

# IMPLEMENTATION NOTE

## Integration of Recurrent and Capital “Development” Budgets: Issues, Problems, Country Experiences, and the Way Forward

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## Abstract

Dual budgeting systems persist in developing countries. This paper identifies and describes both domestic institutions and donor practices that have been contributing to separate recurrent and development budget management systems in different stages of the budget cycle. It examines both the causes of resistance to change and pays attention to the institutional dynamics that may make integration of the recurrent and development budgets possible. Drawing from the experience of the few developing countries that have made progress in this area, it offers practical guidance for countries and other stakeholders on a full integration of recurrent and development budgets, including the institutions and the management of budget preparation, execution, and reporting of a unified budget system. Recommendations are made for country authorities and a possible donor-coordinated policy dialogue with client countries and associated technical support.

This paper is part of a larger effort by The World Bank and its PEFA partners to focus more on public financial management capacity development, including the development of guidance and mainstreaming of lessons on specific issues of concern in implementing reforms. Public financial management includes all phases of the budget cycle, including the preparation of the budget, internal control and audit, procurement, monitoring and reporting arrangements, and external audit. The broad objectives of public financial management are to achieve overall fiscal discipline, allocation of resources to priority needs, and efficient and effective allocation of public services.

The Public Expenditure Working Group is a joint effort of The World Bank's Financial Management, PREM, and Procurement Networks, with the IMF and PEFA Secretariat, to support improvement in country public financial management system performance. For more information, see

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## Abbreviations and Acronyms

AAP	Assessment and Action Plan
CFAA	Country Financial Accountability Assessment
DFID	Department for International Development
GFSM	Government Financial Statistics Manual
HIPC	Highly Indebted Poor Countries
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
MTEF	Medium-Term Expenditure Framework
OECD	Organization for Economic Co-operation and Development
PER	Public Expenditure Review
PIP	Public Investment Program
PRSP	Poverty Reduction Strategy Paper
ROSC	Report on Observance of Standards and Codes
SNA	System of National Accounts

## Contents

Abstract.....	ii
Abbreviations and Acronyms .....	iii
1. Introduction and context .....	1
2. The roots and institutional development of dual budgeting.....	3
Origins.....	3
Dual budgeting in developing countries .....	5
1960s to late 1990s: post-independence, construction, national development planning, and public investment program era.....	5
Late 1990s to date: PRSP, MTEF, sector-wide approach, and budget support era ....	7
3. Budget integration: four necessary elements .....	8
Organizational and staffing integration into a single ministry.....	9
The way forward.....	11
Integration of budget preparation.....	11
The way forward.....	13
Integration of budget documentation and presentation.....	14
The way forward.....	15
Unified budget execution, accounting, and reporting systems .....	15
The way forward.....	17

## 1. Introduction and context<sup>1</sup>

A familiar symptom of weak public financial management in developing countries, identified in the public finance development literature, is completed capital projects that lack the recurrent funds they need to function properly: hospitals that lack funding for medical staff and supplies; schools with no funding for teaching staff, supplies, and books; or roads with no funds in the government's budget to maintain them. Though the calculation and budgeting for recurrent costs of physical assets created by the government budget is a well established budgeting principle, the problems arise from several causes: poor planning and poor information sharing across different processes; lack of planning for future spending within resource constraints, and inability to coordinate donor-financed and domestically-financed budgetary operations. In recent years, the extension of developing countries' capital budgets to include, in addition to capital outlays, substantial amounts of "developmental" recurrent expenditure mostly financed by donor funds, has complicated matters further, and concerns are frequently raised about the weak interaction of the widened capital budget or "development budget" with a government's traditional recurrent budget.

Existing dual budgeting, accounting, and reporting systems do not provide for a comprehensive analysis in the planning and budgeting of government operations or in the evaluation of their outcomes and results. Double budgeting for the same recurrent activity from separate sources may well happen. Moreover, government accounting and banking rules may differ not only between recurrent and capital budgets, but also between two recurrent budgets, one financed from domestic and the other from external sources.

Recent initiatives and developments in public expenditure management call for a renewed emphasis on the integration of recurrent and development budgets. These initiatives include reliance on medium-term expenditure frameworks (MTEF), the preparation of poverty reduction strategy papers (PRSPs), the identification and monitoring of poverty reducing expenditures in developing countries' budgets and financial reporting systems, and the introduction of sector-wide and general budget support approaches along with traditional support for individual projects by most donors. Experience shows that when the preparation and execution of recurrent and development budgets are institutionally, organizationally, and technically separate, real coordination between the two is nearly impossible.

The separation of recurrent and development budgets can occur along several dimensions: (i) separate central ministries managing processes and making different decisions, (ii) separate planning and budget allocation processes, (iii) separate budget

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documentation processes; and (iv) separate budget execution, accounting, banking, and reporting processes.. Several different terms are in use, such as “recurring” and “nonrecurring”, “ordinary and extraordinary”, “revenue and capital”, “current and capital” , “current and investment”, “above and below the line”, “operational and development” and “recurrent and development” budgets. This paper uses the terms “recurrent and development budgets”, because most developing countries currently use these terms. Today in developing countries, dual budgeting is manifested by domestically financed recurrent expenditures, called the “recurrent or current budget”, as distinct from what is jointly called the “capital or development budget”, consisting of externally-financed capital—and, increasingly, recurrent—expenditures, plus expenditures financed from government counterpart funds (recurrent or capital), plus the government’s own-financed capital expenditures.<sup>2</sup>

Almost all international and several bilateral providers of technical and financial assistance have been advising their client countries to take steps toward integrating their recurrent and development budgets. For example, the World Bank’s *Public Expenditure Management Handbook* describes the separation of recurrent and development budgets as the most important culprit in the failure to link planning, policy, and budgeting, and in poor budgetary outcomes.<sup>3</sup> The Bank’s “Country Financial Accountability Assessment (CFAA) Guidelines to Staff” require asking government officials whether any separate investment budget is adequately integrated with the recurrent budget.<sup>4</sup> And the International Monetary Fund (IMF) warns its fiscal economists that a dual budgeting system may be based on inconsistent macroeconomic assumptions, budget classifications, and accounting rules.<sup>5</sup> Other World Bank/IMF advisory notes and/or working documents raise the same issues and concerns.<sup>6</sup> Finally, most country-specific public expenditure reviews by the World Bank, and individual technical assistance reports by the IMF, strongly advise the integration of the recurrent and development budgets in client countries.

Developing countries’ progress in integrating their recurrent and development budgets has been very limited. One factor that helps maintain the status quo is antiquated

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<sup>2</sup> Unlike “capital expenditure”, which has a clear and universal definition in the national accounting system and economic classification of government expenditures, the term “development expenditure” is only a conventional and not even universally accepted term, although it has been widely in use since the 1960s in developing countries.

<sup>3</sup> *Public Expenditure Management Handbook*, World Bank, 1998, p. 53.

<sup>4</sup> *CFAA Guidelines to Staff*, World Bank, 2003, p. 18.

<sup>5</sup> *Guidelines for Public Expenditure Management*, International Monetary Fund, 1999, p.19.

<sup>6</sup> See, for example, *Fiscal ROSC Code and Manual* of the IMF (2001); *Country Assessment and Action Plan for HIPC’s (HIPC-AAP) Guidelines*, jointly prepared by the World Bank and the IMF (2003); the OECD-SIGMA’s *Managing Public Expenditures--A Reference Book for Transition Countries* (2001); and the UK Government Department for International Development (DFID) *Guidelines on Understanding and Reforming Public Expenditure Management* (2001).

economic development theory, emphasizing capital spending for faster economic growth. Another is institutional incentives. Donor practices have also tended to reinforce dual budgeting practices. Donors have traditionally focused on capital investments, and a desire to attract donor funding gives a country a strong incentive to maintain a separate development budget process, even though donors' use of budget support over project aid and multi-donor involvement in financing recurrent expenditures may increasingly change that incentive. The failure to ensure resources for ongoing maintenance of capital investments gives some agencies an incentive to seek earmarked or extra-budgetary revenues (e.g. road funds). On the other hand, some ministries pursue activities through the development budget that would otherwise be treated as recurrent spending, due to the budgetary incentives that are at work. Finally, the simple dynamics of separate ministries for finance and for development or planning, with their own domestic constituencies, and governments' general reluctance to reduce the number of ministerial portfolios, also work against the integration of recurrent and development budgets.

It seems that launching a new and donor-coordinated approach is needed to address these barriers. Such an approach is proposed in this paper.<sup>7</sup> Chapter 2 examines the origins and evolution of dual budgeting systems, paying attention to institutional dynamics that may hinder or make integration possible. Chapter 3 looks at current problems and the causes of resistance to change. Drawing on country experience, it offers practical recommendations for achieving budget integration and for a possible donor-coordinated policy dialogue with client countries, with associated technical support.<sup>8</sup>

## 2. The roots and institutional development of dual budgeting

### Origins

Dual budgeting originated in European countries, but in those countries it lasted only for a short period. It was introduced in the late 1930s in order help governments ensure that the resources they borrowed were used only for capital expenditures.<sup>9</sup> After the Second

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<sup>7</sup> This paper takes its cue from an earlier paper prepared for the Public Expenditure Working Group. On the issue of integration of recurrent and capital budgets, that paper suggested that: "the Bank and bilateral donors could usefully give a lead once again by taking the incremental recurrent costs of the projects they finance seriously. They should continually emphasize in the dialogue with governments the need to fund existing policies adequately before investing in new capital assets. Fortunately the progressive shift to budget support should help integrate better the two budgets." See Mike Stevens, *Institutional and Incentive Issues in Public Financial Management Reform in Poor Countries*, October 2004, pp. 11-13.

<sup>8</sup> The integration of recurrent and development budgets cannot solve other possible public expenditure management problems such as weak foreign aid tracking and reporting or the presence of large off-budget transactions in a country's budget system. It remains, however, the only viable option for ensuring the coordination of these two budgets. As always, the role of supporting reforms should not be underestimated.

<sup>9</sup> Detailed information on the creation of dual budgeting in the UK and Sweden in 1930s and 1940s can be found in A. Premchand, "Government Budgeting and Expenditure Controls--Theory and Practice", International Monetary Fund, 1983, pp. 292-302.

World War, as governments relaxed their use of borrowed funds, budgets were integrated. The change in approach reflected several factors: massive postwar reconstruction work and increased recurrent expenditures, along with the acceptance of the Keynesian model of linking government spending and the size of the budget deficit and borrowing requirements to both fiscal and monetary determinants and the business cycle.<sup>10</sup> Moreover, it soon became clear that the need to reap a return—whether financial, social, or economic—applied to the entire spectrum of government spending.<sup>11</sup> Hence it came to be accepted that regardless of their financing sources, government’s recurrent spending and capital investment are complements in any logical combination that may be required, and that the two types of expenditures together produce results, provided the context is one of overall macro-fiscal balance.<sup>12</sup>

The United Nations’ *System of National Accounts* (SNA) and the IMF’s *Government Finance Statistics Manual* (GFSM) prescribe how a government’s consumption and investment activities should be separately recorded in the government budget and in accounting records and statistics. But they do not call for a dual budgeting system. Separate data on government consumption and investment can be maintained within a unified government budget.

Today both advanced and developing countries use government borrowing, along with government revenues, to finance both recurrent and investment expenditure. What matters is the overall size of the budget deficit, in the context of macroeconomic stability and sustainability in a non-inflationary environment. Borrowing has no relation with the allocation of the borrowed funds to recurrent or capital expenditures, except where a loan agreement is associated with a specific capital project.<sup>13</sup>

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<sup>10</sup> On the liberating ideas of John Maynard Keynes, and his advocacy of deficit spending, among numerous resources, see A. Premchand: *Government Budgeting and Expenditure Controls--Theory and Practice*, International Monetary Fund, 1983, PP. 4-10

<sup>11</sup> The UK Government, in an effort to keep its budget deficit in a fiscally sound range, has in recent years reintroduced the golden rule of limiting capital expenditures to the size of borrowing, but this should be regarded as a self-imposed fiscal discipline measure only, and has not created any type of dual budgeting.

<sup>12</sup> “In the United States, periodic recommendations were made for the introduction of a separate capital budget. But this never materialized, primarily because it might tilt the resource allocation in favor of ‘bricks and mortar’. However, the budget documents presented a special analysis of investment expenditures, which was for information only and had no accounting or other implementation impact for the budget structure.” For further details see A. Premchand, op. cit., p.302.

<sup>13</sup> Unlike in developing countries, budgeting terminology in advanced countries uses the term “capital budget”, rather than “development budget” as used here. In most OECD countries, capital projects have already been completed over the last few decades and today their maintenance costs are of a current expenditure nature, along with other recurrent expenditures, including mainly social payments. This makes the share of capital spending a very small part of advanced countries’ overall spending. The dwindling of capital spending as a share of total spending is a feature increasingly seen in developing countries, but in the latter group, the reason is increased necessary recurrent expenditures only; these countries’ need for capital spending by government will remain high for a long time.

## Dual budgeting in developing countries

In developing countries, the content and coverage of recurrent and capital expenditures differ from both the pre-World War 2 meaning (using borrowing only for capital expenditures) and from SNA and GFS concepts. Though the size of a government's budget deficit and borrowing has no necessary relation to the size of its capital expenditures, dual budget preparation, documentation, and presentation, as well as dual accounting and reporting systems, remain common features. What are the historical and institutional reasons for this?

*1960s to late 1990s: post-independence, construction, national development planning, and public investment program era*

During the 1960s, developing countries' nascent institutions of political and economic management tended to adopt the technical practices of the western democracies. For example, most Anglophone African countries used dual budgets, with an "above-the-line account" showing revenues and mainly "recurrent" expenditures, and a "below-the-line account" showing "extra-budgetary", interest and lending to nationalized industries and a very few local governments, where the latter implemented a central government's investment plans.<sup>14</sup> Many countries in Africa, Latin America, and the Middle East adopted national development planning, which had European roots and was still being practiced in Belgium, France, and Spain. Inexperienced finance ministries could not carry out the new tasks of medium-term development planning and capital project appraisal, so planning or development or economic affairs ministries were set up for the purpose. In practice, the new ministries soon became responsible for the identification, appraisal, budgeting, and even accounting and reporting of investment budgets, in an initial, but major and lasting, step toward dual budgeting.

Frequently, finance and development ministries issued their own separate budget circulars, and the dual approach to budgeting also took root in the line ministries. Politically visible gaps in physical infrastructure, and then capital project supremacy in government budgeting, helped to create new financial power bases, leaving the finance ministries responsible for budgeting civil service salaries and the needs of some small government ministries with minimal operational expenditures. Lack of coordination between the finance and planning or development ministries may also have reflected differences between their ministers and/or heads of state who, in some cases, exercised *de facto* control of investment decisions and their funding. Such settings made it difficult to introduce consolidated budget presentation and classification systems. Moreover, some

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<sup>14</sup> The "below-the-line account" used by the UK before the 1960s differs from the "below-the-line" concept used today in some fiscal terminologies (mainly verbal rather than written) for defining the balance of government operations and how its deficits are financed. Additionally, the term "below-the-line accounts or funds" also is used in some Anglophone African countries for another meaning. i.e. transferring some amounts from a ministry's budget to a special fund, at times supplemented by earmarked revenues and spending them outside government mainstream accounting and reporting procedures, including different classifications, carryover of funds from one year to another, minimum or no reporting, etc.

substantial but unforeseen recurrent costs evolved from the expansion of investment projects.<sup>15</sup>

International lending institutions and the donor community at large found the new ministries more capable than weak finance ministries of conducting business in the area of capital spending, as well as so-called developmental recurrent spending. The donors' responses further institutionalized the practice of separate organizations preparing separate budgets. Though the public investment program (PIP) era in the 1980s saw the introduction of more coordinated project selection and appraisal processes, replacing individual project appraisal, it did not change the dynamics of dual budgeting. Moreover, additional donor support to recurrent developmental and humanitarian expenditures created further coordination problems with governments' traditional recurrent budgets.

Both before and during the PIP era, emphasis was placed on calculating the recurrent spending that capital projects would need after their completion, but in practice finance ministers were uninformed and reluctant or financially unable to provide the necessary funds. The lack of provision for recurrent funds added to the concerns that had already been created by the organizational separation of the two budgets. It might be argued that the main reason for under-budgeting of recurrent expenditures for completed capital projects was, and still is, general fiscal stress in developing countries. But a counter-argument is that the fiscal stress could have been projected before the projects were initiated. Alternatively, it might be said that other spending priorities always crowded out the claims of these projects on recurrent budgets. Both arguments point to the lack of coordination between recurrent and development budgets.

A less often mentioned problem in these circumstances was double or overlapping budgeting for the same or similar recurrent activities of government. Frequently, line ministries managed to receive funds from two sources for the same cause by negotiating separately with the finance and planning ministries. They succeeded in this not only because development budgets contained substantial non-investment and non-project-related recurrent spending, in addition to capital spending, but also because the finance ministries had no proper information, either on the recurrent cost implications of the investment projects or on the independent recurrent expenditures being financed by donors—a problem that continues to date in most developing countries.

In several countries, dual budget preparation in terms of contents, classification, and even calendars, resulted in two different budgets being presented to parliament. Even in some countries where the timing of budget presentation has been unified, the documentation, classification, and presentation format of the two budgets has remained separate. Typically, recurrent budgets were classified on the basis of line ministries and/or those ministries' programs and expenditure items, while budgets for capital projects and

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<sup>15</sup> In some countries, although the minister of finance may have presided over the planning commissions or planning ministries, the latter were directed from the presidency. For details see I. Linert and F. Sarraf, "Systemic Weaknesses of Budget Management in Anglophone African Countries", IMF Working Paper, 2001, IMF Website.

developmental recurrent spending were presented as a list of projects, mostly with identification of their funding sources, but with little or no expenditure itemization.

The main impact of a dual budgeting system on budget execution and reporting occurred through capital or recurrent projects financed by donors, which usually required governments to keep separate accounts for domestic counterpart funds and to deposit such funds along with donor funds in special bank accounts, outside the purview of central treasuries or accountants-general. These special accounts, mainly in commercial banks, were governed by flexible spending rules and often bypassed the national budget systems, undermining the objective of comprehensive government accounting, banking, and cash management coverage. Moreover, to ensure the availability of funds for recurrent expenditures of selected capital projects, government authorities created expedients such as extra-budgetary funds and trust accounts, whose transactions were subject to separate accounting and banking rules. This contributed to weaker reporting and delays in closing government accounts, due to the difficulty of reconciling government accounting records with government banking transactions. Although in most countries central treasury offices and accountants-general issued circulars requiring line ministries to report their transactions, in practice these reports were not complete or timely.

Special project management units were created in line ministries, dealing with the accounting and banking of the cash components of external loans and grants, as well as with government counterpart funds. Since these recurrent and capital transactions were not classified in terms of the object of expenditures, in practice the decision to itemize expenditures was entrusted to line ministries in the course of budget execution. Several line ministries did not use the government standard object classification that was used for traditional recurrent expenditures, thereby multiplying the accounting and reporting problems.

*Late 1990s to date: PRSP, MTEF, sector-wide approach, and budget support era*

Since the late 1990s, new financial assistance policies and instruments such as PRSPs, monitoring of poverty-reducing expenditures, sector-wide and budget support approaches have been changing the dynamics of donor/client relationships. Moreover, responding to urgent needs in health, education, and other sectors in poor countries, several donors have substantially increased their financing of recurrent expenditures. The new approaches have implications for consultations, conditionality, and data requirements, and for technical assistance to support an integrated approach to recurrent and development outlays. Public expenditure reviews (PERs) clearly have moved toward more intra- and inter-sectoral analyses, combining both recurrent and development expenditures, and where data are available, reviewing the joint impact of both types of spending on budgetary outcomes including economic growth, poverty reduction, and asset maintenance. But while most developing countries have at least begun using medium-term expenditure frameworks (MTEFs) to replace five-year national plans and public investment programs, their annual programming and budgeting of recurrent and development operations still tend to be carried out by separate organizations.

Some developing countries have merged their finance ministries with their planning or development ministries, though others are slow in doing so. The organizational separation of planning and finance ministries has become institutionalized in culture and politics in several countries. Political concerns about eliminating a ministerial portfolio, combined with institutional revivalism between the two ministries at the institutional level, persist in many developing countries. On the other hand, in considering eliminating a ministerial portfolio, it should be kept in mind that governments can use their authority to create as many cabinet posts as they wish—say, for example, creating a ministerial post for environment or splitting the ministry of trade and industry into two.

Over the years, staff of planning or development ministries have tended to be better paid, and to benefit from various allowances and better professional treatment, than staff of finance ministries. Their favored position in part reflects the additional financing possibilities associated with externally financed projects. This feature might be a cause of difficulty in the integration of the two institutions.

Line ministries have a strong incentive to prepare and defend separate budgets because they can use the opportunity of donor-negotiated projects to demand further complementary financing and to expand their operations without attention to the future cost implications. These projects may include either capital projects or specific and independent recurrent activities. For line ministries, dealing with two separate central ministries for defending their budgets is more advantageous than dealing with one unified central budget authority, because they can take advantage of the two central ministries' lack of detailed information.

Today more than ever, the integration of recurrent and development budgets in developing countries has become a necessity:

- government borrowing is no longer limited to capital expenditures;
- only an integrated analysis of recurrent and development expenditures can identify those poverty-reducing expenditures that have immediate impact (e.g. social transfers and targeted subsidies, and some other social expenditures) or an indirect impact through accelerating economic growth;
- part of external concessional credits, and the bulk of donor grants, are used for recurrent expenditures, supplementing the government recurrent budget; and
- even after several decades of experience, the recurrent costs of capital projects continue to be ignored, in part for lack of coordination between two separate budgets.

### 3. Budget integration: four necessary elements

A full and meaningful integration of recurrent and development budgets in developing countries requires:

- organizational and staffing integration,
- integrated budget preparation,

- unified budget documentation and presentation, and
- unified accounting and reporting systems.

This chapter discusses each of these four elements in turn, drawing on lessons of experience. Budget integration is an area where developing countries can learn more from each other than from advanced countries. Given that advanced countries integrated their recurrent and capital budgets decades ago, and that the donor factor does not apply to them, the recommendations below do not draw on advanced countries' experience.

### Organizational and staffing integration into a single ministry

Medium-term sectoral policy analyses, and their related projections of both recurrent and development expenditures, are tightly interrelated with the annual budgeting process that translates them into operational programs and related appropriations. Accordingly, any organizational separation of these two tasks, either in developing a medium-term framework or in annual budgeting, can damage their comprehensiveness and quality. The necessary relationship between sectoral analysis and the annual budget appropriations, on the one hand, and coordination between recurrent and capital expenditures on the other, can be maintained if staff dealing with the MTEF and annual budgeting in the central budget authority and line ministries treat these functions as a unified task.

Ensuring the complementarities between recurrent activities and investment projects, combined with measuring their outcomes, requires a comprehensive and holistic approach to initiating, analyzing, and financing government programs. The approach needs to encompass both the recurrent and capital expenditures of a program or, in the absence of a program structure in the budget, the expenditures within interrelated administrative divisions of a line ministry. It requires full organizational integration, not only shared analysis techniques with separate staffing. In fact, this integration should permit some savings of scarce expertise in policy analysis and budgeting.

Line ministries should adopt the same pattern, in order to avoid any dual budgeting before their budget proposals reach the central budget authority. Most external donors initially approach the line ministries for possible funding of their recurrent and/or capital expenditures before the proposals, along with the ministry's traditional recurrent budget, arrive in the central budget authority for further analysis and finalization. For this reason, the integration of recurrent and development budgets, as well their integration with medium-term expenditure planning, are as critical in the line ministries as in the central budget authority.

In both advanced and developing countries, decisions on large infrastructure projects may be made at the center of government (presidency, cabinet of ministers, and even by the legislature) rather than by a finance and planning ministry. But this practice does not justify the retention of a separate ministry or a planning commission. It does not alter the need to combine the preparatory work on such projects (feasibility study, appraisal, annual budgeting, etc.) with government mainstream mid-term expenditure planning and the use of an annual budgeting system, to ensure the provision of operational and

maintenance costs after completion of the capital works. Nor does it remove the need to establish a large project's relations with the government's budget preparation cycle and other ongoing recurrent activities and capital projects of the government.

It seems that only through an organizational merger can both large capital projects (even those that are determined at the center of government) and the rest of the budget (normally finalized by planning ministries and donors in conjunction with line ministries) be coordinated with the government recurrent budget in an adequately informed environment. In a single integrated ministry, staff will have better information on the recurrent operations and domestic financing components of externally financed projects and will be able to harmonize that information with the rest of the budget (i.e. domestically financed recurrent spending as well as spending for capital projects). The integration is also critical to avoid double budgeting, given the rapidly growing share of external aid that takes the form of recurrent developmental expenditures that supplement traditional recurrent expenditures but remain as part of the development budget. Many of these latter recurrent operations, like capital projects, may well have lasting cost implications after donor funding is discontinued.

Some developing countries have overcome major political and bureaucratic disincentives and integrated their finance and planning or development ministries.<sup>16</sup> Several English-speaking developing countries have merged their finance and planning or development ministries<sup>17</sup>, and, interestingly, most French-speaking African countries have completed this stage.<sup>18</sup> Several middle-income countries, including Mexico, Paraguay, Sri Lanka, and Thailand, as well as some Eastern European countries such as the Czech Republic, have closed their planning or development ministries and absorbed them within their finance ministries.

Nevertheless, several other developing countries, mainly in the Middle East and Africa, and the former Soviet union, still retain two separate ministries: one for the preparation of

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<sup>16</sup> For information on country experiences and practices, aside from examining the countries' budget documents in the IMF's Fiscal Library, the World Bank and IMF websites, and some relevant countries' websites, consultations were undertaken with some team leaders and members of World Bank missions who had been involved in technical assistance work in some of the countries named in this paper.

<sup>17</sup> **Bangladesh** (Ministry of Finance and Planning), **Botswana** (Ministry of Finance and Development Planning), **Ethiopia** (Ministry of Finance and Economic Development), **Jamaica** (Ministry of Finance and Planning), **Lesotho** (Ministry of Finance and Development Planning), **The Gambia** (Department of State for Finance and Economic Affairs), **Uganda** (Ministry of Finance, Planning and Economic Development), **Tanzania** (Ministry of Finance). Tanzania has merged planning and budgeting function of the development expenditures in the Budget Department of the Ministry of Finance.

<sup>18</sup> **Cameroon** (Ministère de l'Economie et des finances), **Cape Verde** (Ministère des finances et de la planification), **Central African Republic** (Ministère de l'économie, des finances, du budget et de la coopération internationale), **Comoros** (Ministère des finances, du budget et de l'économie), **Guinée** (Ministère de l'économie et des finances), **Guinée Bissau** (Ministère de l'Economie et des finances de Guinée Bissau), **Madagascar** (Ministère de l'Economie, des finances et du Budget), **Niger** (Ministère des finances du plan et de l'Economie), **Rwanda** (Ministère des finances et de la planification économique), and **Togo** (Ministère de l'Economie, des finances et de la privatisation).

the recurrent budget (normally the finance ministry), and another ministry, commission, or independent organization for the preparation of the development budget, mostly along with the mid-term expenditure planning function.

### *The way forward*

After the principle of organizational integration is accepted in a country, several options may be considered for its implementation:

- In a small country, it is most suitable to integrate the macroeconomic and macro-fiscal analysis tasks, along with aid coordination, sectoral analysis, MTEF, project appraisal, annual budgeting, and treasury functions, in a ministry of planning and finance (or a ministry with an equivalent title).
- In a medium-size country, the macroeconomic analysis function may be entrusted to a small organization outside the ministry of planning and finance, but the remaining tasks, including macro-fiscal analysis and preparation of the resource envelope, need to be consolidated in the ministry of planning and finance.
- In large countries, macro-fiscal analysis, aid coordination, sectoral analysis, MTEF, project appraisal, and annual budgeting functions can form the responsibilities of a ministry of planning and budgeting, while a separate ministry of finance may take charge of treasury functions, along with the traditional oversight of revenue authorities.<sup>19</sup>

### Integration of budget preparation

Having accomplished the major and fundamental step of merging the finance and planning or development ministries, the next step would be to bring together the budget preparation staff in a single budget department supervised by a single manager. The merger of finance and planning or development ministries, though a necessity, would not eliminate dual budgeting unless the recurrent and development budgeting functions are fully integrated within the new ministry. Experience (e.g. from The Gambia, Lesotho, and Madagascar) shows that unless this happens, practice will revert to *coordination* between two budgets, which has never worked, rather than achieving budget *integration*.

Even if a single budget department is created for the two functions, real integration will not take place until the same staff are made responsible for both medium-term expenditure planning and annual budgeting in the sectors covering both recurrent and development expenditures. Lesotho, for example, merged its finance and development and planning ministries so that only one minister and one permanent secretary are in charge of both budgets, but the staff dealing with the development budget have remained

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<sup>19</sup> The term “treasury functions” is used here for the usual government accounting, payment, and cash and debt management tasks, rather than, as in a few countries ( Australia, Canada, and New Zealand), for government fiscal policy and budgeting tasks.

as separate from the recurrent budgeting staff as they were under two ministries; as a result, real integration has not yet happened.

Several factors, mostly pertaining to institutions and incentives, pose challenges to the unified budget preparation process. Politicians normally prefer to focus separately on capital spending because this creates physical assets that they can show to their constituents (even if they know the assets may not provide services). In their eyes, the recurrent budget simply disappears into a bureaucratic machine, which they do not trust. Moreover, the old paradigm of the superiority of public investment spending over current spending still retains a grip on many players' minds. Even if donors are increasing their support to necessary and neglected recurrent expenditures, governments, to the extent they can, still give priority to new capital spending over maintaining existing assets and running current services.

Development expenditures are not subject to a ceiling, and at any time, donor-supported activities may be initiated with or without government counterpart funds. This suits the line ministries' interests, and helps maintain the status quo.<sup>20</sup>

Recurrent expenditures are mostly locally financed, although this practice is changing fast due to their increased financing by donors, and to increased general budget support, which combines recurrent and development budgets. Domestically financed recurrent operations are unreliable, being vulnerable both to across-the-board cuts in budget preparation and to shortfalls in cash releases. Development projects (either capital or recurrent), on the other hand, are largely donor-financed, and their funding is more assured. For the same reason, donors prefer to fund operational costs within capital projects, or independent recurrent expenditures in critical sectors, because they, too, have little faith in the provision of funds through domestic budgets.

As mentioned above, in some countries, even after the merger of the finance and planning or development ministries, organizational disincentives such as dealing with the staff who were engaged separately in recurrent and development budgets, conspire to keep the status quo of separate budget preparation.

These mostly domestic institutional factors may have militated against the integration of the recurrent and development budgets in the budget preparation phase. Donors do not normally suggest that the projects that they are prepared to support should remain outside a country's budget preparation process, though this may not apply to the budget execution and accounting phase described later. It is obvious that when the budget is finalized, it should incorporate all projects agreed with donors. If new donor-assisted projects are negotiated and started in the course of the year, an aid-receiving country should incorporate them in a revised or supplementary budget document (like

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<sup>20</sup> Government counterpart funds are the only portion of the development budget in which the finance ministries are engaged during budget negotiations with line ministries. As a result, those portions that are financed through external grants and loans remain almost unanalyzed by the recurrent budget departments.

government's own-financed recurrent budget), submitted to the legislature, so that budget integrity will be preserved.

It appears that only a few developing countries have advanced in fully integrating their budget preparation processes. Tanzania and Uganda have made some progress by integrating the preparation of recurrent and development budgets within a single organizational unit. Aside from OECD countries, several middle-income countries including Brazil and some East European countries such as the Czech Republic, Macedonia, and Slovenia have already completed this stage of integration but, as mentioned earlier, because of different conditions, in this paper examples have been chosen from low-income countries.

### *The way forward*

To accomplish the integrated preparation of budgets in a country that has already merged its finance and planning ministries, it seems that the only viable alternative would be to create sectoral divisions within a unified budget department. Each division manager and his/her staff collectively would be responsible for sectoral policies, program analysis, and annual budgeting. Such informed and focused sectoral divisions would then deal with line ministries' recurrent and development operations, both in the medium-term expenditure framework and annual budget.

In this proposed set-up, external donors' sector-specific projects should be coordinated by the budget departments rather than by a separate aid management unit, and the line ministries would need to work through the budget department for their budget proposals, whether or not they wish to obtain counterpart funds for their externally financed operations. At present, the separate departments for the recurrent and development budget are not fully aware of all the line ministries' externally financed activities. Moreover, most aid coordination units as presently constituted deal only with the administrative formalities of external aid, and once a donor-supported project is approved, the line ministries neglect to supply them (or budget departments and even central treasuries) with timely financial data.<sup>21</sup>

The number of sectoral divisions appropriate for a budget department depends on a country's size and its organizational and human resources. Also, depending on the size of a country and number of divisions, the responsibility for macro-fiscal analysis and for

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<sup>21</sup> There is no intention to address aid coordination issues and problems in this paper, but it needs to be said that aid coordination units have rarely succeeded. For one thing, they do not have full coverage and detailed information on external inflows. In some countries, donors contact different central agencies, aside from line ministries. For example, in **The Gambia**, UNDP works with the President's Office, while some bilateral donors contact the Department of State for Foreign Affairs, and other donors normally work with the Department of State for Finance and Economic Affairs. In **Kenya**, the aid coordination unit has minimal or no interaction with the staff who prepare the separate recurrent and development budgets in two ministries. A government's need to carry out the administrative work associated with external aid should not detract from the budget department's substantive involvement in the details of externally supported operations.

resource envelope determination can be placed under the same budget director or in another department within the merged ministry.

## Integration of budget documentation and presentation

The integration of documentation and presentation of the recurrent and development budgets—as distinct from the integration of budget preparation—has gained increasing acceptance in some developing countries. It seems that this element of integration can proceed somewhat independently from the integration of the budget preparation system itself.

Some countries have come to accept that better budget documentation is helpful in many respects, including to show that they are initiating some reforms as well as to facilitate their working relations with internal and external stakeholders. Reformed budget classifications, along with computerized budget documentation and printing, have played an important role in improving budget documentation.

Unification of budget classifications and documentation, though necessary for a full integration of recurrent and development budgets, does not mean that the two budgets themselves are prepared and implemented in an integrated manner. But for those countries that have achieved it, integrated documentation provides a platform from which to begin a full integration of the two budgets.

In recent years some countries have assembled their separately prepared recurrent and development budgets in unified documents for presentation to their legislatures. Jamaica, Namibia, Papua New Guinea (PNG), Sierra Leone, The Gambia, and a few others provide good examples. Countries including Jamaica, PNG, and Sri Lanka—and, since the 2004 budget, The Gambia—also use a reformed, unified object/economic classification for their recurrent budget and development projects under line ministries' administrative units and their programs.<sup>22</sup>

In other countries (e.g. Guyana and Lesotho), the budget document is unified but has two separate sections: the recurrent budget classified on a program and expenditure object basis, and the development budget classified on a program basis. In some countries, the documentation is even less useful. Nigeria, for example, produces a unified budget document, but its development budget is only identified by one line item per project and in a separate section from the recurrent budget. Several other countries still prepare and submit two budget documents to parliament, in most cases with no proper expenditure object or program classification for development projects.<sup>23</sup> Both Tanzania and Uganda

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<sup>22</sup> For more information on different types of budget classifications, see: *Guidelines for Public Expenditure Management*, International Monetary Fund, 1999, IMF Website, PP.10-11.

<sup>23</sup> The necessity of identification of expenditure object classification for development projects has two main reasons: (i) it is mostly forgotten that a capital project has its own object classification such as feasibility study, purchase of land, site development, purchase of equipment, construction, etc; and (ii) today, in several developing countries, most development projects are no longer of capital work nature, but simply recurrent operations financed by donors or earmarked revenues, which are normally retained and spent by

have integrated the preparation of recurrent and development budgets in many respects, but still document the two, and present them to parliament, separately.

### *The way forward*

Clearly, the direction should be to unify both the classification and documentation of recurrent and development budgets. This may be facilitated by simple and country-capacity-based computerized budget documentation, as well as by reforming budget classifications and through country-capacity-based integrated financial management information system (IFMIS) projects.<sup>24</sup>

### Unified budget execution, accounting, and reporting systems

The integration of these systems is a critical part of integrating the budget management process in developing countries, and perhaps the most difficult. Almost all developing countries still use different accounting and reporting systems for their recurrent and development budgets, partly in reflection of the separate budget preparation processes, separate budget and accounts classifications, and separate banking arrangements they use for the two budgets. In addition to domestic incentives, donor practices have played an important role in this continued dualism. The latter are now geared to change, however, and the use of country systems is gaining ground among donors and country authorities.<sup>25</sup> Achieving this fourth element of integration depends on accomplishing the integration of budget documentation and classifications, on which certain countries have already made progress, as just noted.

Overall, no significant attempts have been made to integrate budget execution, accounting, and reporting systems in developing countries.

First, as mentioned earlier, only in a few countries does the documentation and appropriation structure for development projects go beyond a single line item for each project, regardless of the size of the project and the nature of its operations (recurrent or capital).<sup>26</sup> This state of affairs provides full flexibility to the executive branch (and

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line ministries or they are allocated to extra-budgetary funds, such as road or hospital funds that often do not follow government standard budget classifications.

<sup>24</sup> Note, however, that an IFMIS project by itself may not facilitate recurrent/capital budget integration, nor improve the accounting and reporting system, if the country's budget and accounts classification is not reformed and especially if the project is over-sophisticated and loaded with marginal features not adapted to a country's capacity to maintain it.

<sup>25</sup> See *Joint Declaration of Aid Effectiveness, Ownership, Harmonization, Results, and Mutual Accountability*, Paris, March 2005.

<sup>26</sup> Other project-related information might be found in the budget documentation, such as project location, source of financing (domestic or external and, if the second, loans and/or grants), and even information on detailed project activities. However, none of these data (though useful) is sufficient for an accounting and reporting system that can be easily combined with data on government recurrent expenditures, which

donors) to decide the expenditure object classification of a project in the course of the budget execution—flexibility that does not apply to items in the recurrent budget. Although this initially seems to be a budget documentation issue, in practice it leads to different accounting and reporting process as well.

Second, only in a few countries (perhaps those that have already unified their classifications in their budget documents) does the object classification of development projects (determined in the course of the year) match the classification used in the recurrent budget.

Third, as noted earlier, separate banking arrangements that exist for development projects outside the treasury's mainstream arrangements almost always cause serious problems in reconciling a government's accounting records with its banking transactions, as part of the accounting and reporting processes. Some recurrent expenditures (financed either by donors or government counterpart funds in the development budgets), along with capital expenditures, are subject to a more flexible pattern of spending and, at times, different accounting rules. Moreover, operations financed by the funds spent outside the country by donors are not reported in a timely manner or using the government's standard accounting and reporting classifications.

The separate accounting and reporting practices of development budgets normally reflect strong incentives of all parties involved in the processes. Country systems that are weak from the donors' viewpoint, combined with direct and indirect benefits (in the form of allowances, facilities, travel per diem, etc.) paid to staff involved in preparing and implementing development projects, have encouraged the use of more flexible accounting and payment arrangements that remain outside government mainstream accounting and reporting systems. Up to now, both donors and line ministries have had strong incentives to defend these arrangements, though this stance may be changing, and donors are now considering using countries' own accounting and reporting systems, although these systems need to be reformed.

In many countries, the rules for the development budget are more flexible than those for the recurrent, including carrying forward unused appropriations to the next year. Once a project is established in the development budget (regardless of its capital or recurrent nature), it is very difficult to remove it, however slow its implementation might be. Moreover, in many countries, virement rules are easier for the development budget, even if an object classification is approved or presented in the budget, though such virements may require donor approval, which is easier than any virements in the domestically-financed recurrent budget.

Unfortunately, solutions such as the introduction of a treasury single account for banking of all government transactions have not moved forward, due to the disincentives mentioned on the part of line ministries and donor agencies. Moreover, banking

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contain a detailed expenditure object classification that provides the basis for a government's financial reporting system and its chart of accounts.

arrangements are only part of the requirement for a fully integrated budget execution, accounting, and reporting system.

*The way forward*

Donor factors play a more significant role here than in the other three aspects of budget integration. On the positive side, donors' acceptance of the need to help strengthen and use country systems for their interventions mainly centers on the accounting and reporting processes, which may further help this element of integration of recurrent and development budgets.

Proposed actions in this context in the future should include:

- Unifying the budget preparation process for recurrent and development budgets, including all donor-funded projects, apart from its own merit and necessity, as a sound framework for accounting and reporting processes.
- Reforming and unifying recurrent and development budget classifications in the functional, administrative, and economic classification contexts, and where possible within a program structure. Action is also needed to unify budget documentation and presentation, as well as to identify the expenditure object classification of development projects in the budget documents, as the basis for their accounting and reporting along with recurrent expenditures.
- Requiring donors to use the client country's expenditure object classification when reporting the amounts they have spent outside the country on a project.
- Until the budget execution, accounting, and reporting process are fully integrated, line ministries should reconcile their accounting books with the banking transactions of donor-funded projects for the funds that the projects managers receive and spend outside central treasuries, and report those transactions promptly to the central treasury offices and accountants-general.
- Finally, the opportunity to implement the recommendations of the March 2005 Joint Paris Declaration of Aid Effectiveness by donors and client countries should be used to accelerate this phase of the integration of the recurrent and development budgets.