policies and programs are pursued, future unit costs rise or fall accordingly.

3. Enrollment projections are combined with unit costs (and unit cost projections) to determine the aggregate recurrent and investment expenditures by level of education.

4. The summary of education expenditures are mapped against projections of total government expenditure to determine the shares of education expenditure from the total.

Historical data is used to determine the initial enrollment and unit costs necessary for modules 1 and 2 above as well as for total government expenditure in module 4. Each of the three scenarios thus begins with the same base year data found in 1994/95.

Three Scenarios: Policy Differences

The basic assumptions and policy variables that comprise each scenario are spelled out later in this annex. Some policies and programs are identical in each scenario in order to provide consistency and less "noise," so that better comparisons of relevant policies can be made. For example, each scenario contains the same desired amount of learning materials per student. However, the level of cost sharing between government and parents differs. By holding the former constant, one can achieve better comparison of the effect of cost sharing on the education budget. Similarly, each scenario maintains the same primary education enrollment. That is, it is assumed that all six year olds enter primary school and that repetition, drop out and progression rates are the same. As a result, the effect of such variables as teacher to pupil and inspector to teacher ratios can be assessed. (Table 1).

However, in other cases, each scenario pursues policies and programs that are very different. Several major policy variables play a particularly important role in determining the required financing and in differentiating the three scenarios from one another, including:

- the desired teacher:pupil ratio at primary and secondary levels (Lower ratios will lead to greater numbers of teachers and a significantly higher government wage bill.);

- the period of certifying the present stock of untrained primary teachers (A shorter period of intensive training will not only require more resources, but will bring forward the time when the newly trained teachers are certified and will demand an increase in present salary.);

- the level of cost sharing for teaching and learning materials (The greater the percentage of material costs that are borne by government, the greater the level of public expenditure on education.);

- the quantity of additional school facilities (classrooms, teachers' houses, administrative blocks, boreholes, resource centers, etc.) built by government and the rate at which they are provided;

- the number of additional secondary school places provided under the planning period;

- the expansion of tertiary education and the cost sharing envisaged.

Table E1
Summary of Education Policies

Policy Variable	Low Scenario	Medium Scenario	High Scenario
Primary teacher: pupil ratio	Ratio of 1:60 in 1994/95, increasing to 1:70 by 2004/05.	Ratio of 1:60 throughout the planning period	Ratio of 1:60 in 1994/95, decreasing to 1:45 by 2004/05.
Secondary teacher:pupil ratio	Ratio of 1:40 in 1994/95, increasing to 1:50 by 2004/05.	Ratio of 1:40 in 1994/95, increasing to 1:45 by 1999/2000.	Ratio of 1:40 throughout planning period.
Teacher Training	23,000 untrained teachers certified within 12 years and modest program of school based support gradually built.	23,000 untrained teachers certified in 9 years and modest program of school based support built.	23,000 untrained teachers certified within 4 years and program with extensive program of school based support.
Cost Sharing	GOM's share of learning materials reduced to 15% by end of planning period.	GOM's share of learning materials held at 20% throughout planning period.	GOM's share of learning materials increasing to 50% by end of planning period.
Capital Development	Construction of 9,000 primary classrooms and 45 secondary schools in planning period.	Construction of 12,000 primary classrooms and 75 secondary schools in planning period.	The construction of 38,000 primary classrooms and 250 secondary schools in planning period.
Secondary Enrollment	Enrollment increase an average of 3% per annum	Enrollment increase an average of 6% per annum	Enrollment increase an average of 7.5% per annum
Tertiary Education	Real expenditure held constant.	Real expenditure held constant.	Real expenditure increase 5% per annum.

Summary of Findings

Enrollment. Based on the structure of 1994/95 enrollment and projected levels of repetition, drop-out, and progression, the model projects that primary school enrollment will decline slowly in the first 10 years of the planning period, before rising in later years of the framework (Table 2). This is the result of the massive influx in enrollment that occurred when free primary education was introduced in 1994/95 that caused large numbers of overage pupils to drop into the system. As overage students work their way out of the system and repetition rates decrease, total enrollment will fall. In later years, however, these factors will be overcome by the growing population of six year olds entering the system.

Table E2
Summary Enrollments, 1994/95 to 2009/10

	Year Level	1994/95	1999/2000	2004/05	2009/10
Primary	Population 6-13 years	2,270,015	2,657,218	3,110,468	3,641,029
	Total Enrollment	3,184,069	2,840,627	2,552,499	3,166,971
	Number of Repeaters	248,665	284,063	176,122	152,015
Secondary	Total Enrollment (I)*	34,180	38,960	46,140	54,780
	Admission (new)	12,000	13,445	15,240	19,400
	Total Enrollment (II)	34,180	45,096	74,096	86,547
	Admission (new)	12,000	14,520	17,520	21,120
	Total Enrollment (III)	34,180	49,589	90,131	91,613
	Admission (new)	12,000	13,657	18,652	28,824
MCDE	Total Enrollment	45,220	44,775	83,121	82,104
	Admission(new)	15,000	13,657	22,382	28,824
Teacher Tr.	Total Enrollment**	3,000	3,000	3,000	3,000
Tech. Coll.	Total Enrollment	1,000	1,599	2,702	2,203

Notes: * Secondary education - projected enrollment for the low case (I), medium case (II), and high case (III) scenarios.

** Teacher training enrollment accounts for students during their residential course only and not those involved in INSET.

Unlike primary education, where enrollment growth is minimal and is held constant in each scenario, growth in secondary enrollment is significant and varies in each of the three scenarios. In the low scenario, total enrollment increases at rate of three percent per annum, while in the high scenario, enrollment increases at a rate of nearly eight percent per annum. However, despite the growing number of secondary school places, the transition rate from primary to secondary is steady or falling as a result of the growing numbers of primary school leavers following the free primary education policy.

Education Expenditure

Results of Low Scenario. The results of the low case scenario, where education expenditure is most constrained, are shown in Table 3. A comparison of unit costs (spending per pupil), by level of education, indicates that primary unit costs are far lower than other levels of education. Nevertheless, due to much larger primary enrollment, expenditures at the primary level are significantly greater than other levels, hovering around 70 percent of total education expenditure. Unit costs of primary education vary little throughout the planning period. However,

Table E3
Education Expenditure: Low Scenario

PROJECTIONS	1994/95	1999/2000	2004/05	2009/10
Primary				
Unit Cost (MK)	239	233	229	237
Total Expend. (MK million)	796	709	632	797
As % of Total	(77.1%)	(74.9%)	(67.8%)	(74.1%)
Secondary				
Unit Cost (MK)	1569	1490	1465	1402
Total Expend. (MK million)	87	87	122	111
As % of Total	(8.4%)	(9.2%)	(13.1%	(10.3%)
Teacher Training				
Unit Cost (MK)	4593	4752	5089	5384
Total Expend. (MK million)	14	9	14	11
As % of Total	(1.4%)	(1.0%)	(1.5%)	(1.0%)
MCDE				
Unit Cost (MK)	600	680	688	725
Total Expend. (MK million)	27	30	52	46
As % of Total	(2.6%)	(3.2%)	(5.6%)	(4.3%)
Tech. College				
Unit Cost (MK)	4375	4601	4787	4157
Total Expend. (MK million)	4	6	7	6
As % of Total	(0.4%)	(0.6%)	(0.8%)	(0.6%)
University				
Total Expend. (MK million)	105	105	105	105
As % of Total	(10.2%)	(11.1%)	(11.3%)	(9.8%)
Total Education Expend.				
Total Expend. (MK million)	1033	946	932	1076
As % of Total	(100%)	(100%)	(100%)	(100%)

mainly as the result of fluctuations in primary enrollment, real primary education expenditure falls nearly 20 percent from 1994/95 to 2004/05. When primary enrollment increases again, expenditures increase to earlier levels. Secondary unit costs fall steadily throughout the planning period as a result of cost-saving policies necessary under the low scenario. Nevertheless, as a result of higher secondary enrollment, secondary expenditures increase. University expenditure is held constant throughout the planning period. The mix of policies and programs pursued under the low scenario leads to total expenditure increase of just 5 percent at the end of the planning period.

Medium Scenario. Education expenditure under the medium scenario grows steadily. In primary education, both unit costs and primary expenditure increase nearly 30 percent during the planning period. Secondary unit costs remain steady, but increased secondary enrollment leads to more than a doubling of secondary expenditure and a rise in secondary's share of total education expenditure. University expenditure remains constant. As a result of this mix of policies and programs, total education expenditure increases nearly 40 percent in real terms during the planning period. (Table 4).

High Scenario. The effect of significantly expanding Malawi's education policies and programs are evident in Table 5. Primary education unit costs nearly double between 1994/95 and 2004/05 and, over the full planning period, primary expenditure increases more than one and a half times. Secondary education also expands greatly. Unit cost increases, combined with significant growth in enrollment, lead to a nearly fivefold increase in real secondary expenditure and more than a doubling in education's share of total education expenditure. Finally, university expenditure doubles over the planning period. As a result of increases in all levels of education, real education expenditure increases 180 percent over the planning period.

Table E4
Education Expenditure: Medium Scenario

PROJECTIONS	1994/95	1999/2000	2004/05	2009/10
Primary				
Unit Cost (MK)	239	274	292	309
Total Expend. (MK million)	796	854	820	1055
As % of Total	(77.1%)	(75.3%)	(69.4%)	(73.5%)
Secondary				
Unit Cost (MK)	1569	1456	1468	1520
Total Expend. (MK million)	87	125	169	192
As % of Total	(8.4%)	(11%)	(14.3%)	(13.4%)
Teacher Training				
Unit Cost (MK)	4593	4944	5259	5555
Total Expend. (MK million)	14	12	19	19
As % of Total	(1.4%)	(1.1%)	(1.6%)	(1.3%)
MCDE				
Unit Cost (MK)	600	703	724	762
Total Expend. (MK million)	27	31	60	57
As % of Total	(2.6%)	(2.7%)	(5.1%)	(4.0%)
Tech. College				
Unit Cost (MK)	4375	4643	4869	4240
Total Expend. (MK million)	4	7	9	8
As % of Total	(0.4%)	(0.6%)	(0.8%)	(0.6%)
University				
Total Expend. (MK million)	105	105	105	105
As % of Total	(10.2%)	(9.3%)	(8.9%)	(7.3%)
Total Education Expend.				
Total Expend. (MK million)	1033	1134	1182	1436
As % of Total	(100%)	(100%)	(100%)	(100%)

Table E5
Education Expenditure: High Scenario

PROJECTIONS	1994/95	1999/2000	2004/05	2009/10
Primary				
Unit Cost (MK)	239	330	468	548
Total Expend. (MK million)	796	1056	1424	2011
As % of Total	(77.1%)	(70.4%	(68%)	(69.4%)
Secondary				
Unit Cost (MK)	1569	1610	1684	1824
Total Expend. (MK million)	87	256	392	565
As % of Total	(8.4%)	(17.1%)	(18.7%)	(19.5%)
Teacher Training				
Unit Cost (MK)	4593	5177	5514	5809
Total Expend. (MK million)	14	13	31	34
As % of Total	(1.4%)	(0.9%)	(1.5%)	(1.2%)
MCDE				
Unit Cost (MK)	600	735	771	810
Total Expend. (MK million)	27	33	65	61
As % of Total	(2.6%)	(2.2%)	(3.1%)	(2.1%)
Tech. College				
Unit Cost (MK)	4375	4643	4869	4240
Total Expend. (MK million)	4	7	13	15
As % of Total	(0.4%)	(0.5%)	(0.6%)	(0.5%)
University				
Total Expend. (MK million)	105	134	168	212
As % of Total	(10.2%)	(8.9%)	(8.0%)	(7.3%)
Total Education Expend.				
Total Expend. (MK million)	1033	1499	2093	2898
As % of Total	(100%)	(100%)	(100%)	(100%)

Education Expenditure within the Macroeconomic Framework

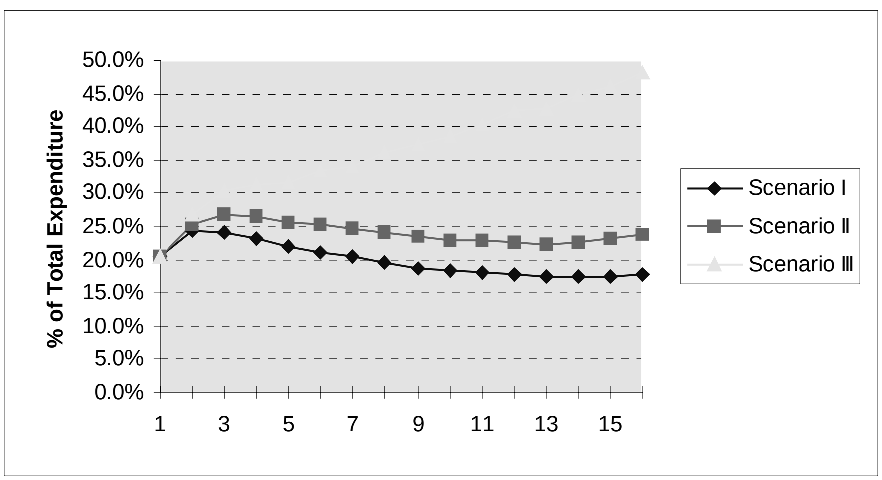
Past levels of education expenditure were low in comparison with many other developing countries. Data presented in Table 6 show that education was only 8.7 percent of government recurrent expenditure in 1988/89. Education expenditures have been increasing steadily since then, rising to 17.2 percent of total recurrent expenditure in 1993/94 and 4.6 percent of GDP.

Table E6
Education Expenditure

Fiscal Year	Ed. Recurr. Exp. as % of Total Recurr. Budget	Ed. Recurrent Exp. as % of GDP
1988/89	8.7%	3.4%
1989/90	12.3%	3.4%
1990/91	13.0%	3.8%
1991/92	11.8%	3.1%
1992/93	14.8%	4.9%
1993/94	17.2%	4.6%

Education expenditure increased substantially with the introduction of free primary education in 1994/95. The level of resources required to pursue future policies and programs, represented by the three scenarios outlined in this note, is illustrated in Diagram 1. Total Government expenditure projections are taken from IMF projections.

Diagram 1
Education. Exp. as a Percentage of Total Gov. Exp.



ANNEX F

THE AUSTRALIAN EXPERIENCE WITH A MEDIUM-TERM EXPENDITURE FRAMEWORK

When Australia embarked on its comprehensive reform program in the early 1980s, a key consideration was the perceived inadequacies in the links between policies and programs and the resources allocated to their implementation. Fiscal crisis subsequently raised fundamental concerns about the affordability of current government policies. The response to this was to take the system of forward estimates, which had played a peripheral role in decision making, and place it at the center of both resource allocation decision making and resource use. The Australian experience is discussed below under various elements of an MTEF.

AGGREGATE FISCAL TARGETS

Beginning in 1985, the central government adopted a medium term “trilogy” strategy of not increasing outlays or revenue as a proportion of GDP and of reducing the deficit/GDP ratio. A subsequent economic crisis saw this commitment tightened to no real increase in expenditure. The credibility of the forward estimates discussed in the next section were central to the success of this strategy. By the end of the 1980s, the deficit of 4 percent had been converted to a surplus of 2 percent; government had significantly reoriented expenditure to reflect its core strategic priorities, and the incentives for efficient and effective use of resources had been considerably strengthened.

Recession in the early 1990s saw a return to deficits, and fiscal targets have been focused on a realistic time path for returning to balance (the 1997-98 budget deficit is forecast to be less than 1 percent). More significantly has been the “Budget Honesty” commitment of the government, which requires the government to regularly publish projections of expenditure and revenue, notably in the three months prior to an election. (The New Zealand Fiscal Responsibility Act goes even further by, in addition, committing government to make public its long-term fiscal objectives and to pursue policies that are consistent with maintaining crown debt at a prudent level and with a reasonable degree of predictability about the level and stability of tax rates in future years).

FORWARD ESTIMATES OF THE COST OF EXISTING POLICY

The “forward estimates” system evolved in Australia from the late 1970s through the 1980s. The forward estimates process develops estimates that, on a rolling basis, project the level and composition of expenditures for three years beyond the current fiscal year, assuming no policy changes. These are adjusted regularly to take account of factors such as inflation, where program expenditures are indexed, and government policy decisions that may increase or decrease estimated costs.

The practice prior to 1983-84 involved the Department of Finance collecting bids for program spending from sponsor departments without rigorously examining the basis for them, except with respect to the first year. Accordingly, these bids reflected departments' own assessments of their future needs, a practice described by M. Keating and M. Holmes (1990) as "a major cause of ... creeping incrementalism of government [expenditures]."

Under the new approach, the Department of Finance negotiated with departments the estimates for existing programs, and then assumed responsibility for updating the forward estimates at regular intervals to reflect, as indicated above, changes in economic parameters, other technical variations and, most important, the effects of government policy decisions. The same process is followed with new policy and program proposals, for which projected costs for the full forward estimates period are required as part of the policy proposal considered by Cabinet. Thus, the Department of Finance is seen as "owning" the forward estimates.

Furthermore, whereas previously there tended to be widespread annual renegotiation of estimated expenditures, the new system is much more policy focused, involving ministers primarily in the relatively small percentage of budgetary matters that require policy or strategic decisions (although the funding implications may involve a high proportion of budget funding). Thus, the forward estimates are a disciplining mechanism in the budgeting process that enables a greater focus on strategic policy issues. At the same time, they provide much greater predictability as to resource levels for departments and agencies. In essence, the system envisages that if government policy does not change then funding will be provided in accordance with the forward estimates.

One senior official has attested to the significant impact of forward estimates as follows:

> "The fact that we now have a budget system in place with forward estimates, and the haggle over the base for each new budget year does not take place any more, is a huge advance. If you had to pick out the one thing that we have done above all others, this reform would be the most dramatic change."

In 1983, a significant decision in the evolution of the forward estimates system was made when the government decided to publish them. The requirement to disclose costs for the three-year forward period was intended to ensure that decisions were made with greater awareness of future commitments, and to provide Parliament and the public with better information about budgetary realities and public expenditure patterns and priorities. The decision to publish also meant that forward estimates had to be taken more seriously, thus leading to their progressive upgrading (M. Keating, M. Holmes 1990).

As the system has evolved, the government is required to disclose and justify the costs of policy decisions leading to discretionary changes in expenditures over the three-year forward estimate period. The estimates are published in the budget alongside the budget year figures and changes between the forward years and the budget are reconciled in budget documents -- that is, the budget estimates are reconciled with the forward estimates compiled the previous year. These reforms have tended to shift the focus for ministers and senior officials to a medium-term period (of four years), rather than the current budget year.

The impact of the forward estimates has been such that an evaluation of government reforms in 1993, in linking the forward estimates system to the record of overall government spending restraint, characterized them as "central to the expenditure control process." More recently, a former official who had been instrumental in the development of the government's budgetary and financial management reforms of 1980s stated:

> The forward estimates process and system was so central because it provided the backbone which linked the Expenditure Review Committee's (see below) macroeconomic and strategic policy-making, portfolio budgeting, and the running costs system [the latter is discussed in a separate note]. It has provided a framework for a more strategic approach to decision making, much greater predictability in funding for current policies and for removing from the budgetary arena those decisions best made elsewhere (most notably management decisions). The system has built on trust and has changed behavior fundamentally. Perhaps the most important factor here has been the fact that, having changed the formal rules, all the players have played by the new rules (1996 interview).

INSTITUTIONAL MECHANISMS FOR MAKING THE TRADE-OFFS

There can be little doubt that the Expenditure Review Committee (ERC) established by the Labor Government in the mid-1980s was central to the subsequent improvements in all three levels of budgetary outcomes. This committee was a subcommittee of the Cabinet, consisting not only of the Prime Minister, the Treasurer and Minister of Finance but also of a number of other senior "spending" ministers. This committee was responsible for determining the overall fiscal framework and for managing strategic policy making, including policy changes necessary to reflect fiscal realities as well as the shifting priorities of the government.

One of the key strategic decisions made by the ERC was the resource envelope for each sectoral minister for finalization of the annual budget. Depending on whether the envelope was higher or lower than the forward estimates of existing policy (adjusted for the individual policy decisions made by ERC), individual sector ministers would have to seek programmatic changes that would produce savings or they may be able to introduce new initiatives. The key point here is that it was left to sector ministers to determine the best allocation of resources to policies and programs in their sector consistent with overall government policy and within a hard budget constraint.

The third element of the system was the running costs system. This system provides line managers with considerable flexibility in managing their personnel and administrative resources within a hard budget constraint but one which is predictable over the medium term. This system has eliminated the annual haggle over funding levels for administration and has meant that ministers have been freed from involvement in decisions at this level. It is the efficiency dividend component of the system which has enabled decisions on running costs to be kept out of the Cabinet arena and has built the trust between line agencies and the Ministry of Finance.

Finally, it is worth noting that the forward estimates system has enabled the Ministry of Finance to assume something of a banker role. This can be illustrated by reference to the example of the major modernization of the Australian tax system. This involves an investment of over A$1billion. Because of the forward estimates, MOF was able to reduce the Tax Office's running costs in the outyears for the savings generated by the investment. The benefits from this are obvious, not least in the changed incentives on line agencies to have sound analysis of expenditure proposals.

DATA ARCHITECTURE FOR GOVERNMENT BUDGETING AND ACCOUNTING SYSTEM

Business Process	Data Entities Created	Definition
Line agencies prepare budget estimates	Line agency budget estimates	Description of programs and projects proposed by line agencies for the coming fiscal year and estimates of funds required by budget category
Receive budget authorizations from MOF after budget is finalized	Approved budget	Description of approved programs and projects to be executed by line agencies during the year and amount of funds voted
Prepare cash requirement forecast	Cash flow forecasts	Forecasts of cash requirements for the year based on known and anticipated commitments for both recurrent and capital expenditures
Assess liquidity position	Liquidity position	Status and forecasts of cash requirements and availability made at a specific point in the fiscal year, based on cash flow forecast revenue projections, foreign aid inflows, and data on maturities of term deposits
Issue and redeem government securities	Issues and redemptions of government securities	Transactions relating to the issues and redemptions of government securities short-term and cash deposits
Release funds to agencies	Budget warrants/ cash allocations	Periodic release of funds by MOF to sector agencies for specific budget categories within budgetary allocations
Request adjustments to budget authorizations (may involve transfer of allocations from one budget head to another, or supplementary authorizations to particular budget heads)	Requests for budget adjustments/ supplementary authorizations	Request by line agency for transfer of budget allocations from one head to another, or for supplementary funds for specific budget categories
Authorize budget adjustments	Budget transfers/ supplementary authorizations	Authorization made by competent authority (MOF/line agency official) for transfer of funds from one budget head to another, and supplementary authorizations to budget category
Prepare expenditure plans	Expenditure plans	Line agencies' projections of expenditure, based on planned programs and projects and available budget funds
Make request for goods and services	Procurement requests	Request for procurement of goods and services made out by managers within line agencies

Business Process	Data Entities Created	Definition
Authorize expenditures	Expenditure/ procurement request authorizations	Authorized request for expenditure for goods and services or other forms of payment. Authorization carried out by line agency managers after determining validity of request and availability of budget allocations
Issue purchase orders	Purchase orders	Order for the purchase of goods and services issued by line agency or central supply organization specifying goods and services required and time of delivery
Commit funds	Commitments	Transaction setting aside funds as a result of approval of specific requests for procurement of goods and services and issuance of corresponding purchase order
Receive bills for goods and services	Bills/invoices	Request for payment made by vendor to line agency for goods and services procured by that agency against a purchase order
Receive goods and services	Goods receiving report/certificate of completion of services	Certificate of receipt of goods/delivery of services required prior to release of payment
Authorize payment	Payment orders/ Payment vouchers	Authorization for payment against a bill or invoice made by line agency finance officials or treasury/MOF officials after determining availability of funds
Pay for goods and services	Check	Financial instrument authorizing recipient to draw money from line agency account with the treasury or authorized servicing bank
Administer payroll and employee benefits	Payments related to payroll	Payroll payments made to civil service employees
Administer pension and retiree benefits	Payments related to pension	Pension payments made to government pensioners
Service public debt	Debt service payments	Debt service payments made for government borrowings
Make other payments	Other payment types	Payments related to grants, subsidies, etc.
Receive requests for products/ services provided by line agency	Service requests	Request made by client for products/ services offered by line agency
Invoices for goods and services	Invoices	Request for payment made by line agency for products delivered or services rendered
Receive payments	Payment receipts	Financial transaction for receipt of funds (which may be for products/services delivered by agency)
Receive government tax revenues	Tax revenue receipts	Receipts of government tax revenues paid into the treasury

Business Process	Data Entities Created	Definition
Receive government nontax revenues	Nontax revenue receipts	Receipts of government nontax revenues paid into the treasury
Receive loan proceeds, grants, etc.	Loan/grant receipts	Receipts of government loan proceeds/ grants paid into the treasury
Maintain budget and commitment ledgers	Budget ledgers	Record of transactions showing amount of budget authorizations and funds allocated for programs and projects and all changes to authorizations/funds allocations as a result of budget transfers or additional fund allocations via supplementary authorizations, with the authority and dates of various changes and totals of expense and commitment transactions against budget categories
Maintain accounts payable ledgers	Accounts payable ledgers	Record of payment and payable transactions carried out over the fiscal year
Maintain receipt/receivable ledgers	Accounts receivable ledgers	Record of receipts/receivable transactions carried out over the year
Maintain general ledgers	General ledgers/journal entries	Record of financial transactions classified according to chart of accounts
Develop cost of programs and projects	Cost-accounting reports	Record of transactions recording costs incurred against programs and projects
Maintain store inventory ledgers	Stores/inventory ledgers	Record of transactions recording physical issues and receipts of goods in stores
Monitor and evaluate budget	Expenditure reviews	Periodic reviews of actual expenditures, analysis of variations with budgetary estimates, and comparison of financial and physical progress; consisting of overall budget reviews and agency reviews of programs and projects
	Fiscal reports	Periodic reports to monitor overall flow of appropriations and inflows of revenues over the course of the year, highlighting major deviations from planned budget program and suggesting corrective measures

ANNEX H

SUMMARY OF FUNCTIONAL REQUIREMENTS FOR THE BUDGETING AND ACCOUNTING MODULES OF A GOVERNMENT FISCAL MANAGEMENT SYSTEM [1]

BUDGET AND FUNDS CONTROL

The budget and funds control subsystems must include:

- expenditure control equivalent to funds allocation;
- financial and other data for budget and program estimates, and periodic budget reports;
- budget control at any nominated segment of the account code;
- budget control on a monthly or biweekly basis (or as required);
- control available either as a warning or to prevent a transaction taking place, as required;
- on-line checking of commitments and expenditure against availability of funds;
- adjustment to commitment at time of posting expenditure;
- on-line checking of forward commitment against limits; and
- formula-driven allocation function to enable a high-level allocation function to be split, in accordance with a user specified formula, to lower level allocations.

PURCHASING

The purchasing subsystem must:

- provide access to a list of potential suppliers and vendor files and a means of maintaining these databases;
- allow recording of details of supplier performance;
- allow entry of requisitions (proposals for expenditure);
- allow entry and printing of purchase orders from any approved location by approved user;
- allow credit card transactions to be recorded, and provide facilities to reconcile transactions with monthly credit card statement;
- allow splitting of orders to multiple accounts;
- provide recording of receipt of goods/services, including partial delivery;
- accommodate variations to, and cancellation of, purchase orders; and
- accommodate multiple vendor addresses (e.g., different addresses for placement of order and payment).

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[1] Extracted from the Report to the Information Exchange Steering Committee, Department of Finance, Government of Australia, December 1990.

ACCOUNTS PAYABLE

The accounts payable subsystem must:

- provide facilities for registration and monitoring of claims;
- match purchase order, invoice, and delivery details;
- process credit notes from suppliers;
- generate recurring payments;
- provide a due date facility;
- allow payment of claims by credit card;
- allow recording of details of cash payments;
- accommodate many-to-many relationships between invoices and purchase orders;
- notify creditors on remittance advice if discount taken;
- provide facilities to enter check-butt/remittance advice details;
- allow splitting of payments to multiple accounts;
- record commitment if invoice does not relate to an existing purchase order;
- allow purchase order to be reopened by authorized staff after final payment has been made;
- verify transaction to avoid payment of duplicate invoices; and
- provide techniques to handle voided checks.

ACCOUNTS RECEIVABLE

The accounts receivable subsystem must provide facilities for:

- processing sales orders, invoices, and debit advice notes; and following up debt, including calculation of interest;
- producing age and trend analyses of debts;
- recording bad debts, write-offs and recoveries;
- recording details of agreements with debtors;
- registering credit notes from suppliers and issuing credit notes to clients;
- producing bank deposit slips;
- acquitting receipts against invoices; and
- maintaining debtor details.

GENERAL LEDGER AND CHART OF ACCOUNTS

The general ledger and chart of accounts subsystem must provide:

- flexible coding system;
- automatic posting to subsidiary ledgers;
- transaction details for previous years;
- totals for previous years;
- cash commitment and accrual accounting;
- user-defined accounting periods;
- journal entry facilities;

- entry and reporting of nonfinancial information;
- account maintenance facilities;
- procedures associated with end of accounting periods;
- facilities for recurring accrual entries;
- facilities for a single transaction to have effect in two accounting periods;
- mechanism for cost allocation; and
- separate recording of expenditure and revenue (not just cash balance).

INTERNAL CONTROLS AND AUDIT

The internal controls and audit system must allow the user/auditor to:

- ensure that all processing complies with statutory requirements;
- produce exception reports;
- reconcile subsystems with general ledger;
- obtain audit trails for all transactions associated with supplier and other master files;
- obtain transaction details to support account balances; and
- obtain audit trails to enable source documents to be traced to financial statements and vice versa.

SECURITY

The security system must:

- provide facilities for electronic signatures, for internal user identification and authorization, and for external authorization and check production;
- log all transactions by user and terminal;
- record user's identification as part of the transaction record;
- limit access to data files and programs both through the system and through access methods external to the system;
- prevent alteration of financial data except through the posting of transactions that are entered through the normal edit and update process;
- provide a system-wide security facility covering all core modules;
- allow detection, reporting, and investigation of unauthorized access to data;
- prevent malicious or accidental destruction/misuse of data;
- provide a security management system that allows individual and generic user security profiles to be created, and that maintains and controls access to data and functions on the basis of these profiles;
- require a single user identification password to access all core modules to which access is allowed;
- allow a limit to be placed on the number of unsuccessful/unauthorized attempts at a particular operation; and
- provide an audit trail of unsuccessful/unauthorized attempts to access the system.

BACKUP AND RECOVERY

The backup and recovery system must work in conjunction with the operating system, the transaction processing system, and the database management system to assist in:

- identifying data files that have been changed and those that will be saved for recovery purposes; and
- backing up all incomplete transactions, restoring the system to its last consistent state, and reapplying the transactions that have not been successfully posted since the last backup.

This system should provide options for selective or full restores, incremental or complete backups, and on-line backups by excluding user access.

ANNEX I

BUDGET EXECUTION USING INFORMATION SYSTEMS

This Annex describes how government agencies involved in budget execution use information systems.

The various steps in the execution of budgetary expenditures are shown schematically in Figure 1. This figure lists the main processes performed by the central and the line agencies in the first column. The diagram shows major information flows that result as the agencies involved in budget execution carry out the functional processes.

Budget Appropriations. The process begins with the recording of the approved budget (and amendments) by the Ministry of Finance (MOF) in the Financial Ledger System (FLS) by individual appropriation item or revenue estimate. The Budget Department of the MOF prepares and registers in the FLS 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 in the cash management system. As the year progresses, sector agencies prepare quarterly/monthly requests for funds by category of spending, which are also input in the system.

Commitment Limits. It may be appropriate for Treasury to propose commitment limits against spending unit expenditure items. The Treasury does this after taking into account the balance in the Central Bank accounts and the balance in ministries' expenditure items by accessing the system.

Fund Allocations (Warrants). Treasury would then make fund allocations to ministries for each category of spending. Under ideal circumstances, the funds allocation would be consistent with the proposed commitment limits advised to 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 advise budgetary appropriations commitment limits and fund allocations to their respective spending units (SU's). 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, registration of actual commitments would be made 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 SU's 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 SU's would process a payment order through the RTU. The latter would check the payment order issued by the SU and register it in the FLS .

In the verification stage, once all the requirements for a particular obligation have been met, the ministry/spending unit should confirm that the commitment is ready for payment.

Payment Processing. At the same time as payment orders are registered in the FLS, the banking system must be advised in order 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 FLS 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 Central Bank, or by the RTU, to the Regional Branch of the Central Bank, which holds the government account. The applicable bank would transmit the relevant information (and funds) to each commercial bank to credit the appropriate account and debit the government account. The appropriate bank would confirm to the FLS (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 FLS. 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.

Payments for 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 additional personnel issues, which 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 government has a better understanding of the flexibility available 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 'out' years.

Tracking the implementation of capital projects normally requires separate subsystems at agency levels. For these, it is important to maintain data on both the financial and physical status of projects, including historical data.

Figure 1 gives the commonly occurring institutional setting in which:

a. all payments from line agencies are channeled to the Treasury;

b. the Treasury is responsible for making payments from the Treasury Single Account (TSA), which is held at the Central Bank;

c. the Central Bank is responsible for the retail banking operations associated with government payments and receipts.

In practice, however, several alternative institutional arrangements are often put in place by different countries 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 Central bank and the Central Bank continues to be responsible for retail banking operations related to government payments and receipts. In these cases, officers from the central treasury could be out posted to the line agencies to ensure compliance with budget execution limits and procedures, or the responsibility for this compliance can be delegated to line agency finance and accounting staff.

A common variation is that the retail banking operations are delegated to a fiscal agent (normally an authorized commercial bank) by the Central Bank. This model is put in place in those cases where the Central Bank does not have an adequate network of provincial/regional branches or does not have the capacity to handle the large volume of transactions that are

associated with government payments and receipts. In these cases, the fiscal agent makes payments on behalf of the Treasury, the Central Bank recoups all payments made by the fiscal agent for government operations and the fiscal agent makes daily deposits of all government revenues to the TSA in the Central Bank. This model can be used in both situations described above, where the payments are channeled through Treasury or where the agencies are directly responsible for authorizing payments.

The alternative models for expenditure processing are shown schematically in Figure 2.

Figure 1. Core Government Fiscal Management Processes, Information Systems and Information Flows

Case Ia: Treasury is Responsible for Making Payments. Central Bank Directly responsible for Retail Banking Operations.

Core Functional Processes	Spending Ministries & SUs	Ministry of Finance Treasury	GFM Information Systems	Central Bank TSA	Commercial Banks

Central Processes

Develop Macro Economic Framework (with Sectoral Ministry Input)

Issue Budget Guidelines

Receive Budget Proposals (Ministries send consolidated proposals (including SUs) to MOF)

Consolidate Budget Proposals & Finalize Budget

Enter Budget Appropriations (original and revisions) into System & Inform Ministries

Monitor Overall Budget Execution

Expenditure Management/Control Processs

(Treasury, Line Ministry Head Offices and SUs at the Center)

Receive Cash Requirement Forecasts from Ministries

Obtain Expenditure Figures and Cash Balances from TLS

Ministries)

Determine Funds Allocations to Ministries (Enter in System, Inform Ministries)

Ministries Determine Budget Appropriations and Commitment Limits for SUs

Financial Releases to SU Accounts (Enter into System and inform SUs)

Request for Expenditure, Administrative Approval & Budgetary Control (at Ministries)

Commitments and Verifications (of Goods Receipt) Transactions

Payment Orders to make Expenditure

Budgetary Control at Treasury

Payment transactions against TSA by Treasury

Creditors

Daily File of payments from TSA and Reconciliation by Treasury

Summary of Receipts (Tax and Non Tax) to the TSA

Detailed Accounts of Ministries from System

Detailed SU Accounts from System

Information flows to/from Subordinate Units

Regional and District Spending Unit Processes

Request for Expenditure Administrative Approval & Local Budgetary Control

Commitments and Verifications (of Goods Receipt) Transactions

Payment Orders to make Expenditure

Budgetary Control at Treasury (RTU)

Payment transactions against TSA by Treasury

Creditors

Daily File of payments from TSA

Summary of Receipts (Tax and Non Tax) to the TSA

Detailed Accounts of SUs from System

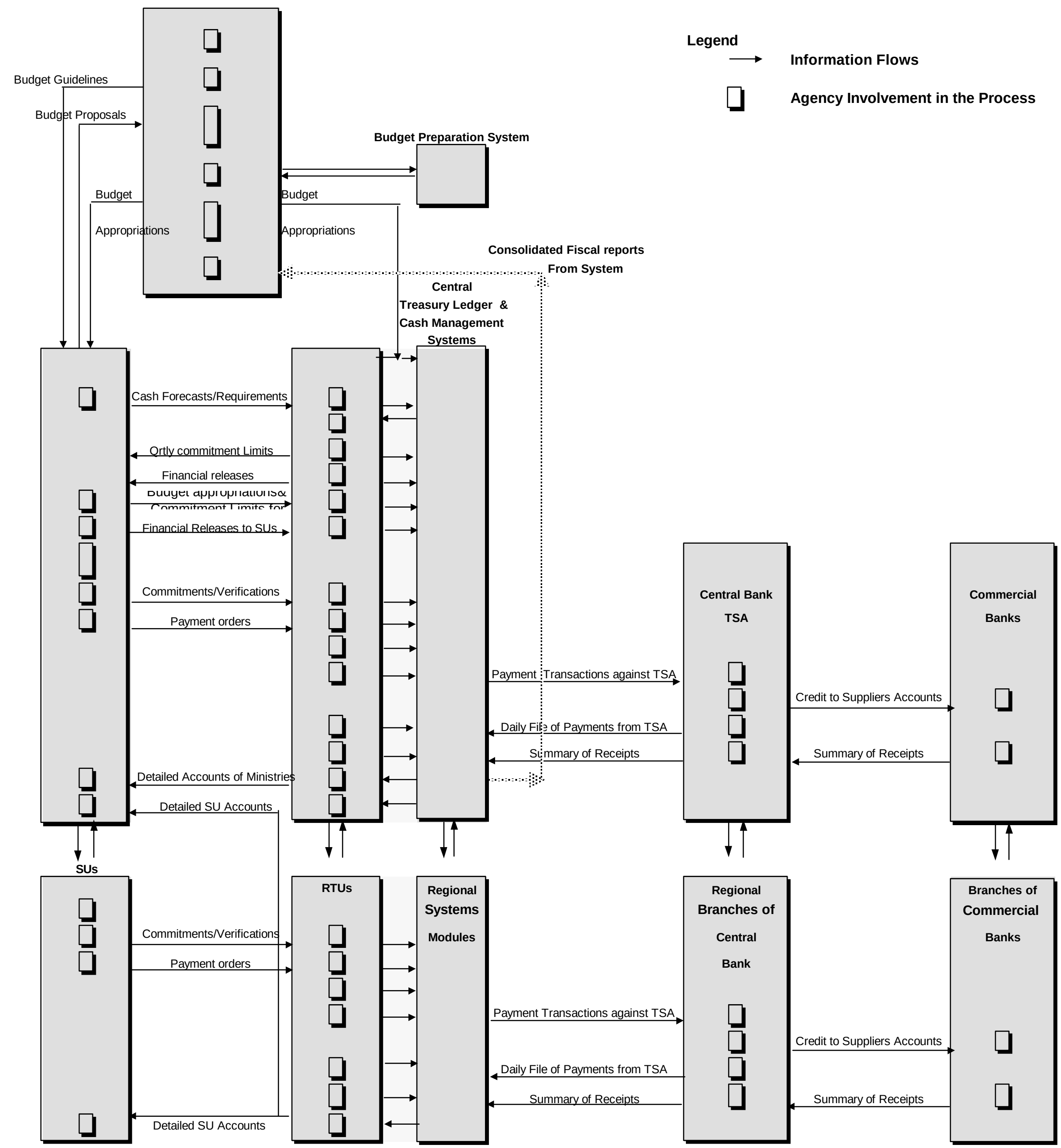
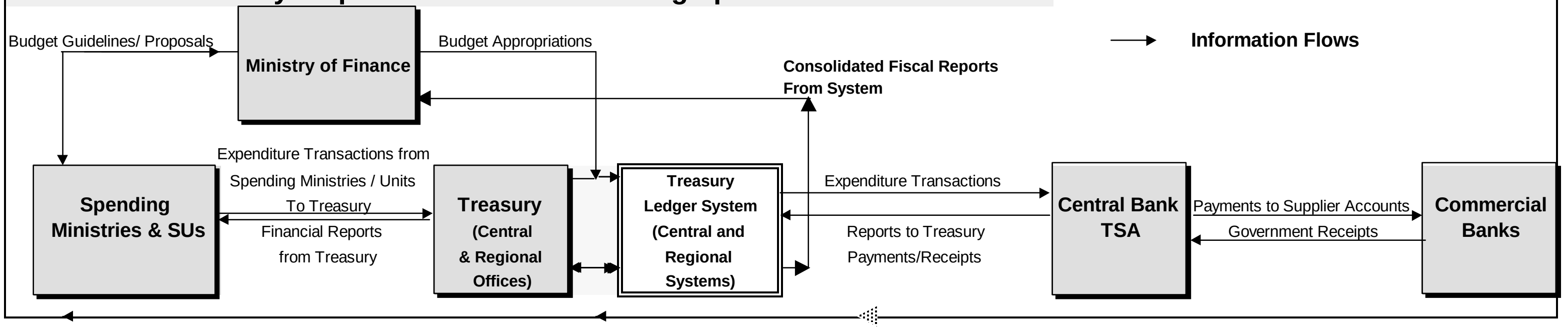
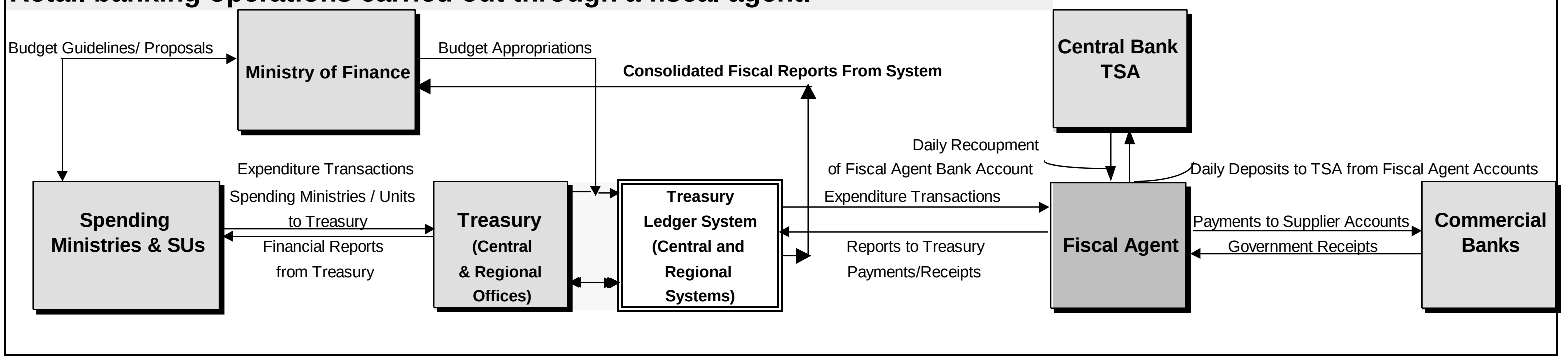


Figure 2. Alternative Models for Expenditure Processing

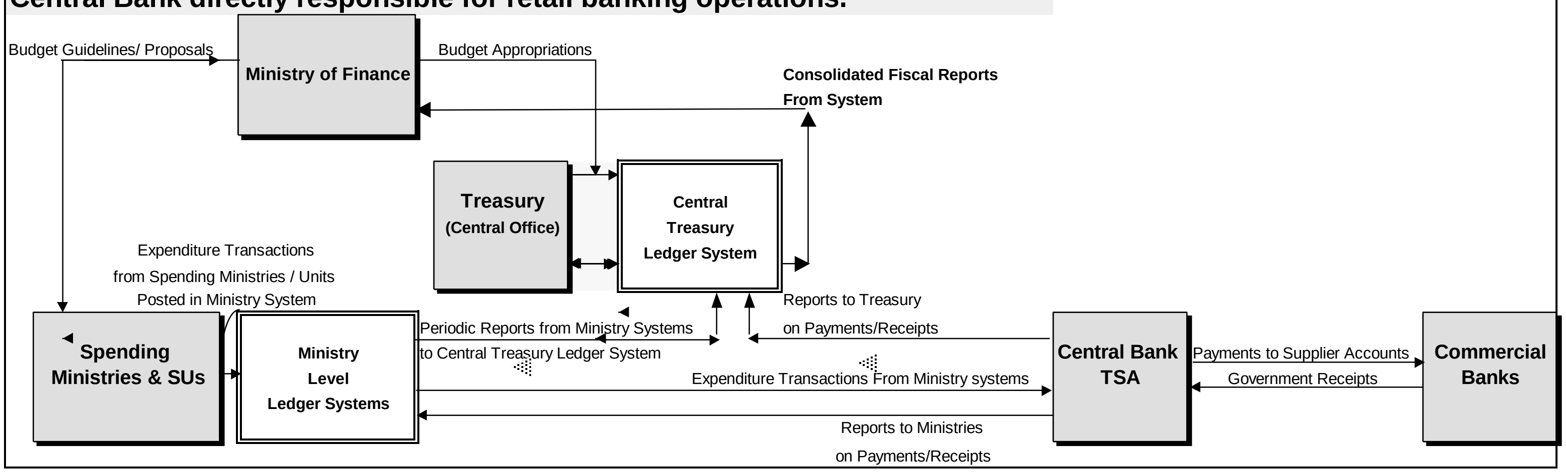
Case Ia: Treasury is responsible for making payments. Central Bank directly responsible for retail banking operations.



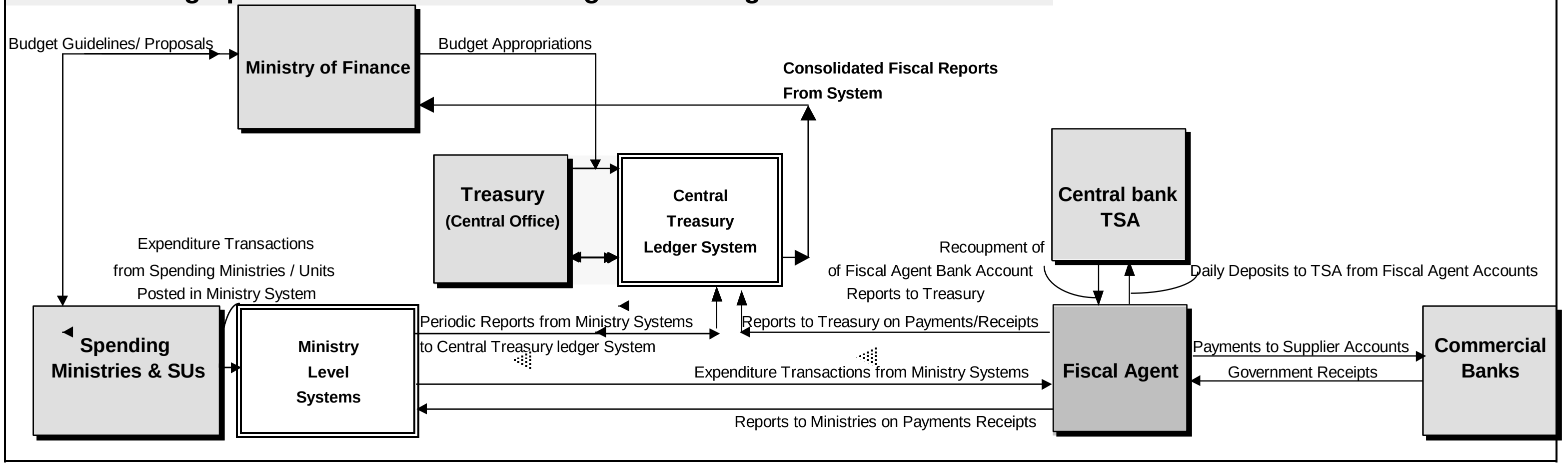
Case Ib: Treasury is responsible for making payments. Retail banking operations carried out through a fiscal agent.



Case 2a: Ministries and spending units are responsible for making payments. Central Bank directly responsible for retail banking operations.



Case 2b: Ministries and spending units are responsible for making payments. Retail banking operations carried out through a fiscal agent.



ANNEX J

CODE OF GOOD PRACTICES ON FISCAL TRANSPARENCY

The Interim Committee stressed the importance of good governance when it adopted the Partnership for Sustainable Global Growth in September 1996, and again at its September 1997 meeting in Hong Kong SAR. Fiscal transparency would make a major contribution to the cause of good governance. It should lead to better-informed public debate about the design and results of fiscal policy, make governments more accountable for the implementation of fiscal policy, and thereby strengthen credibility and public understanding of macroeconomic policies and choices. In a globalized environment, fiscal transparency is of considerable importance to achieving macroeconomic stability and high-quality growth. However, it is only one aspect of good fiscal management, and attention has to be paid also to increasing the efficiency of government activity and establishing sound public finances.

Because of its fiscal management expertise and universal membership, the IMF is well placed to take the lead in promoting greater fiscal transparency. The Interim Committee is therefore seeking to encourage IMF member countries to implement the following Code of Good Practices on Fiscal Transparency. The Code is based around the following key objectives: roles and responsibilities in government should be clear - information on government activities should be provided to the public - budget preparation, execution, and reporting should be undertaken in an open manner, and fiscal information should be subjected to independent assurances of integrity. The Code sets out what governments should do to meet these objectives in terms of principles and practices. These principles and practices are distilled from the IMF's knowledge of fiscal management practices in member countries. The Code will facilitate surveillance of economic policies by country authorities, financial markets, and international institutions.

Guidelines to the implementation of the Code are to be provided in a supporting manual, which is currently being developed. The Code acknowledges diversity across countries in fiscal management systems and in cultural, constitutional, and legal environments, as well as differences across countries in the technical and administrative capacity to improve transparency. While there is scope in all countries for improvement with respect to some aspects of fiscal transparency covered in the Code, diversity and differences across countries inevitably imply that many countries may not be able to move quickly to implement the Code. Moreover, it is recognized that there may be a need for technical assistance if existing fiscal management practices are to be changed, and the IMF must be prepared to provide technical assistance, in cooperation with other international organizations, to those countries that request it in connection with improving fiscal transparency. Modifications to the Code should be considered periodically, in light of the experience with its implementation.

I. CLARITY OF ROLES AND RESPONSIBILITIES

1.1 The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

1.1.1 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.

1.1.2 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 manner.

1.1.3 The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.

1.1.4 Clear mechanisms for the coordination and management of budgetary and extrabudgetary activities should be established, and well-defined arrangements vis-a-vis other government entities (e.g., the central bank, and state-controlled financial and nonfinancial enterprises) should be specified.

1.2 There should be a clear legal and administrative framework for fiscal management.

1.2.1 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.

1.2.2 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.

1.2.3 Ethical standards of behavior for public servants should be clear and well publicized.

II. PUBLIC AVAILABILITY OF INFORMATION

2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.

2.1.1 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 to be presented.

2.1.2 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.

2.1.3 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.

2.1.4 The central government should regularly publish information on the level and composition of its debt and financial assets.

2.2 A public commitment should be made to the timely publication of fiscal information.

2.2.1 Specific commitments should be made to the publication of fiscal information (e.g., in a budget law).

2.2.2 Advance release date calendars for fiscal reporting to the public should be announced.

III. OPEN BUDGET PREPARATION, EXECUTION, AND REPORTING

3.1 Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

3.1.1 A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.

3.1.2 Any fiscal rules that have been adopted (e.g., a balanced budget requirement and borrowing limits for lower levels of governments) should be clearly specified.

3.1.3 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.

3.1.4 Existing commitments should be distinguished from new policies included in the annual budget.

3.1.5 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).

3.2 Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.

3.2.1 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.

3.2.2 A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.

3.2.3 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 judgements about fiscal policy stance on the overall deficit alone.

3.2.4 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.

3.3 Procedures for the execution and monitoring of approved expenditures should be clearly specified.

3.3.1 A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.

3.3.2 Procedures for procurement and employment should be standardized and accessible to all interested parties.

3.3.3 Budget execution should be internally audited, and audit procedures should be open to review.

3.4 Fiscal reporting should be timely, comprehensive and reliable, and identify deviations from the budget.

3.4.1 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.

3.4.2 Timely, comprehensive, audited final accounts of budget operations, together with full information on extrabudgetary accounts, should be presented to the legislature.

3.4.3 Results achieved relative to the objectives of major budget programs should be reported to the legislature.

IV. INDEPENDENT ASSURANCES OF INTEGRITY

4.1 The integrity of fiscal information should be subject to public and independent scrutiny.

4.1.1 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.

4.1.2 Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.

4.1.3 The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.

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