Public Financial Governance for Inclusive Development in Africa
This book was authored by Dr. Salvatore Schiavo-Campo, as a Consultant to the African Development Institute of the African Development Bank. The Author has tested the contents of the book on successive cohorts of seminar participants from African countries.
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Foreword

The African Development Bank Group recognizes the importance of good governance, grounded on the pillars of accountability, participation, transparency, and the rule of law. Moreover, the 2005 Paris Declaration emphasizes that the development efforts of many countries will falter, even if supported with increased funding, if the capacity of the public sector is not strengthened. Sustainable growth and poverty reduction thus require both governance improvements and capacity development, in Africa as elsewhere.

Sound public financial management, mobilizing and distributing revenue equitably, assuring fiscal sustainability, bringing resource allocation in line with development priorities, controlling expenditure while enabling efficient management, and protecting due process, are central to the challenge of raising the quality of governance and reducing corruption. The African Development Bank can help its African member countries by putting at their disposal the basic conceptual framework of public finance, the principles and practice of good tax administration and budget preparation, execution, control, reporting and audit, and international experience with public financial management.

Although a number of books have been published in this area, until now none had addressed the public financial management challenge in a comprehensive manner and with a specific focus on the circumstances of African countries, including fragile states. This is what this book, carved out of the knowledge and capacity development work in the African Development Institute, aims to do. On behalf of the Bank, I hope it will prove valuable to our African member governments and their people.

Donald Kaberuka
President
African Development Bank
Preface and acknowledgements

Objectives and scope of this book
While there have been a number of publications over the years addressing various challenges of public financial management (PFM) in African countries, there has never been a volume covering the entire range of public financial governance issues from the explicit perspective of the circumstances, strengths and constraints of Africa. In this vast continent, differences between countries are at least as great as in Europe, Asia or Latin America, and caution is needed to avoid unwarranted generalizations. However, there are also important commonalities, related partly but not exclusively to the shared historical experience of colonial oppression as well as the rich cultural, religious and ethnic diversity of the continent, which influence both the nature and the impact of appropriate PFM systems for economic and social development.

The full range of public financial management subjects is covered here, from the governance, institutional and macroeconomic contexts to the “upstream” issues of expenditure programming and budget formulation and the “downstream” issues of budget execution, monitoring and evaluation. Special attention is also dedicated to the issues of budgeting at subnational government level, the problems of fragile states and the challenge of assessing and improving African budget systems. While this volume is intended to be comprehensive, it cannot possibly cover all relevant issues in sufficient depth, and can usefully be complemented by selected readings on specific issues and, of course, by material specific to the concerned country. The website of the African Development Bank and those of the World Bank, International Monetary Fund, the UK Department for International Development, the Agence Française de Développement, USAID and other international partners of African development provide relevant country material.

The book is intended to be both conceptually sound and oriented toward the operational needs of African country officials at various levels of management. Thus, the discussion of each topic starts by providing the basic concepts and the theoretical foundation and then proceeds to highlight the practical implementation aspects of the topic. Because the book is also meant to be accessible to parliamentarians, the media and civil society, it attempts to use a communicative and reader-friendly style, avoiding unnecessary jargon to the extent possible and using everyday illustrations and practical examples.

The broad approach of the book
Three major themes underpin the analysis and discussion:

» Adaptation not adoption. PFM systems and practices cannot be imported into a different institutional and cultural milieu without significant adaptation. Thus, the approach of the book is to distill the lessons of good and bad international experiences in public financial governance while spelling out in practical detail the requirements for their success and the pitfalls to be avoided. This is the opposite of the simplistic and dangerous counsel that African countries (or any country) should simply adopt “best practices” developed elsewhere. Moreover, the vast differences among African countries themselves underline the imperative to adapt PFM practices and systems to local conditions and institutional realities.

» Emphasis on capacity. The main reason for the frequent failures of attempts at improving PFM systems in low-income countries, including in Africa, is the insufficient attention paid to capacity considerations and the narrow view of capacity building only as training. The need to consider carefully the realities of “capacity” as encompassing the institutional, organizational, and informatics dimensions in addition to human skills, underlies most of the book.
Focus on management. To assure the usefulness of the book and steer clear of both politics and the broader debates on development policy and poverty reduction, the emphasis of the book is on the management dimension and on the instrumental aspects of public financial management. This does not mean, however, that there can or should be a firewall between the policy question of “what is to be done” and the management question of “how it is to be done”—because policy would then become unrealistic and implementation would be disconnected from the objectives. Thus, macroeconomic, development, and other policy issues are addressed—albeit only as needed to provide the necessary context to public financial management.

Structure and organization of the book

The volume comprises 17 chapters grouped in five parts. Part I outlines the governance, institutional, macroeconomic and fiscal contexts of public financial management. Parts II through IV cover, respectively, budgeting objectives, systems and coverage; the “upstream” phase of expenditure programming and budget preparation; and the “downstream” phase of budget execution, financing, and public financial accountability. The chapters in Part V deal with expenditure management at subnational government level, the special problems of fragile states, and the ways in which to (and not to) foster performance in the budgeting system. The two last chapters describe the methodology of assessing the strengths and weaknesses of PFM systems; suggest a number of criteria and priorities for improvements suited to the circumstances prevailing in most African countries; and conclude with a return to the critical theme of capacity development.

Within each chapter, as noted, there is a systematic progression from the basic concepts and principles to their application in practice and the relevant international experience—with data and illustrations, as appropriate, from African countries—including some 30 “boxes.” A brief “what to expect” section at the start of each chapter frames the discussion.

Detailed references and endnotes are deliberately kept to a minimum within the text, to avoid the feel of pedantry and the discontinuity that are generated by a vast number of notes and detailed references. Moreover, this book is essentially a synthesis rather than a platform for original analysis. Although in many cases credit for specific points cannot be assigned to individual authors, as their contributions were amalgamated and synthesized as needed for the clarity and continuity of the discussion, each major section includes an attribution of credit to the main sources used. The bibliographical and acknowledgement note at the beginning of the References annex lists the main sources used for the book, in addition to those directly credited in the text.

Finally, owing to the multiple audiences for the book, a special effort was made to help the reader navigate through it. For this purpose, the table of contents is unusually detailed. Correspondingly, an analytical index was not deemed necessary.

Acknowledgements

The effort to produce a conceptually sound but operationally oriented synthesis of public financial management theory and practice, with particular reference to developing countries, originated from my recognition of the critical importance of these issues during an intense experience as IMF Resident Representative to Somalia in the mid-1980s. Over the subsequent 25 years, this effort was first brought to fruition in 1998 with a book published by the Asian Development Bank, and then deepened through publication of several other books and articles and delivery of technical assistance and training in some forty countries — half of which in Africa — for the African Development Bank, IMF, World Bank, and the European Commission.

My first and heaviest debt of gratitude is owed to Daniel Tommasi, the co-author of the 1998 book, and A. Premchand. They taught me much of what I know about public financial management and are not responsible for what I do not yet know. I am also indebted to the Asian Development Bank, World Bank Institute and East-West Center for permission to use some of my contributions to their publications.
A large number of colleagues, too many to be listed here, have provided useful comments on different parts of the book.

In addition to the institutional support of the African Development Institute (ADI), which is gratefully acknowledged, I benefited from the guidance by the previous ADI Task manager Mr. J. Elegbe, who encouraged me to embark on this major undertaking and contributed to the conception of the book, the current Task manager Ms. Kanny Diallo for her support and feedback on the first draft, and the ADI Director Mr. Victor Murinde. Finally, much of the book’s operational detail and tailoring to African realities comes from the constructive interaction with the hundreds of African officials participating in the PFM workshops which I had the privilege of conducting for ADI during the past five years. I am grateful to all of them.

While acknowledging all of these valuable contributions and comments, all responsibility for any error or misunderstanding rests solely with the author.

S. Schiavo-Campo
Part I: The Context of Public Financial Management in Africa
Chapter 1: The Global, Governance and Institutional Context
What to Expect

No sound decision on taxation and government spending can be made without considering the overall context within which the public finances are to be managed. Interdependence with other countries is a first contextual dimension. While economic interdependence has increased throughout human history, the last two decades have witnessed an especially rapid increase due mainly to the informatics revolution and worldwide financial and economic liberalization. The issue of “globalization” is not the increase in economic interdependence, as such, but the unequal distribution of its costs and benefits, particularly vis-à-vis Africa. The other major contextual dimensions of PFM are the quality of governance, the impact of institutions, and the management of the state and public administration as a whole. Concerning governance, the four basic pillars are accountability, transparency, participation, and the rule of law. Concerning the institutional and cultural contexts, informal norms and customs can have a stronger influence on the effectiveness of public financial management than formal laws and rules. Concerning the political and administrative contexts, decisions on how the state is to perform the roles assigned to it are as important as the identification of the roles themselves. The effectiveness of public financial management systems and the opportunities for reform depend crucially on appropriate consideration of these dimensions—a theme that will be explored throughout the book.

The global context:
Opportunities and constraints

The meaning and impact of globalization
Economic interdependence among individuals and groups is a reality of any organized society. Moreover, the increase in interdependence among countries is not new. The 14th century was a period of continuing reduction in “economic distance”—i.e., the cost of transferring goods, services, information, labor and capital from one place to another. This reduction in economic distance, stemming from improvements in transport technology and reduction of tariffs and other trade restrictions, reversed several previous characteristic features of the Middle Ages: shrinkage of production to subsistence basis; extremely limited exchange of goods, people and ideas; decline in population; extreme parochialism and static worldview.

Globalization was as dramatic in the late 19th century as it has been since the late 20th century—from trade, foreign investment, and especially labor migration. It was followed by rapid disintegration between the two world wars, associated with the Great Depression and the isolationist/imperialist policies of Nazism, fascism and Stalinism—then restarted after World War II and the end of colonialism, and picked up speed in the mid-1990s.

Thus “globalization” is more than just a catchy term for an old phenomenon. There may be no difference in overall impact between, say, the invention of the steam engine and that of the computer. However, the degree and speed of impact is so much greater as to constitute in effect a new phenomenon—particularly from the informatics revolution and the rapid liberalization of external financial transactions that took place in most advanced countries and large parts of the developing world, including in Africa. Moreover, the current wave of globalization has been especially uneven.
The real debate therefore should not focus on the decrease in economic distance in itself, but should revolve around the concern that in the last two decades economic distance has been shrinking faster than can be reasonably managed by international and regional institutions—let alone by an individual country. Among the consequences of this disconnect between an integrated world economy and an un-integrated world political system is the lack of a functioning mechanism to address the problems of groups and countries on the losing end of the globalization process.

The economic and social benefits from globalization can be large, but the costs can be high as well, and the distribution of costs among groups and countries is different from the distribution of benefits. Thus, while in Asia and parts of Latin America countries have greatly benefited from globalization, much of Africa has been left behind—at least until very recently. Globalization also has an impact on the concentration of economic power, between and within countries: even in countries that reaped an overall benefit, large groups of their people did not. Thus, the globalization challenge is to strengthen the international and regional management of the process of interdependence, primarily to (i) slow down the transmission of destructive developments in any one country (including adverse governance developments) to other countries; and (ii) protect vulnerable groups and countries from carrying the brunt of the adjustment and being left farther and farther behind.

It is well to remember that globalization is a two-way channel for much easier international transmission of both positive and unpleasant changes. For example, not only jobs and technology have been globalized, but crime as well. Naim (2005) provides an analysis and illustrations of the new phenomenon of drug traffickers and other organized criminals operating globally. In recent years, the threat has extended to West Africa.

Globalization and Africa
The global economic crisis has affected African economies as well—especially coming on the heels of the food and fuel price flare-up of 2008.

Renewed upward pressures on food prices in early 2011 threaten to undo some of the still-fragile recovery. Yet, overall, the net impact of globalization on African economies appears to have been positive. Africa’s economic performance has improved during the last decade, with growth rising from an average of 4.6 percent in 2001-05 to almost 6% in 2006-2008. While in some countries the acceleration of growth was triggered by the rise in commodity and oil prices, the improvement has been widespread, and 22 non-oil African countries grew at an annual rate of 4 percent or better. In human and social development, progress was mixed. Primary education completion rates rose to almost two-thirds and the school participation rate of girls increased to over 90% the rate for boys. But health indicators did not improve as much as had been hoped—for example, under-five child mortality is still very high at an average of about 144 per 1,000 live births. Overall, although significant human and social progress was made in several countries (particularly in the countries where the quality of governance improved), as of 2011 the Millennium Development Goals are far from being achieved in Africa. It can be argued, however, that this outcome is due to the very low initial conditions in most African countries (Easterly, 2009).

The economic and social progress made during the past decade could have been faster and better distributed if the global promises made concerning the volume and effectiveness of aid had materialized fully. Optimism was high in 2005, when the Gleneagles Summit pledged to increase assistance to Africa to $52 billion by 2008, and the Paris Declaration committed to a major improvement in aid effectiveness by harmonizing donor practices and supporting capacity development by greater reliance on African countries’ own systems and procedures. Unfortunately, the greater reliance on country systems has not materialized, and net official development assistance to Africa rose to only $39 billion—which included a large increase in humanitarian assistance and debt relief. The latter succeeded in reducing Africa’s debt levels as a percentage of GDP all the way back to the levels of 1980—before the vast and largely uncontrolled expansion of public sec-
tor borrowing (much of it wasted and some of it misappropriated).

The lingering impact of the Great Recession makes it unlikely that the volume of official development assistance to Africa will increase substantially in the next few years, and most debt relief has already been granted. In this decade, therefore, it will be that much more important for African countries to strengthen their management of external aid and their public financial management systems in general. (Aid and its management are discussed in Chapter 11.)

Globalization and public finance
Globalization has an impact on public finances in most countries, as it limits the ability of national governments to act independently. The new reality is an imperative to consider the impact of public financial decisions on the outside world and subsequent repercussions. This reality cuts two ways. On the one hand, there is a new constraint on many governments’ capacity to sustain inefficient economic policies by persistent and structural fiscal deficits; on the other hand, of particular concern to Africa and other developing regions, the implementation of governments’ independent social policies and redistributive objectives is hampered as well. In addition to the importance of better management of aid, five implications of special relevance to Africa can be drawn:

» given the constraint on raising tax rates, the efficiency and equity of tax administration acquires greater importance;
» given the constraint on expanding public expenditure, good expenditure management and more rigorous public investment programming become critical;
» given the need to decentralize, building budgeting capacity at the subnational government level is important;
» given the importance of transparency and accountability, standard norms of budgeting, accounting and audit should be implemented, as appropriate to local conditions;
» finally, of special importance are the international initiatives to harmonize aid, avoid duplication, and foster reliance on national systems of public management and control—described later in Chapter 11.

The governance context

Governance: Definition and components
“Governance” is the manner in which state power is exercised—as distinct from the purposes for which state power is exercised. Good governance rests on four pillars—accountability, transparency, predictability (mainly through the rule of law), and participation—and is built on the foundation of a strong civil society. Accountability means the capacity to call public officials to task for their actions; transparency entails the low-cost access to relevant information; predictability results primarily from laws and regulations that are clear, known in advance, and uniformly and effectively enforced; and participation is needed to improve the quality of decisions and provide a reality check for government action.

All governance concepts are universal in application but relative in nature. Accountability is a must everywhere, but does not become operational until one defines accountability “of whom,” “for what,” and “to whom.” Transparency can be problematic when it infringes on necessary confidentiality or privacy: full enforcement of useless or obsolete laws is not a great advantage and, of course, it is impossible to provide for participation by everybody in everything.

Because governance has to do with the quality of the process, not the quality of the outcomes, it is quite possible for an arbitrary decision-making process to occasionally produce good results, and
bad results can sometimes come out of sound and accountable systems. In the long run, however, good governance tends to produce good decisions, and bad governance leads to bad decisions. Sustainability is the issue. Even when an apparently good decision is produced in arbitrary and authoritarian ways, it cannot command public support and is thus much more likely to be ineffective or to be reversed. Exclusive concern with the quality of each decision and not also with the quality of the decision-making process will eventually produce systematically bad decisions.

The importance of governance has increased in the African Development Bank’s strategic approach to supporting development, as shown in Box 1-1.

**Box 1-1**

**The role of governance in the AfDB Strategy**

In its Multi-Year Strategic Plan for 2003-2007, the African Development Bank set three strategic priorities at the country level: agriculture and rural development; water and sanitation; and human capital formation. Governance was understood as important to support these priorities. At the regional level, economic integration and infrastructure development were emphasized, under the NEPAD initiative, which later assigned to the Bank a lead role in infrastructure, financial and corporate governance.

In the subsequent strategy for 2008-2012, the role of governance became more central as one of the four core areas—in addition to infrastructure, private sector, and regional integration—and included support for public financial management improvements.

This evolution was consistent with and foreshadowed by the African Development Bank’s formal policy on governance, approved in 1999.


As reflected in the major survey of governance—the Worldwide Governance Indicators (WGI) (see Kaufmann, Kraay and Mastruzzi, 2009)—the quality of governance and public management can be measured along six key dimensions:

- **Voice and Accountability**—the extent to which a country’s citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media;
- **Political Stability and Absence of Violence**—the likelihood that the government will not be destabilized by illegal or violent means, including terrorism;
Government Effectiveness—combining quality of public policy; quality of social services; and capacity and integrity of the government workforce and its independence from partisanship political pressures;

Regulatory Quality—the ability of the government to provide an efficient regulatory framework that enables and promotes private sector development while protecting public safety, health and other public purposes;

Rule of Law—the extent to which economic agents have confidence in and abide by the rules of society, including the quality of contract enforcement and property rights, the operation of the police and the courts, as well as the incidence of crime and violence;

Control of Corruption—with corruption defined as the exercise of public power for private gain, including both “petty” and “grand” corruption, as well as the “capture” of state activities by elites for their own interests and profit.

Trends in African Governance and Public Administration

Tables 1.1 and 1.2 show the WGI indicators for Sub-Saharan and North African countries in 1996-2008. For Sub-Saharan African countries in particular, the most comprehensive single measure is the Ibrahim Index of African Governance—shown in Table 1.3. Readers are encouraged to peruse these statistics for details on each country and draw their own conclusions. However, in general the evidence on Sub-Saharan Africa, based on a variety of indicators, identifies three periods: initial governance progress after the end of the Cold War, from 1989 to 1995; backsliding associated largely with civil conflict between 1996 and 2002; and resumption of progress in governance in recent years (McFerson, 2010).

The picture is mixed in North Africa, with declines in average indicators of voice and accountability, government effectiveness and control of corruption, but an improvement in the rule of law. In any case, the popular upheavals begun in early 2011 known as “the Arab Spring” have already drastically changed the fundamental parameters and will undoubtedly have lasting consequences for the quality of governance in the Maghreb, and public financial management in particular.

These broad trends mask large inter-country differences. Tanzania and Ghana are the best-known cases of governance improvement but governance has worsened in other countries. Indeed, Ghana has recently joined the “Group of Seven” best-governed African countries—Botswana, Cape Verde, Mauritius, Namibia, Sao Tome and Principe, Seychelles and South Africa—in the top half of countries worldwide for quality of governance. Overall, African governance is now slightly better than two decades ago, but the progress has been very uneven, remains fragile and needs to be consolidated through stronger participation and improved institutional capacity. Further progress can be supported by the accumulated lessons of experience with reforms in PFM and public management in Africa, and primarily that: (i) improvements cannot be accomplished only from the top, but require concrete efforts at strengthening citizen “voice” and participation; and (ii) reforms must be tailored to the institutional realities and capacity of the specific country.
Table 1.1.
Governance Indicators Percentile Rankings,
48 Sub-Saharan African countries, 1996-2008

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## Chapter 1: The Global Governance and Institutional Context

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Source: Kaufmann, Kraay and Mastruzzi, 2009. Countries are ranked by percentile, with higher values indicating better ratings. (Dots indicate that the information is not available.)
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**North African countries, 1996-2008**

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*Source: Kaufmann, Kraay and Mastruzzi, 2009*
Table 1.3: Ibrahim Index of African Governance, 2005 and 2007-08

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*Source: moibrahimfoundation.org At the time of writing, the 2007-08 survey was the latest available.*
Chapter 1: The Global Governance and Institutional Context

From governance improvement to capacity building

The Nobel prize-winning economist Amartya Sen famously demonstrated (Sen, 1981) that there has never been a famine in a functioning democracy, but his crucial qualifier “functioning” is often glossed over. Most relevant in this respect is the finding that progress in economic and administrative governance in Africa remains fragile and easily reversible if it is not buttressed by capacity development (McFerson 2009).

Massive efforts have been made over the years and substantial financial and technical assistance has been provided for capacity building in Africa, but generally with disappointing results. The reasons are complex, but translating the recent governance improvements into accelerated development will require a strengthening of institutional, organizational, and administrative capacity of African governments. The multi-dimensional nature of capacity is described in Box 1-2.

Governance and public financial management

The African Development Bank’s ambition is to become a partner of choice for African countries in the improvement of public financial governance. This is in pursuit of the core objective to help them build capable and responsive states by strengthening accountability and transparency in the management of public resources, and is consistent with the Bank’s overall Governance Policy (Box 1-3). The relevance of the governance concepts for the various aspects of public financial management will be brought out throughout this book, but a preview is provided below.

Accountability is the core of good governance and has two components: answerability and consequences. First, answerability (the original meaning of the word “responsibility”) is the obligation of central budget officials and sector ministry personnel to respond periodically to questions concerning where the money went and what was achieved with it. Second, there is a need for pre-

Box 1-2

What is “Capacity”?

Capacity is much more than the acquisition of specific skills and competencies, as skills atrophy quickly when not used. The four main dimensions of public sector capacity are:

- Institutional capacity: the basic processes and “rules of the game” (both formal and informal) that influence people’s behavior and determine the incentive framework within which organizations and people function.
- Organizational capacity: clarity of objectives and the internal structures appropriate to administer the “rules of the game”.
- Information capacity, including appropriate computerization.
- Resource capacity—financial, material and, especially human resources: individuals with skills and commensurate with their roles and functions.

Therefore, training is wasted if the new skills provided are not actually used, and training programs cannot be effective unless the institutional environment and organizational structures are conducive to the actual use of the new skills. It follows among other things that capacity-building efforts are more likely to succeed when they are fully country-owned rather than donor-driven.

Source: Adapted from AfDB 2010a and Schiavo-Campo and McFerson 2008.
dictable and meaningful consequences—not necessarily punitive; not necessarily monetary; not necessarily individual. The need for consequences of some sort is so often disregarded in practice that one must make the obvious point that without consequences “accountability” is only an empty and time-consuming formality.

In PFM, because the government must be accountable both for the use of the public money and for the results of spending it, accountability has two dimensions. Stronger internal accountability of budget personnel to their superiors is necessary, particularly in “overhead” activities such as policy advice and macroeconomic forecasting. But for government agencies responsible for providing services to the public, accountability must have both an internal and an external dimension and social accountability vis-à-vis the broader society is thus needed as well. With the dramatic improvements in information and communication technology, feedback from service users and the citizenry can now be obtained at very low cost and for a greater variety of activities. Such feedback is essential to improve the efficiency and effectiveness of service delivery. Strengthening social accountability is especially necessary in the context of initiatives for greater decentralization or managerial autonomy—when new checks and balances are required to assure that the quality of the public services are not compromised.

Participation by concerned public officials and employees and by other stakeholders is required for the sound formulation of government budgets; participation by external entities is necessary for the monitoring of operational efficiency; and feedback by users of public services is important for the monitoring of access to and quality of the services. Participation is also essential to gain consensus and public understanding, without which the difficult decisions made through the government budget are unlikely to be supported and implemented effectively.

Predictability, through the rule of law, of financial resources and the uniform application of the rules underpins the legitimacy of the system, supports the implementation of the budget, and facilitates planning for the provision of services. Predictability of government spending in the various sectors is also a necessary signpost to guide the private sector in making its own production, marketing, and investment decisions.

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**Box 1-3**

**Public Financial Management in the AfDB Governance Policy**

“A key dimension of accountability of particular interest to the Bank Group is that of financial and budgetary accountability. It involves establishing the requisite infrastructure for sound financial management, for both public and private sector projects. The Bank is therefore committed to helping RMCs [Regional Member Countries] to build capacity in public financial management. Bank Group activities will center on the modernization of government accounting procedures, training of accountants and auditors, the development and strengthening of professional code of ethics and disciplinary procedures.

Improving public expenditure management and enhancing budget discipline are an important aspect of effective and accountable public financial management. Therefore, the Bank Group will work closely with RMCs and the other donor community to provide training in project development, analysis and budgeting, and to improve information systems in RMCs.”

Transparency, through timely communication of accurate fiscal and financial information, is a must for parliamentarians and for the public at large (normally through the filter of competent legislative staff and capable and independent public media). It is essential not only that information be provided, but that it be relevant and in understandable form. Dumping on the public immense amounts of raw budgetary material does nothing to improve fiscal transparency. The IMF first assembled in 1998 a Code of Good Practices on Fiscal Transparency, and revised and updated it most recently in 2008. The Code underlines the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. Even though not all the specifics of the Code necessarily apply to all countries, its principles are generally applicable to developing and transition economies as well as developed countries. See Box 1-4 for a summary of principles, and the Annex for the full code.

The institutional, cultural and administrative contexts

The meaning of “institutions”

Although the governance principles are universal, their implementation is country-specific and must be solidly grounded on the economic, social, and cultural realities of the specific country. Particularly important is an understanding of the country’s institutional framework. Colloquially, the term “institution” is used as a synonym for “organization”. However, in contemporary meaning institutions are best understood as rules, and are thus distinct from the organizations that function under them. To use a sports analogy, the game of football is played better or worse depending on the players, but all players must adapt to and follow the same rules; the “institution” of football does not change unless the basic rules are changed (e.g., by allowing the use of hands).

The challenge of assessing the institutional landscape of a country is complicated by the reality that the majority of norms by which society runs are informal norms (including customary incentives or penalties), which are typically not visible to the outside observer. This explains the well-known paradox of several African countries where the formal laws, administrative systems and processes appear sound and coherent, while in reality government efficiency is poor, corruption is endemic, and public services are badly inadequate. Indeed, in some African countries informality is predominant, with the informal economy supplying more goods and services than the government does, but at a high cost in terms of efficiency, equity and development.

Institutions and public financial outcomes

Public financial outcomes are particularly influenced by the nature of the institutional rules. For example, inaccuracies in estimating government revenues may stem from concrete incentives to do so rather than from technical weaknesses. Tax forecasts can be deliberately overestimated so that when expenditures must be cut owing to “unexpectedly” low revenues, cash rationing can be used as a way to favor client and kinship groups. Or, as another example, a performance bonus scheme for budget officials may be well designed on the surface but fail to work if it is inconsistent with the informal rule that managers should use their power to help members of their own ethnic group. Indeed, under these circumstances, “innovation” may
inadvertently lead to worse outcomes instead of improvements.

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

» A design failure to take into account key informal rules is likely to lead to a failure of the public financial management reform itself. Yet, it is very difficult for outsiders to be aware of these informal rules.

» Durable institutional change takes a long time (a result of what Douglass North called “path

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**Box 1-4**

**Selected Requirements for Fiscal Transparency**

Clarity of Roles and Responsibilities

» A budget law or administrative framework, covering budgetary as well as extra-budgetary activities and specifying fiscal management responsibilities should be in place.

» Taxation should be under the law and the implementation should be subject to procedural safeguards.

Public Availability of Information

» Extra-budgetary activities should be covered in budget documents and accounting reports.

» Original and revised budget estimates for the 2 previous years should be included in budget documents.

» Level and composition of central government debt should be reported annually with a lag of no more than six months.

Open Budget Preparation, Execution, and Reporting

» A fiscal and economic outlook paper should be presented with the budget, including, among other things, a statement of fiscal policy objectives, and the macroeconomic forecasts on which the budget is based.

» A statement of “fiscal risks” should be presented with the budget.

» The budget should include all general government activities.

» The overall budget balance should be reported, with a table showing its derivation from budget estimates.

» A statement of accounting standards should be presented with the budget.

» Final government accounts should reflect high standards, and be audited by an independent external auditor.

Independent Assurances of Integrity

» Mechanisms are needed to report external audit findings to the legislature and take remedial action.

» Standards of external audit practice should be consistent with international standards.

» Working methods and assumptions used in macroeconomic forecasts should be made publicly available.

Chapter 1: The Global Governance and Institutional Context

dependence;” North, 1990). The expression “rapid change in PFM” is an oxymoron.

» Public financial ministries and organizations can be merged, restructured, and created, but no change in behavior (and hence in budgetary outcomes) will result unless the basic rules, procedures, and incentives change as well.

» Institutional development—defined as a move from a less efficient to a more efficient set of rules and procedures—calls in most cases for bringing to the surface the informal norms and reconciling them with the formal laws and rules.

The cultural context
In many countries (especially in African developing countries where the repression of colonization froze in its tracks the normal pattern of cultural change and adaptation), the nature and exercise of government authority is explained more by cultural factors, including the role of gender and ethnicity, than by formal legal and administrative rules. The multiple roles played in many developing countries by government leaders—in business, tribal chiefly roles, and the churches—explain why the machinery of government works differently from its formal design, and why ethnic and kinship loyalties often predominate over the formal responsibilities.

While cultural factors do make a major difference on how governments are run and the public sector is managed, recognizing their importance must not lead to immobility or relativism. First, cultural factors do not explain why some countries have succeeded in crafting effective impersonal institutions alongside kinship and ethnic criteria—e.g., Tanzania—while other countries in the same cultural matrix have not. Strong political leaders with broad legitimacy, such as Nelson Mandela and Julius Nyerere, can move society away from parochial standards, and establish an efficient and responsive public administration based at least in part on merit criteria. The fundamental requirement is intolerance of ethnic intolerance.

Also, culture should not be confused with habit—when everyone does something only because they expect everyone else to do the same or, conversely, when nobody obeys a particular rule because they do not expect that anyone else will. In these cases, each individual would be better off if everyone were to cease their dysfunctional behavior, or began to obey a rule designed for the benefit of all. For example, it would be better for each person in a group if everyone lined up in an orderly line to get on a bus than if everyone had to constantly push and shove to do so. In these cases, the ingrained dysfunctional habits can be made to change almost overnight if appropriate material or moral incentives and disincentives are applied—fairly and uniformly—making everyone better off.

The administrative context in Africa
The prevailing views of the role of the state have obviously a strong influence on the kinds of public financial management systems that are desirable and feasible. Before examining the issue of what the African state should be expected to do, it is useful to take a quick look at the overall size of government in Africa compared to other continents.

Is government in Africa too big?
Contrary to popular misperception, the problem with African governments is not that they are too big. On the contrary, whether measured by the number of government employees or by the proportion of Gross Domestic Product accounted for by either government revenue or public expenditure, governments are comparatively smaller in Africa than in other continents. In Africa, the issue is not size of government, but its effectiveness, roles, and geographic articulation.

What should the African state do?
There has been and there will continue to be a perennial controversy on the appropriate roles of the state. Clearly, the functions of the state are neither static nor the same in different countries. In the circumstances of the 21st century, and for middle-income and low-income countries—including African countries—there is a reasonable consensus on the following list of basic state responsibilities. In general, the African state should:

» Assure order and public safety,
» Advance the rule of law,
» Manage relations with neighbors,
» Reduce “economic distance” within the country (through better transport, communications and information),
» Reduce “social distance” within the country (by encouraging the formation of social capital and bridging networks between the different groups),
» Foster competition,
» Enact and enforce efficient regulation,
» Invest in inclusive economic growth,
» Protect the poor and the vulnerable.

Although the enforcement and moral authority of the state are critically important to carry out these functions, none of them can be performed without some form of cooperation with civil society, and all require resources. Every one of the necessary functions of the state carries implications for the mobilization of financial resources (through taxes or other revenues or external aid) as well as for the level and composition of government expenditure.

**How should the African state go about doing it?**

While there is a consensus on the list of core state functions, the question of how best to perform them—at what level of government, and who will bear the financial burden—is answered differently in different political systems and different countries. Moreover, specific decisions must be made frequently and on a case-by-case basis on whether the government should intervene in a particular situation and if so in what way.

The production of goods or services has three components: setting standards, providing the funds, and actually delivering the service. In the private sector, all three components are generally handled by the company producing the good or service. For public services, the government need not be responsible for all three components—standards, financing and delivery—and decisions need to be made on what to take on. For example, in most countries the government is generally responsible for all aspects of national defense, but in provision of medicines some governments take responsibility only for setting standards, leaving it to entities in the private sector to finance production and deliver the drugs. Below is a set of sequential tests useful to help arrive at the appropriate decision:

1. Should government intervene in service or issue X? If No, it only needs to communicate to the public its decision not to intervene. If Yes:
2. Should government (a) retain intervention authority, or (b) devolve intervention authority to other public entity?

If (a), and the government retains authority, should the government:

i. deliver the service directly (through central government ministries, public enterprises or other central government bodies), or
ii. finance the service (either directly to consumers through income support or vouchers, or through service providers such as private firms or local government or NGOs; or
iii. only regulate the service (standards, quality, access, distribution)?

If (b), should the government devolve the intervention authority to

i. an entity set up for the special purpose; or
ii. provincial or local government?

Finally, if the authority is devolved to provincial or local government, that level of government also needs to go through the same process of first deciding whether or not to intervene, and then how to do so and through whom.

Every one of the above decisions is heavily influenced by the developments in decentralization and in information technology during the past two decades, and in a manner that differs substantially in different sectors and for different services. For example, not too long ago the central government would be in charge of telephone services, usually through a public enterprise set up for that purpose. Advances in telecommunications have made such arrangements obsolete,
and in most African countries governments are no longer involved in the provision of telephone or other telecommunication services.

Against this background, the mechanisms and systems of public financial management should enable inclusive development and poverty reduction, and facilitate the provision of good social services to the citizens—in a fiscally responsible and sustainable manner.

The future of public administration: Beyond dichotomies

The field of public administration in developing countries has been sown with false dichotomies that have made clear debate and sensible solutions difficult. While the more egregious instances appear to have run their course, these false dichotomies are still interfering with clarity of thought on efficient public management, which is essential regardless of one’s political views and predilections. They are briefly discussed below.

Public versus private

The conventional wisdom of the late 1960s and 1970s, in Africa and elsewhere, held that government action was inherently superior to the private sector, and that developing countries could expect to make progress only through public ownership and management of major industrial enterprises. Government was “the” solution. The demonstrated failure of this approach was succeeded in the 1980s by its converse, whereby in many countries government came to be seen as “the” problem. (A major corollary was the belief that private management practices can and should be applied to public administration. This is usually not the case, as subsequent chapters discuss, particularly the concluding Chapter 16.) The 21st century has witnessed the simple but fundamental recognition that both “public” and “private” agents behave within the same set of institutional parameters that prevail in their society. For example, if in a particular country kinship and ethnic patronage are widespread in government, they are also widespread in the private sector. The operational concepts are power, size, culture, competition and accountability—and not public or private ownership, per se. There can be no doubt that government can be part of the solution, part of the problem, or both—depending on what it is asked to do and how its activities are supported and monitored.

Efficiency versus control

Measures to give more autonomy to public managers (or to devolve authority to lower government levels) are often resisted from fear of losing necessary central control. Conversely, advocates of those measures tend to view precisely the loosening of central control as one of the advantages of delegation. These opposing viewpoints reflect the same false dichotomy. A plethora of detailed controls is inimical both to operational efficiency and to robust control. But disregard of the need to introduce more effective control in a context of delegation of authority means managerial autonomy survives only until the first major scandal.

The alleged trade-off between efficiency and control is especially damaging in the fight against corruption (as Chapter 14 will explain). When confronted with a new anti-corruption stance by the political leadership, the reflexive tendency of the bureaucracy is to protect itself by introducing a variety of new controls and/or applying more literally and rigidly the controls that do exist and/or avoid taking any decision. (This is more prevalent in government than in large private corporations—because public and media scrutiny usually focus more on government activity.) This tendency is understandable, particularly in countries where public administration has been demonized and trust in civil servants has eroded. Yet, such tightening-up protects against minor misappropriations at the much higher cost of clogging up the operational channels, and does nothing to prevent large-scale corruption to boot. (As the Minister of Public Works of a certain country once told a colleague of the author: “Don’t be naïve: the bigger the theft, the easier the theft.”) As noted, there is no contradiction between efficiency and control, so long as the control mechanism itself is efficient.

Unfortunately, the consequences for the civil servant are asymmetrical. There is no visible result—and thus no reward—from acting to protect public resources while enabling efficient operations, but severe personal consequences are likely...
in the event that something goes wrong. It is rational for the civil servants to act to protect themselves even when they are well aware of the adverse impact on efficiency. There is no easy solution to this dilemma, but a greater degree of public trust in civil servants would help, as would strong political and managerial support, combined with swift and severe penalties for demonstrated malfeasance—as opposed to penalizing honest mistakes or discouraging the flexibility needed to enable operational efficiency.

**Results versus process**

Chapter 15 will examine at length the question of performance, its measurement, and its management. Suffice to note here that “performance” is a relative and culture-specific concept. Government employees could be considered “well-performing” if they always stick to the letter of the rules, in a system where rule compliance is the dominant goal; if they account precisely for every cent of public money, in a system where protection of resources is the dominant goal; if they obey without question a superior’s instructions, in a strictly hierarchical system; if they compete vigorously for individual influence and resources, in a system where such competition is viewed positively; if they cooperate harmoniously for group influence, in a system where conflict is discouraged; and so on. This is not to say that all “performance” notions are equally efficient, but only to recognize that there are different notions. Administrative cultures evolve in response to concrete problems and incentive structures. Even when an administrative culture has become badly dysfunctional, it is still necessary to understand its roots if one wishes to improve it in a durable way. Overall, while process is meaningless without reference to results, an exclusive focus on results without protecting norms of fairness and due process is not sustainable. Thus, holding to the false results/process dichotomy makes it less likely that public performance will actually be improved in a lasting manner.

**Administrative effectiveness: From three to four Es**

Whatever the decision on the appropriate roles of the state, these roles must be performed well. As discussed in Chapter 15, the classic “Three Es” of public administration are Economy, Efficiency and Effectiveness. Economy refers to the acquisition of goods and services of a given quality at lowest cost and on a timely basis. Efficiency entails production at the lowest possible unit cost (for a given quality). Effectiveness refers to the extent to which the ultimate objectives of the activity are achieved. For example, in a vaccination program, the criterion of economy calls for purchasing quality vaccine at lowest cost and on a timely basis; the criterion of efficiency calls for performing the maximum number of vaccinations given the resources available; and the criterion of effectiveness relates to reduced incidence of the disease.

One cannot conclude, however, that a public management system that operates economically, efficiently and effectively is necessarily a good system. First, as noted earlier, due process must be respected or the legitimacy and credibility of government will be impaired over time. Second, someone must look out for the long term and for the needs of the poor and the marginalized. Thus, a fourth “E” must be added to the mix: Equity—consistent with the maxim that the welfare of society must be assessed by looking at the conditions of the base, not of the top. Unless a government takes into fair consideration the circumstances and needs of the poorer and disadvantaged groups in society, the most “efficient” system will not be fair and, to be practical about it, will not be sustainable. This is because it will produce cumulative internal tensions, and eventually cause the withdrawal of that voluntary cooperation by the citizens which is the glue of good governance. In the short run, there may be a conflict between efficiency objectives and equity objectives; in the long run, there is none. The need for equity and inclusiveness is especially great in African countries, most of which are multi-ethnic and where tragic conflict and economic devastation have resulted from disregarding the fundamental requirement of interpersonal and intergroup fairness. Considerations of equity and inclusiveness must particularly be embedded in systems and decisions on public financial management.
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Annex


I. Clarity of Roles and Responsibilities
1.1. The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

1.1.1 The structure and functions of government should be clear.

1.1.2 The fiscal powers of the executive, legislative, and judicial branches of government should be well defined.

1.1.3 The responsibilities of different levels of government, and the relationships between them, should be clearly specified.

1.1.4 Relationships between the government and public corporations should be based on clear arrangements.

1.1.5 Government relationships with the private sector should be conducted in an open manner, following clear rules and procedures.

1.2. There should be a clear and open legal, regulatory, and administrative framework for fiscal management.

1.2.1 The collection, commitment, and use of public funds should be governed by comprehensive budget, tax, and other public finance laws, regulations, and administrative procedures.

1.2.2 Laws and regulations related to the collection of tax and non-tax revenues, and the criteria guiding administrative discretion in their application, should be accessible, clear, and understandable. Appeals of tax or non-tax obligations should be considered in a timely manner.

1.2.3 There should be sufficient time for consultation about proposed laws and regulatory changes and, where feasible, broader policy changes.

1.2.4 Contractual arrangements between the government and public or private entities, including resource companies and operators of government concessions, should be clear and publicly accessible.

1.2.5 Government liability and asset management, including the granting of rights to use or exploit public assets, should have an explicit legal basis.

II. Open Budget Processes
2.1. Budget preparation should follow an established timetable and be guided by well-defined macroeconomic and fiscal policy objectives.

2.1.1 A budget calendar should be specified and adhered to. Adequate time should be allowed for the draft budget to be considered by the legislature.

2.1.2 The annual budget should be realistic, and should be prepared and presented within a comprehensive medium-term macroeconomic and fiscal policy framework. Fiscal targets and any fiscal rules should be clearly stated and explained.

2.1.3 A description of major expenditure and revenue measures, and their contribution to policy objectives, should be provided. Estimates should also be provided of their current and future budgetary impact and their broader economic implications.

2.1.4 The budget documentation should include an assessment of fiscal sustainability. The main assumptions about economic developments and policies should be realistic and clearly specified, and sensitivity analysis should be presented.
2.1.5 There should be clear mechanisms for the coordination and management of budgetary and extra-budgetary activities within the overall fiscal policy framework.

2.2 There should be clear procedures for budget execution, monitoring, and reporting.

2.2.1 The accounting system should provide a reliable basis for tracking revenues, commitments, payments, arrears, liabilities, and assets.

2.2.2 A timely midyear report on budget developments should be presented to the legislature. More frequent updates, at least quarterly, should be published.

2.2.3 Supplementary revenue and expenditure proposals during the fiscal year should be presented to the legislature in a manner consistent with the original budget presentation.

2.2.4 Audited final accounts and audit reports, including reconciliation with the approved budget, should be presented to the legislature and published within a year.

III. Public Availability of Information

3.1 The public should be provided with comprehensive information on past, current, and projected fiscal activity and on major fiscal risks.

3.1.1 The budget documentation, including the final accounts, and other published fiscal reports should cover all budgetary and extra-budgetary activities of the central government.

3.1.2 Information comparable to that in the annual budget should be provided for the outturns of at least the two preceding fiscal years, together with forecasts and sensitivity analysis for the main budget aggregates for at least two years following the budget.

3.1.3 Statements describing the nature and fiscal significance of central government tax expenditures, contingent liabilities, and quasi-fiscal activities should be part of the budget documentation, together with an assessment of all other major fiscal risks.

3.1.4 Receipts from all major revenue sources, including resource-related activities and foreign assistance, should be separately identified in the annual budget presentation.

3.1.5 The central government should publish information on the level and composition of its debt and financial assets, significant non-debt liabilities (including pension rights, guarantee exposure, and other contractual obligations), and natural resource assets.

3.1.6 The budget documentation should report the fiscal position of subnational governments and the finances of public corporations.

3.1.7 The government should publish a periodic report on long-term public finances.

3.2 Fiscal information should be presented in a way that facilitates policy analysis and promotes accountability.

3.2.1 A clear and simple summary guide to the budget should be widely distributed at the time of the annual budget.

3.2.2 Fiscal data should be reported on a gross basis, distinguishing revenue, expenditure, and financing, with expenditure classified by economic, functional, and administrative category.

3.2.3 The overall balance and gross debt of the general government, or their accrual equivalents, should be standard summary indicators of the government fiscal position. They should be supplemented, where appropriate, by other fiscal indicators, such as the primary balance, the public sector balance, and net debt.

3.2.4 Results achieved relative to the objectives of major budget programs should be presented to the legislature annually.

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

3.3.1 The timely publication of fiscal information should be a legal obligation of government.
3.3.2 Advance release calendars for fiscal information should be announced and adhered to.

**IV. Assurances of Integrity**

4.1 Fiscal data should meet accepted data quality standards.

4.1.1 Budget forecasts and updates should reflect recent revenue and expenditure trends, underlying macroeconomic developments, and well-defined policy commitments.

4.1.2 The annual budget and final accounts should indicate the accounting basis used in the compilation and presentation of fiscal data, following generally accepted accounting standards.

4.1.3 Data in fiscal reports should be internally consistent and reconciled with relevant data from other sources. Major revisions to historical fiscal data and any changes to data classification should be explained.

4.2 Fiscal activities should be subject to effective internal oversight and safeguards.

4.2.1 Ethical standards of behavior for public servants should be clear and well publicized.

4.2.2 Public sector employment procedures and conditions should be documented and accessible to interested parties.

4.2.3 Procurement regulations, meeting international standards, should be accessible and observed in practice.

4.2.4 Purchases and sales of public assets should be undertaken in an open manner, and major transactions should be separately identified.

4.2.5 Government activities and finances should be internally audited, and audit procedures should be open to review.

4.2.6 The national revenue administration should be legally protected from political direction, ensure taxpayers’ rights, and report regularly to the public on its activities.

4.3 Fiscal information should be externally scrutinized.

4.3.1 Public finances and policies should be subject to scrutiny by a national audit body or an equivalent organization that is independent of the executive.

4.3.2 The national audit body or equivalent should submit all reports, including its annual report, to the legislature and publish them. Mechanisms should be in place to monitor follow-up actions.

4.3.3 Independent experts should be invited to assess fiscal forecasts, the macroeconomic forecasts on which they are based, and their underlying assumptions.

4.3.4 A national statistical body should be provided with the institutional independence to verify the quality of fiscal data.
NOTES

1 From the vast literature on accountability, an interesting articulation is offered by Callahan, 2007.

2 Mo Ibrahim is a wealthy Sudanese businessman committed to fostering good governance in Africa. In addition to financing the construction of the Index of African Governance, his foundation grants the extremely generous annual Mo Ibrahim Prize for Achievement in African Leadership—of US$5 million over 10 years and $200,000 a year for life thereafter. The winner is selected by an independent committee of eminent persons—mostly Africans but including two non-African members—chaired by former UN Secretary General Kofi Annan. Like the Nobel Peace Prize, the Ibrahim Prize is intended to provide a strong financial and reputational incentive for African leaders to foster democratic mechanisms and strengthen accountability, integrity and transparency in public administration in their country. The first winner, in 2007, was former Mozambican President Joaquin Chissano, for leading his country to peace and prosperity, and then stepping down voluntarily. The second winner, announced in October 2008, is former Botswana President Festus Mogae, who consolidated the economic progress and already very good governance framework of the country.

3 See North, 1991.
Chapter 2: The Policy, Macroeconomic and Fiscal Contexts
What to Expect

As an instrument to implement government policy, public financial management must be guided by the main policy goals of growth, stability and equity, and framed by policies that are clear, realistic, disciplined and transparent. Beyond the connection between policy and the budget, public expenditure decisions should be made in the context of fiscal decisions that, in turn, must be framed by a coherent and realistic view of all components of the economy. The chapter therefore includes a brief synthesis of macroeconomic programming and preparation of the fiscal framework within which the budgeting process must be placed.

The policy context

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

Criteria of good policy-making
For public financial management to function well as an instrument of economic stability, growth and poverty reduction, the policies themselves must first meet certain basic criteria. Decision-making authority belongs to the political leadership of the country. With that authority, however, comes the responsibility to make sound decisions. The main criteria of good policy decision-making are the following:

- **Discipline** Policies should be consistent, without internal contradictions.
- **Realism** Policies should be affordable and implementable.
- **Stability** Frequent policy reversals should be avoided: a clear vision and sense of direction for the medium term are necessary for good policy making.
- **Openness and clarity** Although the deliberations leading to budgetary policy decisions must usually be confidential, political accountability requires that the criteria and processes of decision making be explicit and public.
- **Selectivity** In developing countries, the capacity to make good policy decisions is perhaps the scarcest resource of all. Because the focus ought to be on important issues, an appropriate administrative mechanism is needed to filter out minor matters and prevent wasting political leaders’ time and attention.
- **Communication** A badly understood policy cannot be implemented and is unlikely to be properly reflected in the budget.

The interaction of policies
In pursuit of the basic economic goals of growth, stability and equity, a number of policy instruments can be used: external trade policy (tariffs, quotas, exchange rates) affects the country’s relations with the rest of the world (including, in Africa, the important subject of regional econom-
ic integration); fiscal policy deals with taxation and expenditure; monetary policy is concerned with regulating the supply of money, credit and interest rates; and the productive sectors are affected by a host of government policies and actions—extension services in agriculture, rural health programs, educational issues, transport decisions, regulation etc.

These various policies need to be brought together into a consistent “package,” both to maximize their impact and prevent duplication or gaps. For example, the policy objective of low inflation is influenced by the level of the fiscal deficit, and the specific instruments can include both tax measures and credit policy measures; but the fiscal deficit is in part a function of the government revenues generated by economic growth, which is in turn affected by credit policies, and so on. Therefore, the process of formulating a consistent policy package is necessarily iterative, with each decision affecting others that, in turn, call for adjustments in the initial decisions. Moreover, because all policy decisions affect different individuals and groups to a different extent, the iteration is also essential to gain a broad social consensus on the eventual policy package to be implemented.
The macroeconomic and fiscal context

**Macroeconomic programming: The foundation of public financial management**

Rich countries can afford to waste resources; poor countries cannot. To continue the improved record of economic growth and poverty reduction of the last decade, African countries need to program policies and government actions in a manner that is both sustainable and conducive to economic growth, stability and equity. This book is not the place to discuss development strategy and economic planning for the long term—except to emphasize that short-term actions are unlikely to succeed without an aspirational vision for the long term. But conversely, it is also true that without a coherent and realistic program for the medium term, even the best vision cannot be implemented—hence the need for macroeconomic programming.

Macroeconomic programming has been dominated for well over a generation by the simple but powerful model developed by Jacques Polak and used in virtually all stabilization programs supported by the IMF. (For a description of the technical aspects of a macroeconomic framework see Davis, 1992. For a readable and short summary see Polak, 1997b.) The model is naturally more applicable to complex economies in relatively stable circumstances (for which the basic relationships among monetary, fiscal and real sector aggregates can be presumed to remain approximately constant), than to developing countries in fluid environments—especially fragile states just emerging from conflict. In all cases, however, it is a useful starting point and an important capacity-building tool.

A macroeconomic framework includes four sets of projections, on the real sector (i.e., production), the balance of payments, the fiscal accounts, and the monetary sector. It is a tool for checking the consistency of the main targets (usually, the growth rate, inflation, and employment) with the assumptions or projections made about the several main variables in each sector.

The simple model is based on accounting relations and a limited number of behavioral relations defined by simple ratios. The main identities are as follows:

- Gross domestic product = private consumption + government consumption (current expenditure) + private investment + government investment + the balance of trade (exports minus imports.)
- Quantity of money = domestic credit + foreign reserves
- Domestic credit = credit to the government + credit to the private sector
- Change in foreign reserves = balance of trade + net flow of capital (including aid)

The main behavioral relations are:

- Inflation rate = \( \alpha \) (change in quantity of money)
- Imports = \( m \) (GDP)
- Quantity of money = \( 1/v \) (GDP), where \( v \) is the income velocity of money

When these identities and relations are combined with empirical estimations and with the targets set for real GDP growth, inflation, etc., one may obtain a framework that comprises the main macroeconomic variables and embodies both policy priorities and economic/financial realities.

The main linkages among the different macroeconomic variables are illustrated in Figure 2-1. It is worth perusing the figure and reflecting on the nature of the complex interactions in even such a simplified scheme.
Figure 2.1: Selected Linkages among Main Macroeconomic Variables

REAL SECTOR

National Accounts
- Private consumption
- General government consumption
- Private investment
- General government investment
- Exports of goods and nonfactor services
- Imports of goods and nonfactor services

EXTERNAL SECTOR

Balance of Payments
- CURRENT ACCOUNT
  - Exports of goods and nonfactor services
  - Imports of goods and nonfactor services
  - Factor services (net)
  - Transfers (net)
  - Official
  - Private
- CAPITAL ACCOUNT
  - Direct investment
  - Medium/long-term capital (net)
  - Short-term capital (net)
  - Overall balance
  - Change in net foreign assets

CENTRAL GOVERNMENT

Revenues and Grants
- Expenditures
  - Current
  - Capital
- Overall Balance
- Financing
- Domestic Financing
  - Banking system
  - Nonbanking sector
  - External financing (Net)

MONETARY SECTOR

Monetary Authorities
- Net Foreign Assets
- Net Domestic Assets
- Net credit to central govt.
- Credit to banks
- Other items (net)
- Reserve money

Deposit Money Banks
- Net foreign assets
- Banks’ reserves
- Net domestic assets:
  - Net credit to central govt.
  - Credit to private sector
  - Other items (net)
- Liabilities to monetary authorities
- Private sector deposits
Chapter 2: The Policy, Macroeconomic and Fiscal Contexts

Fiscal programming and adjustment

The role of fiscal adjustment

Adjustments in government revenues and expenditures have always been important in the Polak model, partly through their impact on domestic credit and money creation, and partly through their influence on national income and the demand for imports. Furthermore, since the early 1990s, the rediscovery of the economic costs of excessive fluctuations in exchange rates has reduced the emphasis on currency devaluation as an instrument of economic and financial adjustment. As in the fixed exchange rates “Bretton Woods” system operating in the postwar period until 1973, the IMF has come back in the last two decades to regarding the exchange rate as a nominal “anchor”, not to be changed except in response to major and permanent shocks. Moreover, the introduction of the euro has ruled out the use of devaluation as a tool of economic adjustment throughout much of Europe. The burden of economic adjustment has correspondingly shifted to the domestic economy and primarily on the fiscal side—adding importance to the appropriate management of the public finances of developing countries.

This changed emphasis in macroeconomic programming toward domestic—particularly fiscal—adjustment has coincided with a major rethinking of the role of the state—toward downsizing of the state and the shedding of many functions it had taken on in earlier years. Essentially, poor economic performance in Africa during the 1960s and 1970s showed the fallacy of the view prevalent in those years that direct state intervention is required in most areas of the economy to stimulate economic activity and generate growth. (As discussed in Chapter 1, this view was accompanied by the equally wrong assumption that in African countries only authoritarian one-party government could assure stability and foster development.) The failed approach of direct intervention by authoritarian government was gradually replaced during the 1980s by the opposite view—also fallacious—that the government was “the problem” and only unfettered private sector actions could produce development. In the late 1990s, a sensible consensus emerged to the effect that the private sector is the main engine for economic growth, including in developing countries. But appropriate state action and regulation is required for the private sector to run efficiently (the more so when markets function imperfectly) and to produce a measure of equity and social stability and development—provided that the quality of governance is reasonably good.

The degree of fiscal adjustment is normally measured by the reduction in the overall government deficit. Because the fiscal deficit is determined by both revenue and expenditure, a fiscal policy that is focused entirely on public expenditure adjustment would be incomplete. Measures on the revenue side do remain important in most developing countries—but they should move away from short-term tax increases and toward actions that broaden the tax base and raise the elasticity of the tax system with a view to long-term revenue expansion. Nevertheless, the downsizing of the role of the state has led to greater emphasis on public expenditure reductions as an instrument of fiscal adjustment. In turn, sustainable expenditure reduction is a chimera unless the expenditure management system is in reasonable good shape—hence, the growing importance of public financial management and its key role in implementing macroeconomic policy and programs.

The composition of expenditure adjustment

The composition of fiscal adjustment is as important as its degree. On the expenditure side, the key issue in this regard is the essential distinction between government consumption and government investment. In the fiscal accounts, government consumption is reflected in current expenditure and government investment in capital expenditure. Current expenditures are those for all goods and services that are needed for the regular operations and functioning of the government during the fiscal year, mainly: salaries, pensions, goods and services for operations and maintenance; subsidies and other transfers, and interest payments. Capital expenditures are associated with the production of new physical assets, which expand the economy’s productive capacity and have a useful economic life extending beyond the fiscal year.
Capital budgeting and public investment programming are addressed in Chapter 8. At this stage, it is important to emphasize the following three interrelated principles:

» Fiscal adjustment must consider the totality of government expenditures, owing to their economic interaction. It does little good in terms of either stability or development to focus expansion or contraction on a single category of expenditure. Such a focus may be appropriate to address specific problems (i.e., targeted subsidies to reduce poverty in certain areas), but from a fiscal standpoint all expenditure must be on the table, to allow comparison of the relative costs and advantages of changing one or another type of expenditure.

» Fiscal programming must carefully consider the balance between current and capital expenditure and their very different impacts on the economy and development.

» Some expenditure categories may not be amenable to adjustment in the short or medium term. For example, interest payments must be made on schedule, as per the contracted debt obligation—except through an agreed process of debt rescheduling or cancellation. Certain entitlements, too, constitute legal obligations that cannot be changed in the absence of a major reform. Therefore, fiscal adjustment must necessarily deal with the expenditure categories that can legally be changed. However, no category of expenditure should be defined as a residual. Too often, especially in African developing countries, cuts or changes are made only where it is politically or administratively easier to do so, and the residual adjustment that is required to meet the overall fiscal deficit target automatically falls on the remaining expenditure categories. Typically, the expenditures defined in such residual manner have been in operations and maintenance, and in expenditures on ongoing investment projects. Haphazard cuts in the former harm the efficiency of current government operations, and cuts in the latter damage the implementation of the projects.

Preparing the macroeconomic framework

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

Preparing a macroeconomic framework is always an iterative exercise. A set of “initial” objectives must be defined to establish a preliminary baseline scenario, but the final framework requires a progressive reconciliation and convergence of all objectives and targets. The problems revealed by the initial projections (e.g., lack of consistency between economic growth targets and monetary policy) must be discussed among the agencies involved in macroeconomic management. The preliminary baseline scenario gives the macroeconomic information needed for preparing projections for various sectors, and these projections usually lead in turn to revising the baseline scenario. Such iterations should continue until overall consistency is achieved for the macroeconomic framework as a whole.

The iteration process is not only necessary for sound macroeconomic and fiscal programming, but is also an invaluable capacity-building tool, to improve the awareness and understanding of the staff in the agencies involved—and therefore elicit their cooperation in formulating a realistic budget and implementing it correctly.

The preparation of a macroeconomic framework should be a permanent activity. The framework needs to be prepared at the start of each budget cycle to give adequate guidelines to the line ministries. (See Chapter 9.) During budget execution, too, macroeconomic projections require frequent updating to assess the impact of exogenous changes or of possible slippage in budget implementation. (See Chapter 10.)
In addition to the baseline framework, it is important to formulate variants under different assumptions, e.g., changes in oil prices. The risks related to unexpected changes in macroeconomic parameters must be assessed and policy responses identified in advance, albeit in very general terms, of course.

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

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

The macroeconomic and fiscal projections must also be credible. In some countries, the government projections are submitted to a panel of independent and respected experts to ensure their reliability and to remove them from partisan politics, while preserving the confidentiality required on a few sensitive issues. In other countries, such as the United Kingdom, the projections are validated by the independent Auditor General. In most African developing countries, the macroeconomic and fiscal projections are developed with the support of external organizations, which gives them a measure of added credibility. In some countries, such as Tanzania, this cooperation has become close enough to make the formulation of these frameworks a virtual partnership (albeit without infringing on the country’s sovereign authority to make its own decisions).

Preparing the fiscal framework
The starting points for fiscal programming are: (i) a realistic assessment of resources likely to be available to the government and (ii) the establishment of fiscal objectives. (There follows iteration between the two until the desired relationship between resources and objectives is reached.) Because forecasts of government revenue depend on the other developments in the economy, preparing the fiscal program is only possible in the context of and after the preparation of the overall macroeconomic framework. (Each of the necessary elements are summarized briefly in this section, but are discussed at length in subsequent chapters, to which reference is made below as needed.)

The fiscal module of the overall macroeconomic framework includes only the major categories of revenue and expenditure. For revenue, the categories are direct taxes, indirect taxes, grants, other taxes, and nontax revenue; for expenditures, they are salaries, interest, goods and services, subsidies, and capital expenditures. For expenditure, a macroeconomic framework is at a very aggregate level, showing government current expenditure (wages, operations and maintenance, interest, transfers), and capital expenditures (by source of financing)—without any consideration of the allocation of resources among sectors. Moreover, transfers or entitlements are not reviewed in detail and assumptions on future developments are not compared with continuing commitments. Thus, when elaborating a fiscal framework on the basis of the overall macroeconomic framework, estimates of the impact of the assumptions and the aggregate fiscal targets on the composition of expenditure, by sector or economic category, are required to assess whether the fiscal targets are realistic and sustainable, and to determine the conditions to meeting these targets. In cases of serious discrepancy, it may be necessary to revisit the macroeconomic framework itself.
Fiscal targets and indicators
The establishment of explicit fiscal targets gives a framework for budget formulation, allows the government to state clearly its fiscal policy and the legislature and the public to monitor the implementation of government policy. Ultimately, explicit fiscal targets make government politically as well as financially accountable. Fiscal targets and indicators should cover three areas: the fiscal position (e.g., fiscal deficit), fiscal sustainability (measured by debt-GDP, tax-GDP, and expenditure-GDP ratios), and vulnerability (e.g., composition of the foreign debt, issuance of loan guarantees, etc.).

The summary indicator of fiscal position used most commonly is the overall budget deficit on a cash basis, defined as the difference between actual expenditure payments and collected revenues on a cash basis, plus grants, cash or in kind. (The term deficit is used here, rather than the more neutral “balance”, because almost all African countries run a fiscal deficit for a variety of good and less good reasons.) The cash deficit is by definition equal to the government borrowing requirements (from domestic or foreign sources) and is thus integrally linked to the money supply and the inflation targets and prospects. The overall cash deficit is therefore a major policy target.

The cash deficit does not take into account payment arrears. In countries where expenditure control is weak, contractual commitments are often not paid in time by the government, and payment arrears emerge (as discussed in Chapter 10). When there are significant arrears, the deficit on a cash basis plus net increase of arrears is an important indicator. The IMF Code of Fiscal Transparency described in Chapter 1 requires reporting on payment arrears, when (as is usually the case in Africa) the accounting system is on a cash basis (see Chapter 12), in order to avoid mistaking a fragile situation for a healthy one when the government is simply pushing off payment obligations to subsequent years.

The primary deficit is the difference between non-interest expenditures and revenues and grants—thus the cash deficit minus interest payments. Because interest must be paid in any event, the evolution of the primary deficit is a better measure of the government’s efforts for fiscal adjustment. It is a better policy target also because it does not depend on the vagaries of interest rates and exchange rates.

The current deficit is the difference between revenues and current expenditure, and does not include capital expenditures. A current surplus is by definition equal to “government saving” and thus, in theory, shows the contribution of government to investment and economic growth; a current deficit represents government dis-saving, and thus a subtraction from resources available for investment. Using the current deficit in this way insulates investment expenditure from cuts, and focuses necessary fiscal adjustment on revenues or current expenditure. In most African developing countries public investment is potentially critical for development (provided that it is composed of sound investment projects and is well programmed, as discussed in Chapter 8) and, moreover, is largely financed by aid on “soft” terms. However, some current expenditures may be as important for development as investment expenditure; for example, a new hospital needs doctors and medicines. On the other hand, focusing on the current deficit as an indicator of the fiscal situation generates a temptation to make the situation look better by artificially reclassifying certain current expenditures into investment projects.

When the investment program is in good shape, an additional useful indicator is the primary current balance, which focuses on streamlining and making more effective the non-interest portions of current expenditure (salaries, subsidies, and goods and services).

In high-inflation countries, to take into account the impact of inflation on the stock of debt, a frequent indicator is the operational deficit, which is equal to the deficit on a cash basis less the inflationary portion of interest payment. Calculating the inflationary component of interest payments is not an easy matter, and to obtain a good picture of the fiscal situation it is generally preferable to rely on (i) the overall cash deficit, (ii) the primary deficit, and (iii) the current account deficit.
Scope of the fiscal program

Ideally, “general government” (i.e., government at all levels, central, provincial, municipal) should be considered when preparing the fiscal projections and defining the fiscal targets, but the fiscal targets should also be broken down and applied to national and subnational government levels. It is also desirable to prepare a consolidated account of the public sector, including the public enterprises, to identify the financing requirements for the public sector as a whole. Considering only the central government gives a misleading fiscal picture, and produces the temptation to “download” expenditure and fiscal problems onto subnational government entities—which is neither conducive to sound fiscal policy for the country as a whole nor to implementing effective decentralization. (See Chapter 5 for considerations relevant to coverage of the budget.)

In many African countries, where reliable data on subnational and local government are not available, it is better not to include suspect data or guesswork and to limit the fiscal framework to central government. In such cases, the limitations of the fiscal picture should be kept in mind, and consistent efforts should be made to progressively improve data availability and local capacity in order to eventually expand the fiscal framework to general government. Note, however, that the operations of the departmental subsidiary units of central government must be fully included in the fiscal framework and the budget. Financial accountability does not depend on where central government carries out its activities. In any case, measures are needed to minimize the probability that local public financial management may be a source of instability and fiscal risk for the country as a whole (as discussed in Chapter 13.)

Fiscal projections: Simplicity versus accuracy

The degree of detail of the fiscal projections depends on the technical capacities within the country and the availability of data and appropriate tools. Sophisticated models can be useful. Nevertheless, since the major objective is to set a general frame for formulating macroeconomic objectives and checking their consistency, the preparation of a macroeconomic framework does not necessarily require sophisticated modeling techniques. On the contrary, these techniques may give a sense of misplaced concreteness and a “forecast illusion” which may hamper the practical value of the framework.

Using simple models is both practical and, in most cases, desirable. Such models include mainly accounting relations (e.g., GDP plus net imports equals consumption plus investment) and only a limited number of behavioral relations defined by simple ratios (e.g., consumption, income), without resorting to complex econometric techniques. The models are also easier to use in discussions on fiscal policy, whereas the use of a sophisticated econometric model leads to a more opaque process. Given that the quality of the dialogue and the dissemination of major policy decisions is of paramount importance in African countries (especially multi-ethnic countries), the greater transparency of simple models is a critical advantage. The fluid and changing circumstances of developing countries always make complex behavioral models highly suspect. (But note that forecasting of revenues should be based on detailed analyses and forecasts by individual tax rather than on the aggregate outputs of any macroeconomic model.)

In any event, focusing only on technical issues, while neglecting the fundamental institutional questions of the division of administrative responsibility and the need for close cooperation among the agencies involved, inevitably produces a weak or inoperative fiscal program. (See Chapter 9 for a full discussion.)

Financing the budget

Whatever the overall deficit, it must be financed. The conceptual distinction is between those transactions that are undertaken for their own “autonomous” reasons, and financing transactions that are undertaken only as “compensatory” of the autonomous transactions—e.g., governments borrow in order to finance certain expenditures, not as an end in itself. The expression “above the line” and “below the line” thus refers to the distinction between autonomous fiscal transactions and the compensatory financing ones.
Financing includes government borrowing from domestic sources, borrowing from foreign sources, exceptional grants (recurrent grants are part of ordinary revenue), changes in the stock of debt, and net changes in payment arrears. (Note in particular that while interest payments are part of current expenditure, principal payments—amortization—are part of financing.)

How the fiscal deficit is financed, and the source of the financing, are both important, since different forms of financing have different costs, advantages, and implications for the future. Clearly, for a given level of programmed deficit, the implications for future public finances and development are vastly different if the deficit is financed by concessional aid at long maturities (as for example through the African Development Fund) or by domestic borrowing and credit expansion, or by external borrowing at commercial terms. If a high proportion of financing is on grant terms and not tied to specific project expenditures, a higher fiscal deficit may be perfectly acceptable (other things being equal), while the same level of deficit may be very worrisome if it is financed by expensive foreign loans. (See Chapter 11 on financing of the budget.)

The key is sustainability

In conclusion, two fundamental principles should be underlined:

» Because the various fiscal measures are interrelated, and have a different impact on different groups of citizens, when formulating a fiscal program, the focus should never be on any item of revenue or expenditure taken in isolation, but on the overall fiscal picture, including financing.

» The objective of fiscal policy is not a specific level of deficit, per se, but a fiscal position that advances the policy goals and is sustainable in terms of likely resource availability. A temporary budget surplus may mask structural fiscal problems, e.g., when expenditures are dominated by rigid and mounting entitlements, and a large budget deficit may not be a cause for any concern if it arises from productive investment spending. In African developing countries, running a fiscal deficit is both normal and desirable. What is undesirable is running a deficit because the tax base is too narrow and/or because wasteful expenditures are made and/or because the deficit cannot be financed in efficient ways and at favorable terms.

The macroeconomic framework: A concrete illustration

The above discussion can be illustrated with the hypothetical simplified macroeconomic framework for 2010 and initial program for 2011 shown in Table 2-1. The hypothetical macroeconomic program for 2011 is based on two main targets: a 5% real growth rate of GDP, and a 5% inflation rate. The assumed values of the other variables are shown at the bottom of the table. Readers may wish to invest some time to understand how the numbers are related to these targets, to the values of the variables, and to one another.

The correct estimation of the values in the table for the 2011 program is essential to set the baseline, but it is the beginning of the real story, not its end. This initial program brings to light certain issues, problems, and risks for the future—and thus provides an initial platform for discussing and deciding on what changes in the initial targets and/or policy adjustments would be needed to address these problems and risks. For example, the sharp increase in private consumption and decline in private investment between 2010 and 2011 may be either a source of major concern or only a temporary blip—depending on its reasons and the circumstances—but in any case calls for analysis. Likewise, the jump in government current spending may or may not signal a need for adjustment, but the fact that it results from a large 20% increase in salaries/pensions and a decline in operations and maintenance expenditure is a major red flag. Readers are encouraged to peruse these illustrative numbers to see if they can spot additional potential issues or positive aspects of the initial macroeconomic program for 2011 and, if so, reflect on how these issues could be addressed. As just one example, what type of improvement might permit reallocating a given amount from government capital expenditure to O&M expenditure—without affecting the GDP growth target?

The program would then be revised to reflect the changes, and the process of reflection/re-esti-
mation/discussion/reflection would continue until a program is reached that provides consistency between goals and possibilities, between ends and means, between desires and resources. Only then can the government (and the country) have reasonable assurance that the taxation is warranted, the expenditures appropriate, and the overall fiscal result consistent with both the targets and realities.

In addition to this technical assurance, the budgeting system needs to provide space for building “ownership” by the political leadership as well as the legislature. Thus, internal consultations within the executive branch are critical, and at an appropriate time before the start of the annual budget preparation the macroeconomic framework needs to be explained to and debated by the legislature.

Table 2-1:  
**Illustrative macroeconomic program (*)**

<table>
<thead>
<tr>
<th></th>
<th>2010 (Actual)</th>
<th>2011 (Program)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP (nominal)</strong></td>
<td>1000</td>
<td>1100</td>
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<tr>
<td>Private consumption</td>
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<td>730</td>
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<tr>
<td>Private investment</td>
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</tr>
<tr>
<td>Government consumption</td>
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<td>170</td>
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<tr>
<td>Government investment</td>
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<tr>
<td><strong>Balance of payments</strong></td>
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<tr>
<td>Exports</td>
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<tr>
<td>Imports</td>
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<tr>
<td>Net capital flows</td>
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<tr>
<td>Balance</td>
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</tr>
<tr>
<td>Stock of reserves</td>
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<td><strong>Government accounts</strong></td>
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<td>Revenue</td>
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<tr>
<td>Expenditure</td>
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<tr>
<td>Current (Govt. consumption)</td>
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</tr>
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<td>Salaries/pensions</td>
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<td>Interest</td>
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<td>Subsidies</td>
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<td>50</td>
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<tr>
<td>Operations &amp; Maintenance</td>
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<td>25</td>
</tr>
<tr>
<td>Capital (Govt. investment)</td>
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<td>-20</td>
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<td>Foreign financing</td>
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<tr>
<td>Domestic financing (borrowing)</td>
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<td>20</td>
</tr>
<tr>
<td><strong>Money</strong></td>
<td>200</td>
<td>220</td>
</tr>
<tr>
<td>Net foreign assets</td>
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<tr>
<td>Net domestic assets</td>
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<td>Credit to private sector</td>
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<td>Credit to government</td>
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</tr>
<tr>
<td>Other</td>
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</tr>
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</table>

(*) Targets for 2011: GDP growth in real terms: 5%; Inflation rate: 5%. Income velocity of money = 5 (meaning that each unit of money “turns over” an average of five times a year, implying that the quantity of money is one fifth of the GDP in nominal terms). Government revenue elasticity with respect to GDP = 1 (meaning that government revenue changes in the same proportion as GDP).
The issue of “fiscal responsibility”

A major issue is whether to adopt binding rules on fiscal outcomes (for example, a prescribed level of deficit) or behavior (for example, prohibition against borrowing except for investment spending). This chapter concludes with a brief discussion of this issue, which often goes under the name of fiscal responsibility.

Several countries have laws and rules that restrict the fiscal policy of government and prescribe fiscal outcomes. For example, the so-called golden rule stipulates that public borrowing must not exceed investment (thus in fact prescribing a current budget balance or surplus, as in Germany). In many countries the budgets of all subsidiary governmental entities must be balanced according to law. In the European Union (EU), the Maastricht Treaty stipulated specific fiscal convergence criteria, concerning both the ratio of the fiscal deficit to GDP and the debt-to-GDP ratio. (The former criterion has been by far the more important.) EU member countries whose fiscal deficit is higher than the permitted three percent of GDP limit are, supposedly, liable for large penalties. Box 2-1 summarizes similar arrangements in countries of the West African Economic and Monetary Union.

A frequent criticism of such rules is that they favor creative accounting and encourage nontransparent fiscal practices by burying expenditures or listing one-off revenues as regular revenue. Also, when the rules are effectively enforced, the criticism is that they can prevent governments from adjusting their budgets to the economic cycle, thus making worse both recessions and inflationary pressures. The European experience has, unfortunately, also shown that the Maastricht rules are selectively enforced, with no penalties exacted for violation by the largest and most important EU members.

In contrast with an approach based on rigid targets, other countries (for example, New Zealand) do not mandate specific fiscal targets but refer to criteria such as prudent levels and reasonable degrees. The government is left to specify the targets in a budget policy statement, which presents total revenues and expenses and projections for the next three years. This statement is published at least three months before the budget is presented to the parliament and is reviewed by a parliamentary committee, but not formally voted on until after review.

The problem with fiscal responsibility rules is that they are usually a government’s contract with itself. In a presidential system of government, the system has extreme difficulty enforcing on itself a fiscal discipline rule when the chief executive feels the need to violate it, as he or she can always claim reasons of state and unusual needs. In a parliamentary system, where the government is a creature of the legislature, for the legislature to enforce a fiscal rule is equivalent to declaring no confidence in its own government. The issue is thus the oldest issue in contract law: a contract, however freely entered into, has no legal or practical meaning unless it is enforceable, and no enforcement mechanism exists in a government’s contract with itself to respect certain rules of fiscal behavior.

Reality still allows three situations in which binding fiscal rules may be useful. First, in countries with a vibrant civil society and an active political exchange, breaking a major and public commitment may entail a political price. Second, in countries with fragile coalition governments, fragmented decision making and legislative committees acting as a focus for periodic bargaining, setting up legally binding targets may be effective to limit daily political bargaining. Third, and probably most relevant, fiscal responsibility rules may apply to states in a federal country, for in this case the contract enforcement authority does exist: the national government. Overall, in Africa, the argument in favor of binding fiscal rules applies only to the subnational government entities in the handful of large federal countries. In all other cases, there is no practical alternative to careful budgeting within a medium-term...
perspective. This is the best way to be responsive to the rapidly changing realities of a developing society.

In conclusion, the fundamental meaning of “fiscal responsibility” does not lie in whether government expenditure is lower or higher, taxes are raised or reduced, or if a particular level of budget deficit is maintained. Nor does it lie in the establishment of specific rules and prescriptions. Fiscal responsibility lies in confronting the real social worth of government activities and their short and long-term financial implications, and in finding transparent and efficient ways to pay for them.

Box 2-1

**Fiscal Rules in the West African Economic and Monetary Union**

The West African Economic and Monetary Union (WAEMU) consists of eight countries (Benin, Burkina Faso, Côte d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo), which have a common central bank (Banque Centrale des États de l’Afrique de l’Ouest) and a common convertible currency pegged to the euro (the CFA franc). To coordinate macroeconomic policies, WAEMU countries have set up convergence criteria within the framework of the Convergence, Stability, Growth, and Solidarity Pact adopted by WAEMU governments in 1999. As in the Maastricht Treaty, the convergence criteria pay special attention to the fiscal deficit and to public debt sustainability, because these factors can undermine the viability of the common currency. In addition, the pact prohibits use of the exchange rate and interest rate as policy instruments by member states.

The following first-order criteria apply:

- Average annual inflation rate of no more than 3 percent, based on the objective of keeping a low inflation differential between the WAEMU and the euro area;
- Budget balanced or in surplus, defined as revenues (without grants) minus expenditures (excluding foreign-financed investment);
- Overall debt-to-GDP ratio lower than 70 percent;
- No change in the domestic and external stock of arrears.

These first-order criteria are supplemented with the following second-order criteria:

- Government wage bill less than 35 percent of tax receipts;
- Ratio of domestically financed investment to tax receipts no lower than 20 percent;
- Tax-to-GDP ratio of at least 17 percent;
- External current account deficit, excluding grants, lower than 3 percent of GDP. Only one country met this criterion in 2005.

Each year the WAEMU member-states prepare a three-year convergence, stability, growth, solidarity program, and every six months the WAEMU commission publishes a report to assess progress in implementing these programs.

NOTES

1 Readers already familiar with financial programming may wish to skip this section, which is intended to provide at least a basic understanding of the logic, utility and limits of macroeconomic models.


3 The extent of the downsizing, among other things, can be seen by the sharp reduction in government employment worldwide from the peaks of the early 1980s. (See Schiavo-Campo, 1998.) In fragile states, instead, the key issue is the collapse of government revenue. In these countries, reconstruction and recovery depend to a great extent on reintroducing revenue mechanisms and strengthening tax administration and collection.

4 Gross investment is the increase in the stock of physical capital. Because physical assets lose value (depreciate) over the years either physically as a result of their use or economically as a result of technological advances, the increase in the country’s productive capacity must be measured on a net basis: net investment is gross investment minus depreciation.

5 For an early definition of the issue, see Kopits and Symansky (1998).
Chapter 3: The Revenue Side
What to Expect

As noted, public financial management decisions and systems must be viewed in the broader context of governance, the role of the state, and the national economy as a whole. Moreover, decisions on public expenditure need to consider the overall situation of the public finances—including of course the taxes and other revenues required to fulfill the roles and implement the priorities of the government. Indeed, good management of public expenditure begins with a reliable forecast of revenue. Thus, while the remainder of the book focuses mostly on the management of public expenditure, this chapter provides a short synthesis of the main principles of taxation and the tax policies best suited to developing countries, concluding with a brief summary of key rules for effective tax administration. In each case, the application of these principles and policies to the circumstances of African countries will be briefly discussed. Also addressed is the special issue of transparency and accountability for extractive resource revenue, critically important in the light of Africa’s abundant oil and other mineral resources.

Why Taxes?

Without a prior assessment of financial resources available to the government, sound decisions on public expenditure obviously cannot be made—any more than a family can decide what to buy and when if it doesn’t have reliable information on the income it can expect. The availability of resources, in turn, is a function of the tax and revenue policy as well as the effectiveness of the administration of the tax system. There is a fundamental difference between the policy choice of revenue and the implementation decision on how to administer that policy. But in practice the policy and implementation aspects are related, since the choice of taxes is partly influenced by the ease with which different taxes can be collected—which in turn depends on the particular characteristics of the country concerned. The subject of taxation is too vast for even a summary to be included in this book. The interested reader is referred to Musgrave and Musgrave’s classic text in public finance, and to Gruber for a more recent treatment (Musgrave and Musgrave 1989, Gruber 2004). Nonetheless, a brief synthesis of the elementary rationale for taxation and a description of the main taxes is needed to provide a minimal necessary view of the revenue side of public financial management—without which a discussion of public expenditure management is like the sound of one hand clapping.

Whether for development, national security, social protection, law and order, etc., government services do not materialize out of thin air as the result of political decrees or willpower. Like any entity in the public or private sector, government too requires resources—labor, materials, supplies, equipment, and information. Those resources must be provided mainly through taxes (largely supplemented in African developing countries by foreign aid) by the country’s own citizens, who are collectively the presumptive beneficiaries of governmental activities. In the words of U.S. Supreme Court Justice Oliver Wendell Holmes, taxes are the price we pay for a civilized society.

In principle, a country’s citizens, through their votes and the actions of their elected representatives, should first determine what they wish their government to do, and then decide how to pay for it. In practice, the two decisions are made continuously in an iterative manner through the
same process of annual budgeting—influenced by the interests of various internal groups, the advice and pressure from donors, and the constraints of globalization. Accordingly, debates on taxation normally do not revolve around the abstract question of whether taxes are “too high” or “too low,” but around the hard political, economic and social issues of how well the tax money is spent and for whom, and which groups in society should pay more for the country’s government and why.

Tax Policy Issues

**Basic principles of taxation**

**Legitimacy** is the bedrock principle of public finances. No tax can be imposed or other moneys taken from the people without explicit approval of the people, through its duly constituted representatives—i.e., the legislature. The same applies to foreign aid loans, which normally require legislative consent. Subject to the basic requirement of legitimacy, the two other basic principles of taxation are:

- **Efficiency**: a given tax should maximize the revenue collected relative to the cost of collecting it. (If taxation is visualized as a form of production, efficiency means “producing” a unit’s worth of tax revenue at the lowest possible administration and collection cost.)

- **Equity**: Because taxation necessarily involves a burden on those who are taxed, the tax system as a whole should attempt to equalize that burden across individuals, groups and regions in society. Among other things, the equity principle entails spreading the tax burden as widely as possible by broadening the base of tax.

The above three principles of legitimacy, efficiency and equity are valid in Africa as in every country under all circumstances. Their practical application, however, depends on the specific realities of the country concerned, and its particular development needs and institutional capacity.

In African low-income countries, capacity limitations and the need for trust and credibility require that the tax systems meet, to the maximum possible extent, the criteria of simplicity and transparency. Tax expenditure, that is, the loss of revenue from special subsidies, exemptions, and the like, is of particular concern for governance because of lack of visibility.

**What is taxed?**

Taxes can be levied on property, on income, or on transactions. Each type of tax has advantages and disadvantages, which have to be examined in the light of government objectives and country realities, and the tradeoffs among the three principles of taxation. (For example, transaction taxes are cost-effective, but also regressive.)

**Property taxes**

These include mainly real estate and land use taxes—the main source of revenue for local governments in many countries. Other property taxes are inheritance tax, existing in most countries, or the wealth tax levied (as in France annually) on the worth of personal assets. In general, the tax on inherited assets is the single most equitable and least burdensome form of taxation, as the owner of the assets is dead and the heirs are acquiring the assets through no effort or merit of their own.

In African low-income countries, property taxation is neither simple nor, in most cases, equitable. Lack of tax collection capacity, inadequate records, obsolete valuation of properties, or simple collusion between tax collector and property owner—these are factors that reduce the tax revenue collected and generate large and unpredictable inequities against property owners.
who lack “connections”. For example, Somalia’s capital of Mogadishu officially reported fewer than 3,000 residential buildings for a population of nearly one million, before a large-scale registration exercise in 1986 revealed the existence of over 33,000 residential buildings.

**Income taxes**

Income taxes are levied on the income of corporations and of individuals. Corporations are taxed on their net income, i.e., corporate profits. Individual income taxes are levied on income from work (wages and payroll taxes to finance social security and medical care) and on income from capital and other assets (e.g., taxes on stock dividends or on rents and royalties). Different from taxation of income from capital are taxes on capital gains, i.e., the difference between the sale price and the original price of an asset.

In African developing countries, for efficiency and competitiveness as well as to minimize incentives for tax avoidance and opportunities for corruption, personal income tax structures should be simple and corporate tax rates low. There is very little scope for efficient taxation of capital gains in Africa, except for a handful of middle-income countries (e.g. South Africa) where there is a functioning stock exchange and market for other assets.

**Taxes on transactions**

Transaction taxes include mainly sales taxes and customs duties. Some of these taxes are levied by central governments and others by provincial or local governments.

In African developing countries (and especially in fragile states), transaction taxes are of necessity the main source of revenue, owing to their simplicity and efficiency of collection. (Indeed, customs’ duties were the earliest form of taxation, as the security personnel and facilities typically stationed at the country’s borders make it relatively simple to control and tax incoming and outgoing goods.) Transaction taxes are heavily regressive, however (see below) and thus should be compensated by progressive spending.

**Who is taxed?**

**Progressive, Proportional, Regressive Tax**

A progressive tax is one where the tax rate increases as the taxpayer’s income increases; in proportional taxes, the rate is constant; and a regressive tax takes a greater bite out of the income of lower-income taxpayers. For example, sales taxes are regressive because they take the same percentage of the value of the transaction whether the buyer is wealthy or poor—and hence necessarily a higher percentage of poorer buyers’ income. The same is generally true of real estate taxes and customs duties. (Government-run lotteries are the single most regressive and least equitable form of tax, and they almost entirely hit the poor hardest.) Income taxes, instead, are typically progressive, with wealthier persons paying a higher rate in tax, and people below a certain income level exempt from income taxes altogether.

**Why progressive income taxes?**

*The benefit principle.* In principle, every citizen gets some benefit from public expenditure. Since it can be assumed that people with higher incomes receive disproportionately greater benefit from the protection of organized society (among other things because they have more valuable assets to be protected), and are in a better position to take advantage of the opportunities it offers, it follows that they should pay a commensurately higher percentage of their income in taxes. (The benefit principle is also applied to user charges and other fees directly related to the provision of specific public services.)

*Equalizing the burden.* Nobody enjoys paying taxes. A second criterion of tax fairness is to try and equalize the subjective “pain” of taxation across all citizens. The basic consideration is that the satisfaction we derive from consuming or owning more of any particular thing diminishes the more we have of it. A loaf of bread means far more to a starving person than to somebody who just had a big lunch. A first TV set is much more valuable than a second, and to add a fifth TV set to a never-used guestroom will yield very little additional satisfaction. Because the utility of money, as a medium of exchange, derives from the utility of
the things that money can buy, this basic consideration underpins the principle of “diminishing marginal utility” of money: an extra $100 in annual income means far more to someone making $2,000 than to someone making $100,000 a year. Therefore, the only way to try and equalize the pain of taxation is to tax a higher fraction of the additional $100 of income for the higher-income person than for the poorer person—that is, a progressive income tax structure.

Offsetting regressive taxation. A third justification for progressive income taxes is that they are needed to offset the regressivity of the many other forms of taxes. In most countries, when all taxes are considered, the relative tax burden on lower- and middle-income persons is the same or higher than on the wealthiest individuals.

An important caveat is in order, however. When the top tax rates on income become too high, they reduce individual incentives to work harder, innovate and invest, and raise the incentives to find ways to avoid the tax altogether—including relocating outside the country. A reasonable balance must be found between tax equity and tax efficiency.

Who does the taxing?
In all countries, but particularly African developing countries, where social and economic integration is critical, tax policies must be coordinated between central, intermediate and local government, to prevent “migration” of mobile tax bases between regions. The possibility of such migration would cause a jurisdictional “race to the bottom” whereby regions compete with one another to provide lower tax rates and various “incentives”, and thus create an inefficient and opaque overall fiscal system, as well as reduce tax revenue for the country as a whole.

It is also necessary to set clear rules for allocating tax revenues among jurisdictions in a way to avoid tax gaps or double taxation—a major aspect of “fiscal federalism”. The general criteria to decide the assignment of tax responsibilities to central and subnational government levels are as follows:

Central government
At central government level, the appropriate taxes should be those which:

- cover mobile tax bases (e.g., corporate income, capital gains, inheritance taxes) to avoid inter-jurisdictional tax competition,
- are “buoyant” (or “elastic”, i.e., sensitive to changes in income) for purposes of macroeconomic stabilization,
- cover tax bases that are unevenly distributed across regions—e.g., taxes on natural resources—but sharing tax proceeds with local government, and,
- customs duties should be set centrally and collected by central government.

Subnational government
Symmetrically, at subnational government level, the appropriate taxes should be those which:

- have a relatively immobile tax base, e.g., real estate taxes;
- provide stable and predictable revenue yield, e.g., the so-called “sin” taxes on alcohol, tobacco, etc.;
- are easy to administer, e.g., sales taxes.

Who really bears the overall tax burden?
The distribution of the burden of taxation on the various regions, groups and individuals in society is difficult to assess. Even the most thorough analysis will have gaps and ambiguities, and the data are so diverse as to allow persons of opposing political viewpoints to pick and choose from the numbers to support very different conclusions. But some general criteria help form a reliable judgment, if not of the actual distribution of the burden of taxation, at least of how such distribution is likely to change in response to major tax policy changes.

Tax incidence (shifting the burden of tax)
The distinction between those who carry the “first-line” official responsibility for collecting and paying the tax, and those who ultimately end up actually bearing the burden of the tax is important to understand. Two illustrations may help. A sales tax is officially paid by the buyer and collected by the seller for turning over to the
government. However, the characteristics of the transaction determine who actually ends up paying the tax. If the good or service being sold has a very inelastic demand—i.e., is a necessity without close substitutes, such as gasoline—the seller will not need to reduce the sale price to offset the tax, which is therefore indeed paid by the buyer. If instead the purchase is more discretionary and the good has close substitutes, the seller will be forced to reduce the net sale price to avoid losing customers and ends up in effect paying for part or most of the sales tax, even though it is formally charged to the buyer. Similarly, medical insurance taxes are shared between employer and employee. However, if the labor market has a surplus of the skills of the employees and there are few employers, the employers may in fact make the employees pay for some of the employers’ own contribution, in the form of lower salaries. On the contrary, if the labor market is very tight and the industry is expanding fast, employers may have to raise worker salaries to offset part or all of the medical insurance tax and will end up in effect paying more than their official share of the tax. The point is that one should not assume that just because a tax is charged to one party it is ultimately paid entirely by that party—the distribution of the actual tax burden between seller and buyer depends on the nature of the tax, the characteristics of the market, and the interaction between the supply and demand of the good or service being taxed. 

**Look at all the taxes**

When trying to assess the distribution of the tax burden, it is essential to consider the totality of the tax system—all types of taxes, at central, state and local government levels—and not just one category of tax or another. Thus, a shift from individual income taxes, which are progressive, to other taxes automatically shifts some of the overall tax burden onto lower-income individuals and reduces the progressivity of the tax system as a whole.

One must also take into account the implications of the tax assignments between central, intermediate, and local government. Because provincial and local revenue depends heavily on sales and real estate taxes—both of which are regressive—shifting the tax burden from the central government to intermediate government and municipalities makes the overall tax structure less progressive.

**Assessing the impact of overall government activity**

Finally, the challenge becomes even more complex if one wishes to understand the impact of overall government activity on people in different income groups or regions of the country. Doing so requires taking into account not only the distribution of the burden of taxation but also the distribution of the benefits from public expenditure. For example, expenditures on rural health clinics benefit lower-income people disproportionately, while subsidies to gasoline accrue largely to individuals who can afford cars; the benefits of police protection of property are naturally most important for persons with valuable assets to protect; and so on. In African developing countries, with their greater dependency on heavily regressive transaction taxes and the tilting of the benefits of organized society in favor of the richer citizens, even with progressive income taxation the overall tax system tends to be regressive—making it that much more important to have a pattern of government expenditure that favors the poor.

**Effective tax administration**

Assuming that a good tax structure has been put in place, suited to the circumstances and realities of the specific country, it is necessary to assure that the taxes are administered fairly and effi-
ciently. Just as good expenditure policy requires
good expenditure management systems, good
tax administration is essential to implement tax
and revenue policy. Once again, only the basic
principles can be presented here. (Bird, 2010,
provides a synthesis of the issues, and readers
interested in an extensive treatment of tax ad-
ministration in developing countries are referred
to Bird and Casanegra, 1992.)

Effective administration of the tax system al-
ways requires an appropriate organizational
structure, adequate staffing and resources, and
reliable information database. Especially in Af-
can developing countries, the most important
requirements for good tax administration are:
(i) simplicity of the tax system (as noted at the
beginning of the chapter) and (ii) high-level
political support for robust, uniform, and fair
collection of taxes. Assuming simplicity of the
system and the political will to support it, the
three major tasks of tax administration are to fa-
cilitate taxpayers’ compliance, enforce the rules,
and prevent corruption.

**Facilitating compliance**

As with any regulatory framework, the voluntary
compliance of citizens is the key to implementa-
tion of the rules. To facilitate compliance in tax
administration, it is necessary to:

- locate the taxpayers, by a registration pro-
cess that should be as simple and easy as
possible and a system to identify taxpayers
who do not register voluntarily;
- have good services for the taxpayers, e.g.,
information, payment facilities, etc.;
- have a sound process to determine tax lia-
bilities, which will have different forms for
different taxes, e.g., property taxes require
accurate identification of the property, val-
uation rules, etc.; and
- collect the tax efficiently (as much as pos-
sible through bank checks and with “third
party” controls—cash payments are risky).

**Enforcing compliance**

Even with high voluntary compliance, tax eva-
sion will occur. Note that tax evasion is an illegal
violation of the tax rules, tax avoidance is a legal
use of the existing rules to reduce the amount of
tax due. Tax avoidance can result in much greater
loss of revenue than outright evasion, however,
and is generally associated with rules that are
complex or unclear—usually both. Once again,
simplicity of the tax system is a requirement for
its effectiveness.

Just as enforcement is very difficult in the ab-
sence of voluntary compliance by a large major-
ity of taxpayers, so in the absence of robust en-
forcement voluntary compliance will eventually
fall off. Nothing discourages honest taxpayers
as quickly as the knowledge that the dishonest
ones are not penalized—especially when the tax
evaders are the richer and better “connected”
persons. However, an enforcement strategy is
needed, instead of merely trying to catch indi-
vidual cheaters, and such strategy should include
among other things: (i) respect for taxpayers,
only if they are expected to be tax evaders they are
more likely to try and meet that expectation; (ii)
immediate and systematic follow-up when tax
deadlines are missed or errors are revealed; (iii)
interest charges high enough to discourage late
payments; and (iv) appropriate penalties for tax
evaders.

**Assuring integrity**

The honesty of the tax collectors is paramount.
The best tax structure and organizational ar-
rangements for tax administration will avail
nothing if those in charge of administering the
system are corrupt or tolerate corruption and
bribery. In addition to the two main conditions
of a living wage and swift and predictable pun-
ishment for malfeasance—without which tax
collectors cannot be expected to resist tempta-
tions—the single most important measure is to
limit as much as possible direct contacts between
the taxpayer and the tax collector. For this, in-
formation technology can help considerably—
although capacity limitations and data security
considerations must be kept in mind.

But the taxpayers have responsibilities, too, and
mainly the responsibility to refuse to pay bribes.
Such refusal is not only conducive to improving
the integrity of the system, but is also in the in-
terest of the taxpayers themselves for, if they pay
once, they are signaling to the corrupt tax collectors that it is worth their while to come back for bribes again and again. It is far less costly in the long run to pay in full one’s tax obligations.

**A hopeful initiative for Africa**
Recognizing the importance for governance and development of effective and equitable tax administration, 25 African governments agreed in late 2009 to create the African Tax Administration Forum (ATAF), headquartered in South Africa. Although the effectiveness of any such coordinating organization depends largely on the strength of the commitment of the authorities in the individual countries, the ATAF has a good potential for disseminating good practices and, even more important, the ways in which tax evasion can be reduced and the effectiveness and equity of the revenue system improved. This will require among other things that the organization operates transparently and does not shy away from identifying and publicizing issues inimical to good fiscal management and development in Africa. Initial activities have been promising, including a major technical event held in Accra in October 2010 at which the ATAF participants discussed strategies to fight domestic tax abuse and the role of tax audit within small and medium size businesses.

**The special issue of extractive resource revenue**

**Poverty in the midst of wealth**
Africa shows extreme poverty in the midst of abundant resources. The incidence of poverty is very high, with between 40 percent and 60 percent of the 900 million Africans living below the poverty line of $1.25 dollar a day. Moreover, the depth of poverty (how far incomes fall below poverty line) is greater in Africa than in any other continent, and the vulnerability of Africans (the probability to fall below the poverty line if any adverse event occurs—as is typical in fragile states) is the highest in the world. Low human development is the consequence: despite some recent progress, African countries rank among the lowest by the UN Human Development Index (which combines life expectancy, literacy, educational attainment and other measures.)

Yet, African countries own 8 percent of world oil reserves, compared to 3 percent for the U.S., with at least $300 billion in oil revenues estimated to accrue into African government treasuries over the next decade (more than the total of foreign aid). In addition to oil, African countries have large deposits of gems and other very valuable minerals, with additional revenue from their export. What explains this “paradox of plenty”? **The “resource curse”**
Between 1996 and 2009, as reviewed in Chapter 1, there have been improvements in African governance overall, with several nations making substantial progress. Countries where no governance improvement has taken place include all but one of the ten African countries richest in mineral resources (Botswana is the exception). Corruption losses in Africa have been estimated by the African Union at around $150 billion a year—several times the total volume of aid, and equivalent to one quarter of Africa’s GDP. As seen from the earlier Table 1-1 the mechanisms of corruption control are weakest and the perception of corruption is highest in the extractive resource-rich countries, which also show comparatively lower economic growth. While one supposes that abundant government revenues from extractive resources would help greatly in financing development, growth and poverty reduction, the reality contradicts; a “resource curse” seems to be at work. (The subject is discussed in
detail in Chapter 3 of the African Development Bank’s Annual Report for 2007.)

It must be pointed out that the resource curse is not at all exclusive to Africa. Resource-rich countries in other regions exhibit similar problems. Larry Diamond (2008, 2009) noted that globally none of the 23 countries that rely on oil and gas for 60% or more of their exports are democracies—and has termed this state of affairs a “democratic recession”. The resource curse is not inevitable—with Norway and Botswana the best examples of very successful resource-rich states with excellent governance. But regrettably, the resource curse is prevalent in Africa.

In general, the various explanations of the resource curse include the following:

» The rent-seeking state: When government receives most of its revenue in royalties from a foreign company which conducts all extraction, transport and marketing activities, it need not expend any effort to interact with the citizens to mobilize domestic resources. This engenders a breach in the link of consultation between government and citizenry, and replaces this link with negotiations between government and the international company, usually conducted without transparency. In effect, no taxation can mean no representation.\(^5\)

» “Dutch disease”: This refers to the discouragement of domestic production of other goods and services that arises from the abundance of revenue from exports of valuable minerals. The de-industrialization of the nation’s economy occurs because the exploitation of a valuable mineral resource raises the value of the currency, which makes the country’s goods less competitive, increases imports and decreases exports, and thus domestic production. In time, the dependence on natural resource revenue makes most domestic production disappear, and when the mineral resource becomes depleted, the country is left without an economic base of its own.

» Revenue volatility: The greater the dependence on mineral exports, the greater the vulnerability to price changes. In turn, the greater the volatility of revenue, the harder it is to plan, and the greater the internal conflict over revenue.

» Weakening of governance structures: this occurs when the revenue from the extractive resources is used to consolidate non-representative state power. While the resource curse and mal-governance reinforce each other, it is not clear which occurs first. Where evidence does exist, it points to the strong hypothesis that if governance is weak, the discovery of large extractive revenues constrains its improvement. However, if governance is sound to begin with and institutions are representative—as in Botswana—the subsequent large extractive revenues are used for development and poverty reduction. (If true, this augurs well for the African countries where governance has already improved and new mineral resources have been discovered recently but not yet exploited.)

**What has been done?**

A number of international initiatives have been taken in the last few years to improve transparency in the extraction and sale of mineral resources and to contain corruption. Among these are the following:

» “Publish What You Pay” is a call by a coalition of NGOs worldwide for mandatory disclosure of the payments made by oil, gas and mining companies to all governments for the extraction of natural resources—in order to help citizens of resource-rich developing countries hold their own governments accountable for the management of revenues.

» “Promoting Revenue Transparency” is a related initiative calling on the international oil and gas companies to make regular reports in all areas relevant to revenue transparency, on a country-by-country basis, and to discourage governments from including confidentiality clauses in contracts.
The African Peer Review Mechanism, as a key driver of African governance improvements, entails periodic progress reviews to ensure that participating countries conform to agreed values in: (a) political governance; (b) economic governance; (c) corporate governance; and (d) socio-economic development.

The Extractive Industries Transparency Initiative (EITI), discussed below, is so far the most important, but still limited, international effort targeted at the “resource curse” worldwide.

Resource-rich African countries and the EITI
The EITI is a coalition of governments, companies, civil society groups, investors and international organizations governed by a Board with representation from all those constituencies. It aims to strengthen governance by improving transparency and accountability in the extractives sector, and sets a global standard for companies to publish what they pay and for governments to disclose what they receive. EITI has a well-defined implementation process in which countries are evaluated on the basis of certain progress indicators—at the conclusion of which the country is certified as EITI compliant.

As of the end of 2010, the number of African countries candidates for membership in the EITI had grown to 19—among which eight countries have produced EITI reports. In Africa so far, only Liberia has been certified as EITI compliant (in October 2009, including the production of reports on the environmentally sensitive forestry sector). If the EITI requirements are fully met, several other countries can, in time, progress to full transparency in their revenue from extractive resources.

In general, there is a consensus that the EITI has had some success, within its limitations. However, all the major governance indicators for the ten resource-richest African countries (except for Botswana) have actually worsened after the introduction of the EITI, and compare increasingly unfavorably with the rest of Africa on every single dimension of economic and administrative governance—with the largest gaps found in government effectiveness, rule of law, and control of corruption.

EITI++
Revenue transparency is necessary but not sufficient to improve the use of the large extractive revenues for growth, social development and poverty reduction. This improvement would require also a much more accountable and responsive expenditure and distributional policy than is currently the case. This was the rationale for the creation in 2006 of the “EITI++” initiative, which aims at addressing the problems throughout the entire value chain of natural resource extraction, exploitation, revenue, and utilization—from the award of concessions to the adequacy of public financial management systems and the quality of public investments (Alba 2009).

While the EITI is an international standard-setting and rule-compliance initiative, the EITI ++ is intended to provide technical support to governments that wish to use the extractive revenue for development and poverty reduction, and thus requires real government ownership to be effective. How to persuade governments that currently control and use the resources for purposes other than development and poverty reduction to implement the advice that will weaken such control and use is a challenge. Stronger international initiatives, acting on the demand and marketing side, would be required to meet that challenge and combat the resource curse in Africa. This book is not the appropriate vehicle for discussing them and in any event the likelihood of an international consensus on sufficiently strong initiatives is very low.

What else can be done?
Supporting local communities
First, international initiatives to support local communities and small-scale and artisanal mining are realistic and highly relevant to economic and social goals. It is only by empowering the people in the mining areas themselves, protecting them and giving them voice that the sharing of extractive revenues can become less inequitable and some of the conflict and human costs of mineral exploitation can be alleviated.

Strengthening and extending the Kimberley Process
In 2003, spurred by the tragedy of the conflict in West Africa that was partly fueled by the ex-
exploitation of diamonds by combatants, the United Nations introduced a scheme to certify that rough diamonds originate from sources free of conflicts financed through diamond production. This Kimberley Process Certification Scheme (KPCS), so named after the city in South Africa which served as the first chair, is intended to prevent “blood diamonds” from entering the international diamond market, and thus assure buyers that they are not indirectly financing war and human rights abuses. The KPCS functioned relatively effectively in its first years, but has been subject to recent criticism that it has been failing to deal effectively with non-compliance, smuggling, money laundering and human rights abuses in the producing countries. Clearly, the approach remains valid, but calls for urgent strengthening.

Related to the above, approaches similar to the Kimberley Process should be devised and applied to other “conflict minerals”, the exploitation of which has been associated with severe conflict and human tragedy on a massive scale, particularly but not exclusively in the eastern Democratic Republic of Congo. Some steps may also be taken within the affected countries themselves: the key is to gradually and selectively increase the capacity of citizens to exert influence over their government.

**Preventing the resource curse in future cases**

Finally, bold efforts and novel initiatives should be taken by donors and international companies to help those African governments that are genuinely interested in building strong protections against the resource curse. This is especially the case when the valuable resources have been recently discovered and are not yet exploited on a large scale, as in Uganda and Ghana. For example, the Ghanaian government has not only agreed to the extension of EITI principles to the management of its future oil revenue, but is also actively soliciting contributions and advice by civil society and is encouraging the Ghanaian and international media to play a collective “watchdog” role to assure both transparency of revenue and accountability for its use.

**NOTES**

1. This phenomenon is more complex than described here, because the extent to which payment of the sales tax is effectively shared between buyer and seller depends on the interaction between the supply and demand for the good or service, and not simply on the characteristics of demand.

2. For a discussion on how to improve tax compliance and fight tax evasion see Baer et al., 2002 and Lai Lan Mo, 2003. Specifically for a discussion of contemporary tax administration issues in Africa, see the African Tax Administration Forum, (www.ataftax.net)

3. The term was coined by Karl, 1997.

4. The term was apparently used for the first time by Gelb, 1988. This section is based in part on McFerson, 2010b.

5. The word was coined in the late 1970s by The Economist magazine to explain the consequences of the discovery of North Sea natural gas near Holland.

6. Altogether, 29 countries in late 2010 were recognized as EITI candidates: Afghanistan, Albania, Burkina Faso, Cameroon, Central African Republic, Chad, Côte d’Ivoire, Democratic Republic of Congo, Gabon, Ghana, Guinea, Iraq, Kazakhstan, Kyrgyzstan, Madagascar, Mali, Mauritania, Mongolia, Mozambique, Niger, Nigeria, Norway, Peru, Republic of the Congo, Sierra Leone, Tanzania, Timor-Leste, Yemen and Zambia.
Part II: Government Budgeting: Concepts, Systems and Coverage
Chapter 4:

Budgeting: Concepts, Objectives and Systems
Chapter 4: Budgeting: Concepts, Objectives and Systems

What to Expect

Starting from the fundamental principle that no moneys may be collected from or spent on behalf of the citizens without approval of their representatives in the legislature, the chapter defines the major concepts of government budgeting; outlines the public expenditure management objectives; and describes the main approaches—obligation and time-limited authorizations, line-item and program budgeting; cash-based and commitment budgeting. The importance and types of classifications of government expenditure are discussed last.

The budget: financial mirror of society’s choices

The government budget is often viewed as a purely technical assemblage of words and numbers, dull, opaque and best left to the bureaucrats and a few politicians. The reality is very different. Under legitimate governance, the government is expected to fulfill the roles and respect the limitations decided by society. Those roles are articulated into policy objectives—quantitative ones, such as raising the literacy rate by a certain amount, or qualitative ones, such as correcting market imperfections. Some of these policy objectives may be met by issuing regulations or prescriptions, granting loan guarantees, or intervening in other ways that do not require direct and immediate expenditure. Most policy objectives, however, require financial resources, which can come only from the public in the form of taxes and fees—and, for most African countries, are complemented by aid from external partners.

The word “budget” (bougette in old French) originally meant purse, and in medieval England it was understood as the King’s own purse. In those days, a country’s public resources were deemed to be the personal property of its ruler. The meaning of the term has changed since then, along with the political evolution from dictatorships and absolute monarchies to constitutional governments. In most countries today, including a large majority of African countries, approval of the budget (the so-called “power of the purse”) is the main form of legislative control over the executive, as public money must be collected and spent only under the law. In a few countries, the public perception persists that some of the country’s resources are the personal property of the leader or of the ruling group. This perception should progressively be dispelled, and executive accountability should be established, as the system evolves toward greater legitimacy and better governance. Improvements in public financial management are a major route to that goal.

The fundamental principle of public financial governance is that the executive branch of government can neither take moneys from the public nor make any expenditure from those moneys, except by explicit approval of the legislature as the representative organ of the citizens. Consequently, properly understood, the budget should be the financial mirror of society’s economic and social choices and is thus at the very center of the country’s economic governance structure. As such, the government budget is much, much more than a large and boring technical document.

The requirement of legitimacy of the tax system, discussed in chapter 3, has an exact parallel on the expenditure side. Just as the government has
no right to levy taxes on the citizens without the express authorization of their representatives, so the government has no right to spend any moneys on behalf of the people without parliamentary approval of how it intends to spend it—i.e., the proposed budget.

However, the executive branch of government does have both the right and the responsibility to prepare the draft budget, which must be consistent with the overall macroeconomic picture and the country’s development and other public goals (as explained in Chapter 2). This task cannot be delegated to an assembly of representatives elected on grounds other than their economic and financial qualifications. The political leadership, however, must endorse the key objectives of the budget, owing to the close linkage between public expenditure decisions and the economic health and development of the country, and the parliament must be consulted on those objectives.

**The objectives of public financial management**

*The traditional triad: Control, allocation, efficiency*

Public financial management (PFM) is instrumental in nature. As a central instrument of policy, it must pursue all three overall economic policy goals of economic stability, growth and equity. Stability calls, among other things, for fiscal discipline; economic growth and equity are pursued partly through allocating the moneys to the various sectors; and all three policy goals require efficient and effective use of public money. Hence, the three goals of overall policy translate into three key objectives of good public expenditure management: fiscal discipline (expenditure control); allocation of resources consistent with policy priorities (“strategic” allocation); and good operational management. (The two objectives of strategic resource allocation and good operational management are easily recognizable in the distinction traditionally made in economics between efficient allocation and use efficiency.) In turn, good operational management calls for both efficiency (minimizing cost per unit of output) and effectiveness (achieving the outcome for which the output is intended). In addition, as stressed in Chapter 1, the PFM system cannot be sustainable without respect of proper norms, and equity and due process must be added as the fourth objective to underpin the entire system.

There are linkages between the three key objectives of expenditure management, their corresponding major functions, and the government level at which they are mostly operative. Fiscal discipline requires control at the aggregate level; strategic resource allocation requires good programming, which entails appropriate cabinet-level and inter-ministerial arrangements. Operational management is largely an intra-ministerial affair. Fiscal discipline and operational management are more amenable to “technical” improvement than is the strategic allocation of resources. This is because the distribution of resources among sectors and ministries is the least technical and the most “political” of the three objectives: “The allocation of funds results from a series of forces that converge at different points of the decision-making process...according to an imperfect perception of present and future political realities. ... The decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want. In any event, the effort made at this stage of the budget process to collect and analyze information is less than at any other stage” (Petrei 1998).

Owing to the essential link between revenue and expenditure, the triad of public expenditure management objectives can easily be expanded into a triad of fiscal objectives. Fiscal discipline results from good forecasts of revenue as well as expenditure control; strategic allocation has a counterpart in the tax incidence across different sectors; and tax administration, of course, is the revenue aspect of good operational management of expenditure. These relationships are summarized in Table 4-1.
Table 4-1. The Objectives of Public Financial Management

<table>
<thead>
<tr>
<th>Objective</th>
<th>Revenue Function</th>
<th>Expenditure Function</th>
<th>Organizational Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal discipline</td>
<td>Reliable forecasts</td>
<td>Expenditure control</td>
<td>Aggregate</td>
</tr>
<tr>
<td>Resource mobilization and allocation</td>
<td>Tax bases and incidence</td>
<td>Expenditure programming</td>
<td>Inter-ministerial</td>
</tr>
<tr>
<td>Operational efficiency</td>
<td>Tax/revenue administration</td>
<td>Expenditure management</td>
<td>Intra-ministerial</td>
</tr>
<tr>
<td>a. Economy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Efficiency</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Effectiveness</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity (due process)</td>
<td></td>
<td></td>
<td>Throughout government</td>
</tr>
</tbody>
</table>

**Complementarity and interaction**

The scheme in Table 4-1 is a simplification. Reality is more complex. First, as noted, the three objectives may be mutually conflicting in the short run (and trade-offs must be made) but are clearly complementary in the long run. For example, mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Second, good aggregate budgetary outcomes must emerge from good outcomes at each level of government. For example, while fiscal discipline must ultimately be manifested at the aggregate level, it should emerge as the sum total of good expenditure control (and reliable revenue forecasts) in each ministry and agency of government, rather than being imposed top-down, in which case it will quickly fall apart if political circumstances change.

An overall expenditure constraint is necessary but not sufficient for good PFM. On the contrary, imposing the constraint only from the top may result in misallocation of resources and inefficient operations. Typically, such top-down aggregate limits are intended to root out waste, fraud, and corruption. But waste, fraud, and corruption are hardy weeds. If the top-down limit is imposed in isolation and without any attention to the internal workings of the public expenditure system, the outcome may well be to starve the funding of the more efficient and worthwhile activities, precisely because they do not carry benefits for the individual bureaucrats and their private “partners”. Conversely, it is difficult to improve the internal systems in the absence of a hard expenditure constraint. Similarly, the best mechanisms for inter-ministerial coordination are worth little if the sector expenditure programs are inappropriate or inconsistent with overall government policy. Finally, management and operational efficiency cannot normally be improved except in an overall context of fiscal discipline and sound allocation of resources—to which good management itself makes a key contribution. To reiterate: all three PFM objectives are complementary and interrelated.

**A word about sequencing**

The complex issues of appropriate prioritizing and sequencing PFM improvements in African countries are addressed in Chapter 16. As a quick preview, consider that if you can’t protect the public money, you can’t allocate it, and if you can’t allocate it you can’t manage it. Therefore, fiscal discipline and expenditure control come first, and resource allocation and operational efficiency come next. This is literally true in those few African countries that have extremely weak revenue forecasts and cash management systems. In those countries, improving expenditure control is the first and foremost priority, and any effort at addressing the other two objectives would be futile and even counterproductive if it takes attention away from the key priority. Even in these countries, however, it is essential to: (1) design and implement improvements in expenditure control in ways that do not jeopardize the
chances of subsequent improvements in sector allocation and resource management; and (ii) have a clear sense of how far to push improvements in expenditure and cash control before it becomes timely and necessary to address strategic allocation and management issues.

In countries where expenditure control and cash management are already minimally acceptable, none of the three objectives of expenditure control, resource allocation, and good operational management should be pursued in isolation from the others. Improvements in one or another area should go forward as and when permitted by circumstances. But a coherent vision of the entire reform process is needed to prevent “progress” in any one objective from getting so far out of line as to compromise progress in the other two and thus the PFM reform process in its entirety.

Budget types: The form of legislative authorization

Given that the budget must always receive parliamentary approval, the budget systems depend on the form of authorization the legislature gives to the executive to use the public money for certain approved purposes. The legislature can give one of four authorizations. It can authorize the executive either to make payments or to enter into commitments (up to certain amounts); and then either within a specified period or without time limit. Authorizing the executive to make payments at any time in the future would be an open invitation to executive abuse and would make fiscal transparency and programming impossible. This leaves the three other possibilities.

**Obligation budget**

In an “obligation” budget, the legislature gives to the executive the authority to enter into commitments for approved purposes and make the related payments—up to specified amounts but without time limit. Because there is no time limit, obligation budgeting can be used only for special programs. (An example is the Environmental Quality Incentives Program in the U.S. — see www.ers.usda.org/programs/equip).

**Cash budget**

In a cash budget, the legislature gives to the executive the authority to make payments for the approved purposes up to specified amounts and over a limited period, usually one year—but without legally limiting commitments. This is by far the most widespread budget system, which is a best fit for macroeconomic programming as well as compliance and expenditure control, and is advisable for all African countries. For example, ministries are authorized to pay up to “x” millions for fuel within the fiscal year, but may sign fuel contracts for amounts larger than “x”. The cash payments for the fuel are legally limited; the commitments are not. Since there is no annual limit on commitments, a cash-based budget needs a complementary system to monitor commitments. (The reader should not confuse cash-based budgeting with cash-based accounting. Although in actual practice the two normally go together, cash budgeting is compatible with other bases of accounting as well, as explained in Chapter 12.)

**Commitment budget**

In a commitment budget, the legislature gives to the executive the authority to enter into commitments for the approved purposes up to specific amounts and over a limited period, usually one year—but without legally limiting payments. For example, ministries are authorized to enter into fuel contracts of a value of up to “y” millions within the year, but may make payments for fuel during the year larger than “y.” The value
of the total fuel contracts is legally limited; the payments are not. Because there is no annual limit on payments, a commitment budget needs to be complemented by an annual cash plan. (In reality, a reliable cash plan is necessary for good budget execution regardless of budget system, as explained in Chapter 10.)

A few countries (e.g. France) include in their budgets authorizations for multiyear commitment for certain categories of expenditures (mainly for investment). However, annual appropriations are still required to make the payments, and these multiyear authorizations are therefore different from “obligations” budgeting, which carries no time limit on payments. (In reality, all budget systems must include some appropriate provision for budgetary authority to launch investment projects, which necessarily require entering into contracts and making payments for many years until project completion.)

Classifying budgets as obligation-based, cash-based, or commitment-based according to the form of legislative authorization does not answer the basic question of what the money is given for. Essentially, the money can be given to the executive branch in order to purchase inputs—which entails “line-item budgeting”; or to produce specific outputs—which entails “output budgeting”; or to achieve certain outcomes from integrated programs of activities—which entails “program budgeting”. Each of these three different budgeting systems is described below. At least in principle, each of these three budgeting systems could be implemented on either a cash or a commitment basis.

**Line-item budgeting**

In a line-item budget, the money is allocated for the purchase of “objects”, i.e., the various types of goods and services. Thus, the resources provided to a ministry in the budget specify the amounts given to buy fuel for the ministry vehicles, furniture for its offices, services of its staff (salaries), etc., during the fiscal year. The ministry is thus accountable for the total expenditure as well as for assuring that the money is used to purchase the items for which it was allocated. Accordingly, line-item budgeting is optimal for aggregate expenditure control and fiscal discipline. However, ministries’ accountability for “performance” is limited to inputs. Therefore, line-item budgeting requires putting in place realistic complementary mechanisms if one wishes to ascertain what has been actually accomplished with the expenditures.

Line-item budgeting is essential for sound macroeconomic programming, protection of the public resources, expenditure control, and accountability for the resources. Nevertheless, line-item budgeting has been rightly criticized in many instances for serious inefficiencies arising from: (i) excessive detail of the classification, with inclusion of several thousand separate line-items; (ii) intrusive ex-ante controls on individual transactions; and (iii) rigid rules on transfers between line items. Excessive classification detail makes for unnecessary red tape, tends to focus the attention of the legislature on minor expenditures rather than the major items, and generates a temptation to micromanage. Detailed ex-ante controls are not only costly to administer, but also inefficient, since they dilute the accountability of budget managers. And rigid rules for transfers make it impossible for budget managers to adjust to changing circumstances. (These weaknesses are discussed in Chapters 9 and 10.)

Such inefficiencies, however, are not intrinsic to line-item budgeting as a system, but are related to specific modalities of its implementation—typically the result of an excessively detailed classi-
fication (as in India), or cumbersome allotment rules with tens of thousands of different items (as in Indonesia), or a confusion of administrative items and inputs (as in Tunisia). The obvious response is to address these inefficiencies—cutting the number of line items, streamlining the allotment rules, reducing ex ante controls, providing more flexibility—and not to jettison a budgeting system that works well for most countries in order to replace it with a different and complex budgeting system that is unsuitable to local realities and likely to lead to worse budgetary outcomes in terms of expenditure control, resource allocation, and operational management.

A major criticism of line-item budgeting as a system is that it cannot address key government objectives and their links to the budget, the services to be delivered, the search for the most efficient combination of inputs to deliver services, etc. In sum, line-item budgeting is concerned with the protection and modalities of spending the public money, but not what is achieved by it. Thus, since the early 1950s in both rich and poor countries, various “program budgeting” reforms attempted to address the question of the outcomes of public spending.

Output budgeting
In output budgeting, the resources are provided to produce specific goods and services. A quasi-contract is devised before the start of the fiscal year based on the outputs expected from the ministry or agency and their production cost. The money is then allocated on the basis of the contract, and the ministry is accountable for delivering at the end of the year the contracted products in accordance with the agreed specifications.

Output budgeting produces the tightest form of executive accountability for specific results, provided that the analytical, costing, contracting and monitoring capacities are highly developed throughout the government; governance quality is very high; corruption is low to minimal; and information is adequate, accurate and timely. Moreover, many government activities are not suited to funding on a unit-price basis in any country. Output budgeting is inapplicable to low- and middle-income countries, and most high-income countries that have considered the system have also decided against its introduction. It will not be discussed further in this book. (The interested reader is referred to Robinson, 2002.)

Program budgeting
An overview
Also sometimes called “performance budgeting”, the term program budgeting has been applied to a variety of approaches aimed at improving the prioritization of expenditure toward activities of greatest benefit to society. In “pure” program budgeting, the resources are provided to a ministry to finance packages of activities aimed at a common objective—including both investment and current expenditure and without any earmarking to specific objects. The ministry has flexibility to use the money for salaries, equipment, or goods and services in any manner it deems best to achieve the agreed programs objectives. Accordingly, the ministries are accountable for “performance” in terms of the progress achieved toward the outcomes of their various programs.

Among the prerequisites for program budgeting is the need to assure every year not only a consideration of new expenditure priorities but also a review of existing activities to identify what activities can be cut to provide “fiscal space” for the new priorities. Unlike output budgeting, some careful experimentation with aspects of program budgeting may yield positive results at an acceptable cost in a few African countries that have the necessary capacity—provided that it supplements rather than weakens the essential line-item, cash-based budgeting system. (Program budgeting is closely associated with the most elaborate variant of the “medium-term expenditure framework” (MTEF) discussed in Chapter 7.)

A thumbnail history
The first experience with program budgeting on a wide scale was launched in 1949 in the U.S., following the recommendations of the Hoover Commission. The 1951 U.S. budget included listings of the programs or activities by budget account and narrative statements of program and performance, some of them presenting workload and cost information, calculated on an accrual
basis. The experiment was a failure and the U.S. abandoned it soon thereafter. A “performance budgeting” experiment was launched in 1954 in the Philippines, following the U.S. example. Twelve government agencies adopted a performance budget model; detailed line items were abandoned and expenditures were presented in the budget by blocks corresponding to programs and projects. The system soon reverted back to the traditional model, as a result of the complexities of the “performance budget” and loss of expenditure control, although some of the presentational changes remained.

In the U.S., the Planning Programming Budgeting System (PPBS) was launched in 1965. PPBS aimed at ensuring a better linkage between objectives and goals, programs and activities. In the planning phase, systems analysis was used to establish the objectives and identify related solutions. At the programming stage, means were reviewed and compared to the solutions identified at the planning stage. Sets of activities are grouped into multi-year programs, which are appraised and compared. Finally, the budgeting phase translated these programs into the annual budget. The initial objective of PPBS was to integrate programs into budgetary decision-making and overcome administrative compartmentalization by making programs independent of organizational affiliation. It proved impossible to implement not only because of (predictable) bureaucratic resistance, but because reaching an indisputable “rational” organization of government objectives and activities is an illusion. In addition, this approach muddled up ministers responsibilities and hampered accountability.

In the late 1970s, another experiment—Zero-Based Budgeting (ZBB)—was attempted in the U.S. as a reaction to the drawbacks of purely incremental budgeting (see Chapter 9). In a pure ZBB system all programs are evaluated each year and must be justified from scratch—failing which they are zeroed-out. The logic is compelling: the plain fact that resources have already been granted to a program in the past does not necessarily mean that it must be continued—and only regular review can assure that obsolete programs or those that have not accomplished their goals do not continue to absorb public money. In practice, every program corresponds to a particular constituency and the assumption that it can be terminated on technical grounds is unrealistic. Also, the sheer amount of work and cost involved in reviewing and re-justifying the major programs is enormous and rarely justifies the savings to be achieved. Thus, the ZBB approach is useful for occasional expenditure reviews, but is practically impossible to undertake each year for the preparation of the annual budget. In actual fact, ZBB was accommodated by focusing scrutiny on a few marginal programs. In any event, the U.S. Congress decided to go back to the traditional budget presentation and put aside the voluminous and complex ZBB documentation.

Program budgeting and PPBS-like approaches were attempted over and over again in many developed countries in the late 1960s and the 1970s, generally not for long and largely abandoned in the 1980s. Program budgeting however, has witnessed a resurgence in this century, with the growing interest in the results of public spending rather than just the manner of spending.

In developing countries, attempts to introduce program budgeting and systems to manage were pursued in the 1980s in several Asian and Latin American countries—and a handful of African countries)—rarely taking into account the negative lessons of experience of the previous decade, and usually with the encouragement of international donors and enthusiastic endorsement of international consultants. Not surprisingly, actual experience proved unfavorable, and the initiative was sidelined and its role sharply reduced. On the positive side, the more recent experiences have contributed in some countries to improve the presentation of the budget.

In Africa, a 2009 decision of the Council of Ministers of the West Africa Economic and Monetary Union (WAEMU) replaced the 1997 directive on budgetary principles to be applied in member countries, based on the traditional approach to budgeting, with a new set of principles oriented toward program budgeting (Box 4.1). One wishes that such a fundamental reorientation in the budgeting system will be successful in leading to im-
Improvements in the main budgetary outcomes of fiscal discipline, strategic resource allocation, and operational and service efficiency. Unfortunately, such an outcome appears to be highly unlikely. First, as Tommasi (2010) argues, it is hard to imagine that such a demanding budgeting system will be implemented better than the simpler budgeting system in countries where the simpler system is not well implemented in the first place. More generally, all member countries lack some of the many and burdensome prerequisites for successful introduction of program budgeting (and some countries lack most of these requirements. See Box 4-2.) Even in developed countries where these requirements were met (e.g., France and Korea), the introduction of program budgeting has taken a large investment and sustained efforts over a long period of many years (Kim 2007).

The WAEMU directive includes certain restrictions—primarily, a limit of 10% on the total annual transfer of resources within programs. Also, in some countries, the wage bill is presented at ministry level while other expenditure categories are presented at departmental or divisional levels, making it difficult to calculate the costs of the different programs. These factors, while absolutely necessary for control and management, run counter to the logic of pure program budgeting—which calls for giving program managers unrestricted flexibility to implement the program, based on the agreed targets, and then to be accountable for their achievement or non-achievement.

It is possible that such initiatives may lead to a somewhat greater performance orientation by budget officials. However, as discussed below, there are ways in which more modest steps toward a programmatic approach in African countries where the capacity exists, can generate at much lower cost and risk both the necessary initial attention to the results of public spending and some accountability for performance.

**Introducing selected programmatic elements into the budgeting system**

The disappointments with program budgeting should not lead to rejecting useful attempts at introducing selected programmatic elements in the existing budget system. The disappointments have been associated with the expansive definition of “program”, and the related attempts to introduce a programmatic approach into the whole of government. An expansive definition (e.g., “rural health care”) calls for defining very

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**Box 4-1**

**Main aspects of the WAEMU program budgeting directive**

The following are the main provisions of the June 2009 directive:

- Financial resources are allocated to programs rather than to categories and objects of expenditure
- Authority for program implementation rests personally with the minister concerned (who, however, may delegate such authority to the program managers)
- Program managers determine the objectives of the program, allocate the resources, monitor the implementation, and assure internal management and financial controls
- A statement of expected results of each program is annexed to the annual budget, and a statement of actual results is submitted after the budget execution
- Multi-year budgetary and economic forecasts, on both the economy as a whole and on ministry and program accompany the draft budget, after previous debate in parliament.

*Source:* Adapted from Tommasi, 2010.
By contrast, the progressive introduction of selected programmatic elements in the existing budget system can best be attempted on the basis of the narrow definition of program: "a set of concrete activities designed for a common specific outcome", e.g., pre-natal maternal care. Piloting such narrower programs can generate much stronger accountability for results and stimulate operational efficiency. It is particularly consistent with a limited-capacity environment, and thus can be implemented selectively, gradually, with attention to unintended consequences and unnecessary red tape, and with the benefit of user feedback on service quality and access.
The problem occurs when a programmatic approach is forced onto an entire ministry that has barely enough capacity to carry on its routine business. This is what tends to happen with the “pilot ministry” approach that is often advocated. An entire ministry encompasses such a variety of diverse activities and subprograms as to make it impossible to attribute clear accountability for results and to learn from experience. Accountability must be individual if it is to be meaningful, and the best form of capacity development is learning by doing.

The logic of accountability for results and of capacity building calls for shifting the programmatic focus from an entire “pilot ministry” to small and specific “pilot subprograms”—comprising very few activities with a common objective. Most importantly, the approach opens the door to genuine voice by service users and citizens in general—adding to administrative accountability internal to the executive branch of government an element of social accountability (See Chapter 1). It does no good to elicit citizens’ views about an entire ministry because they don’t have the necessary information and their view would not carry much impact in any event. Users’ opinions and citizens’ voice are heard only when they relate to very specific services, particularly in countries without active and assertive civic organizations, as is the case with many African countries. This “learning and listening” approach to introducing specific programmatic elements in the budgeting system is developed further in Chapter 15 on the meaning and methodology of monitoring and evaluation.

**Unbundling the issue**

As noted, while there is only one “pure” program budgeting system, a number of partial variants can be identified. It is almost always more constructive to consider the full menu of possible improvements than to be trapped into an all-or-nothing binary choice between two incompatible systems. In that spirit, Shah and Shen (2007) offer the following useful taxonomy of what they call “performance budgeting” (in reality a virtual synonym of program budgeting). In ascending order of complexity, the four categories are:

» **Performance-reported budgeting** presents performance information as part of the budget documentation, which however is not used for allocation of resources;

» **Performance-informed budgeting**—in which information on results is taken into some account but only as a minor contributing factor;

» **Performance-based budgeting**—in which performance information plays an important role along with other factors but does not determine the amount of resources allocated; and

» **Performance-determined budgeting**—whereby the allocation of budgetary resources is directly and explicitly linked to performance units (the equivalent of full program budgeting).

**Budgeting systems in Africa: The bottom line**

The lessons of experience with PFM reform, combined with country circumstances, capacity-development needs and realities on the ground, lead to the following conclusion. For most African countries, the clear priority is to strengthen the cash-based, line-item budgeting system (including simplification where necessary), while progressively allowing greater flexibility for managing the budget and introducing some orientation toward results.
Budget classifications

Budget classification is another item that looks narrowly technical but is critically important for budgetary outcomes and public financial governance. Whatever the budget system, a uniform classification of expenditures consistent with international standards is a must to assure accountability of the executive vis-à-vis the legislature, as well as for analysis and day-to-day budget administration. What matters more than one or another form of classification is to have a classification that is uniform and applicable to all types of expenditures—however financed. It is easy to imagine how a haphazard and inconsistent classification of different kinds of expenditures would make it impossible to control commitments and payments—let alone to assure that the resources have gone to the intended sectors and have been managed efficiently. Unclear and/or heterogeneous classifications are also an excellent way for ill-intentioned people to hide their activities or simply steal the money. (A library “loses” books most often when they are mistakenly placed in the wrong shelf, not when they are actually taken out of the building.)

International standards for different budget classifications have been established by the U.N. and the International Monetary Fund, and are periodically reviewed to assure their continued relevance. The main classifications of expenditure are: (i) the economic classification, closely related to line-item budgeting; (ii) the functional classification, loosely related to the administrative organization of most governments; and (iii) the program classification.6

Clearly, the nature of the budget classification adopted is closely related to the budgeting sys-

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**Box 4-3**

**Abbreviated Economic Classification of Expenditure**

*Compensation of government employees* (Sometimes referred to as “the wage bill”)

*Use of goods and services* (Also referred to as “Operations and Maintenance”)

*Subsidies*
- To public enterprises
- Others

*Social benefits*
- Social security and social assistance
- Employer social benefits

*Interest*
- To foreign creditors
- To domestic creditors

*Capital*
- Capital expenditure (“Investment” — the change in the stock of capital)
- Capital grants

*Other* (Various expenses)

*Financing* (lending, repayment of loans, sales of public assets, new borrowing, etc.)
tem—in particular, line-item budgeting requires an economic classification, and program budgeting requires a functional classification. However, the basic uniform classification compatible with the budgeting system may be complemented by elements of another classification as needed to meet special additional reporting purposes and the interests of the various stakeholders.

**Economic and line-item classification**
The economic classification groups expenditures according to the type of resources used in government activity—the various factors of production: labor (salaries), capital (interest, investment), and materials (goods and services)—in addition to transfer payments such as subsidies. See Box 4-3.

An economic classification of expenditures is essential for fiscal policy and analysis of the budget. For example, civil service compensation must be based on correct information on the wage bill and on comparisons with other countries on the share of government expenditures absorbed by wages. Whatever economic classification is used in the country must be fully consistent with the Government Financial Statistics (GFS) classification developed by the IMF.

Closely related to the economic classification is the line-item classification, which underpins the line-item budgeting system discussed earlier. In addition to serving as a clear basis for allocation of expenditure in the budget, a classification oriented to inputs is required in any management system. For example, managers of spending units in the ministries need to monitor fuel and vehicle maintenance expenditure to prevent “disappearance” of the fuel or inoperable vehicles.

As noted, the line-item classification needs to be made compatible with the GFS economic classification. For goods and services, this usually requires only grouping the items in a manner to fit the GFS classification. Conversely, for other current expenditure items, it may be necessary to break down a line-item into several sub-items. There may be differences between capital expenditure as defined in GFS and the “development” expenditure used in several developing countries, which often includes items of current expenditure (some salaries and goods and services). Although it is possible to specify subcategories of capital expenditure in a manner that fits the circumstances and preferences of the particular country, a single basic economic classification is essential, covering both the current budget and the development budget and consistent with the GFS. Efficiency and transparency in public expenditure require the ability to compare and assess all expenditures against one another at the same time and on the same basis (as elaborated in Chapter 5).

**Functional and administrative classification**
While an economic classification groups expenditures according to the resources used in government activity, a functional classification groups expenditures according to the function or purpose they serve (e.g., education, housing, etc.). A functional classification is important to analyze the allocation of resources among sectors, to reorient government activity toward certain sectors (e.g., in conformity with a poverty reduction strategy), and to follow the historical development of government spending.

The U.N. Classification of the Functions of Government (COFOG) consists of 10 major groups, 69 groups and 147 sub groups. The major groups and most groups are widely used in African developing countries. It is advantageous for a country to adopt the COFOG instead of trying to develop a customized functional classification—since COFOG is well established and well documented. However, if a country adopts its own functional classification, it must develop a mapping table to allow going to/from COFOG and its own functional classification, in order to permit international comparisons. The 10 major groups of COFOG are shown in Box 4-4, with group 3 broken down as an illustration. The full list of 69 groups is shown in the Annex.

Just as there is a kinship between economic and line-item classifications, there is a general correspondence between functional and administrative classification. An administrative classification groups expenditure according to
the government organization responsible. Expenditures are therefore subdivided into separate sections for each ministry, department, etc. An administrative classification is needed for accountability, delegation of responsibility, and day-to-day budget management. There is always some correspondence between the administrative and functional classifications, but the two are rarely identical, as the administrative classification must fit the organizational architecture of the government and the different levels of responsibility and accountability in budget management. For example, while COFOG includes all tertiary education in the Education major group, in some countries responsibility for parts of tertiary education may be assigned to a ministry of science and technology.

Program classifications
A program classification does not replace but can complement and coexist with economic and functional classifications. The hierarchy of a program classification comprises: (i) functions, (ii) programs, (iii) activities, and (iv) cost elements. A “function” corresponds to a broad objective of the government (e.g., promotion of agriculture); a “program” is a set of activities that meet the same set of specific objectives (e.g., development of a new crop); an “activity” is a subdivision of a program into a homogenous category (e.g., irrigation for the new crop). There is no hard and fast rule on how to define and delimit “programs” and “activities”. The identification of “program” depends on the definition of the specific objective (as discussed in Chapter 7). In principle, the activity category is the level at which performance indicators can be elaborated and costs measured—but this level differs according to the performance indicators selected and costing detail. (Performance indicators and related issues are discussed in Chapter 15.)

The hierarchy of “function”, “program”, and “activity” is comparable to that of government structures (“ministry”, “department”, and “divisions”), but there is no systematic relationship between the program classification and the organizational structure of government. When the two are badly disconnected, problems of lack of “ownership” and loss of accountability arise. If responsibility for a particular program is not assigned to a specific unit or spans more than one

<table>
<thead>
<tr>
<th>Classification of the Functions of Government (COFOG)</th>
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<tbody>
<tr>
<td>01—General public services</td>
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<td>02—Defense</td>
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<td>03—Public order and safety</td>
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<tr>
<td>03.1—Police services</td>
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<td>03.2—Fire-protection services</td>
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<td>03.3—Law courts</td>
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<td>03.4—Prisons</td>
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<td>03.5—R&amp;D Public order and safety</td>
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<td>03.6—Public order and safety</td>
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<td>04—Economic affairs</td>
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<td>05—Environmental protection</td>
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<td>06—Housing and community amenities</td>
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<td>07—Health</td>
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<td>08—Recreation, culture and religion</td>
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<td>09—Education</td>
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<tr>
<td>10—Social protection</td>
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unit, it is impossible to assign authority and accountability. This suggests that the classification of functions, programs and activities should fit the administrative structure. Programs should thus be defined by the line ministries and, in a majority of cases, correspond to a major subdivision of the line ministry. Similarly, the classification of expenditure by activity cannot be prescribed from the top down, and must be prepared by the line ministries concerned for subsequent discussion with the Ministry of Finance. However, when the program classification is made to coincide exactly with the administrative structure, it risks becoming just a relabeling exercise—the vocational education department is renamed the vocational education program, its technical manuals division is renamed the technical manuals activity, etc—producing a lot of meetings, paperwork and consultant fees without any effective reorientation toward outcomes.

Thus, the challenge when introducing a program classification is to avoid both the extreme of an over-detailed classification that cannot be implemented and the opposite extreme of superimposing useless categories onto the existing classification system. A convenient alternative to introducing a whole new program classification is to use the COFOG itself as the programmatic classification, provided that it is supplemented by other expenditure categories dealing with special policy issues relevant to the country—e.g. a program for HIV/AIDS or for combatants’ reintegration). For these special cross-cutting issues inter-ministerial programs can be established. In such cases, it is important to assign “lead responsibility” to one ministry or agency, and specify the cooperation obligations of the other ministries concerned.

**Combining economic and functional classifications**

Because both economic and functional classifications are important for budget analysis and policy-making, the simple matrix in Table 4-2 which combines the major categories of the GFS and the COFOG can be useful to provide a snapshot of the main structure of the budget.

Table 4-2:
**A simple format for budget analysis and comparisons, FY 20XX**
*(In currency units and/or percent)*

<table>
<thead>
<tr>
<th>Economic Categories</th>
<th>Wages</th>
<th>Goods &amp; Services</th>
<th>Subsidies</th>
<th>Social benefits</th>
<th>Interest</th>
<th>Capital</th>
<th>Other</th>
<th>TOTAL</th>
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<td>General services</td>
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</tr>
</tbody>
</table>

*Source: Adapted from Tommasi, 2010*
ANNEX

Classification of the Functions of Government (COFOG)

01—General public services
  01.1—Executive and legislative organs, financial and fiscal affairs, external affairs
  01.2—Foreign economic aid
  01.3—General services
  01.4—Basic research
  01.5—R&D General public services
  01.6—General public services not elsewhere classified
  01.7—Public debt transactions
  01.8—Transfers of a general character between different levels of government

02—Defense
  02.1—Military defence
  02.2—Civil defence
  02.3—Foreign military aid
  02.4—R&D Defence
  02.5—Defence not elsewhere classified

03—Public order and safety
  03.1—Police services
  03.2—Fire-protection services
  03.3—Law courts
  03.4—Prisons
  03.5—R&D Public order and safety
  03.6—Public order and safety not elsewhere classified

04—Economic affairs
  04.1—General economic, commercial and labour affairs
  04.2—Agriculture, forestry, fishing and hunting
  04.3—Fuel and energy
  04.4—Mining, manufacturing and construction
  04.5—Transport
  04.6—Communication
  04.7—Other industries
  04.8—R&D Economic affairs
  04.9—Economic affairs not elsewhere classified

05—Environmental protection
  05.1—Waste management
  05.2—Waste water management
  05.3—Pollution abatement
  05.4—Protection of biodiversity and landscape
  05.5—R&D Environmental protection
  05.6—Environmental protection not elsewhere classified

06—Housing and community amenities
  06.1—Housing development
  06.2—Community development
  06.3—Water supply
  06.4—Street lighting
  06.5—R&D Housing and community amenities
  06.6—Housing and community amenities not elsewhere classified

07—Health
  07.1—Medical products, appliances and equipment
  07.2—Outpatient services
  07.3—Hospital services
  07.4—Public health services
  07.5—R&D Health
  07.6—Health not elsewhere classified

08—Recreation, culture and religion
  08.1—Recreational and sporting services
  08.2—Cultural services
  08.3—Broadcasting and publishing services
  08.4—Religious and other community services
  08.5—R&D Recreation, culture and religion
  08.6—Recreation, culture and religion not elsewhere classified

09—Education
  09.1—Pre-primary and primary education
  09.2—Secondary education
  09.3—Post-secondary non-tertiary education
  09.4—Tertiary education
  09.5—Education not definable by level
  09.6—Subsidiary services to education
  09.7—R&D Education
  09.8—Education not elsewhere classified

10—Social protection
  10.1—Sickness and disability
  10.2—Old age
  10.3—Survivors
  10.4—Family and children
  10.5—Unemployment
  10.6—Housing
  10.7—Social exclusion not elsewhere classified
  10.8—R&D Social protection
  10.9—Social protection not elsewhere classified
NOTES

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

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

3 There is also an accrual budget, whereby the legislature gives the executive the authority to cover the full costs of operations during the year—i.e., cost of goods consumed rather than purchased, including depreciation, changes in liability, and all other elements of budgeting and accounting that would apply in private enterprises. It is not discussed further in this book because it is not applicable to government except in less than a handful of highly advanced countries.

4 The U.S. Department of Defense still uses PPBS methodology. The extent to which this is a useful exercise is debatable. Certainly, the system does not appear to have eliminated duplication and waste.


6 A handful of advanced countries use a fourth classification, which distinguishes appropriations related to outputs from other appropriations. Thus, the New Zealand budget has seven classes of appropriation: (i) output classes (e.g., policy advice, management of contracts, policing, custodial services, etc.; (ii) benefits (e.g., unemployment, scholarships) (iii) borrowing expenses; (iv) other expenses (e.g., legal costs, overseas development aid; (v) capital contributions, to ministries or public enterprises; (vi) purchase and development, of highways, buildings, etc. and (vii) debt repayment. Benefits and capital contributions are appropriated on a cash basis and borrowing expenses on an accrual basis—as in most other countries—but all outputs are appropriated on an accrual basis. As noted, output budgeting is not discussed in detail in this book.
Chapter 5:

Budget Coverage, Fiscal Risk and Legal Framework
What to Expect

The chapter explains the need for a comprehensive budget and its connection to the efficiency of expenditure as well as the executive-legislative balance of power. It also addresses issues of revenue earmarking, tax expenditure, and user charges. The provisions for controlling quasi-fiscal activities and contingent liabilities are discussed next, as part of the need to mitigate fiscal risk and encourage public integrity. Finally, the chapter provides an outline of the key provisions to be included in an “organic budget law” or a similar legal instrument to regulate the management of public finances.

The basic principle: Unity of the budget

Given that public money should be spent only under the law, the budget should be as comprehensive as possible. Moreover, if major expenditure is excluded, it is impossible to compare the relative costs and benefits of different proposed expenditure programs and thus allocation to priority programs cannot be assured, accountability is weakened, and the actual expenditure itself is uncertain.

If it includes only a small proportion of revenue and expenditure, it is clearly impossible for the government budget to financially mirror the preferences and choices of society and incorporate the principles of good governance. In this case, the legislature would be able to review and approve only some of the activities for which public monies are spent. Lack of information on the other expenditure may lead to abuses of executive power: it provides a large opening for corruption and large-scale theft of public resources.

Two major issues are involved. First, if the budget excludes major expenditure, there can be no assurance that scarce resources are appropriately allocated to priority programs and that legal control and public accountability are properly enforced. Only if all proposed expenditures are on the table at the same time does it become possible to review them in relation to one another and to choose those that have higher relative benefits for the community. Second, the amount of expenditures that are not included is itself often uncertain and opaque. In turn, this uncertainty makes macroeconomic programming more difficult and increases the risk of corruption and waste. Imagine that, as the head of a household, you have large sources of income in addition to your salary but discuss with your family the allocation of only your salary. At best, even if the additional income is allocated well, family members cannot cooperate in making sure that it is spent well, nor can they feel any responsibility for mistakes in this respect. At worst, the additional income will be frittered away on frivolous expenditure, with adverse impact on the family’s future finances and well-being.

For all these reasons, the budget should in principle cover all transactions financed through public financial resources. Budget comprehensiveness does not mean that all expenditure should be managed according to the same set of procedures. In practice, as discussed in Chapter 6, certain categories of transactions may need to be administered separately from the overall government budget. For efficiency, specific arrangements may be established for administering some programs financed through public resources, provided that they are not allowed to lead to a fragmented approach to budgeting and expenditure policy formulation.
Coverage, periodicity, and basic budget rules

The coverage of the budget
The coverage of the budget naturally depends on the scope of activities of the government, as decided, directly and indirectly, by the society it represents. Whatever revenue and expenditure are included in the budget, it is important to review them and present them together. Government policy objectives can be achieved through tax policy, public expenditure policy, or a combination of the two. Therefore, direct comparisons are needed of the costs and benefits of alternative revenue and expenditure packages. Moreover, a sound program of public expenditure requires as a starting point a realistic estimate of revenue. This is because the choices among different expenditure proposals, choices that are at the center of the budgeting process, cannot be made without a clear idea of how much money is likely to be available. An expenditure program that does not conform to a realistic limit on resources available is a wish list, not a program, and the budget that contains it is only a bulky paper document. That said, this chapter focuses on the expenditure side.

The annuality of the budget
Obviously, the legislature’s approval to collect revenue and spend it cannot be given on a weekly or monthly basis, or for an indefinite period of time. In almost all countries, the budget covers 12 months and both the government’s revenue-collecting authority and its spending authorization expire at the end of the fiscal year. (This fiscal, or financial, year is usually but not always the calendar year.) The annuality rule is justified both by the need for legislative control of the executive and—especially in developing countries—by fluid economic circumstances, which would make budgeting for two or more years totally impractical. The annual nature of the budget is often confused with the multiyear periodicity of the medium-term expenditure frameworks (MTEFs) used in many countries to frame the annual budget process. It is important to keep in mind the distinction between the legislative authorization to spend, which covers only one fiscal year, and the multiyear forecasts and intentions of the MTEF. There is no such thing as a multiyear budget anywhere in the developing world.

The levels of the budget
In principle, fiscal targets should cover “general government”, which includes all government authorities and their instrumentalities and comprises three categories:

» Central government includes all governmental departments, establishments, and other bodies that are instruments of the central authority of a country, plus the extensions of central government authority that operate at the regional or local level but lack the attributes necessary for existence as separate government units.

» Local government consists of governmental units that exercise independent competence in the various urban and rural jurisdictions of a country’s territory, including counties, cities, towns, school districts, and the like. An entity is treated as local government only if it is entitled to own assets and raise funds, has some discretion in its spending, and is able to appoint its own officers independent of external administration. These are the key differences between decentralization, which entails devolution of policy authority, and deconcentration, by which the authority of the center is exercised more effectively through local entities acting as agents of the central government.

» State governments are intermediate subnational entities in federal countries (for example, Australia, India, and Nigeria). In unitary countries, the intermediate level of government is usually called a province.

For decentralized or autonomous agencies, the nature of their function and the source of their
authority are the criteria for deciding at which level of government they belong. For example, a hospital managed by the central ministry of health is part of the central government no matter where it is located. Remember that accountability is the key.

The basic principle of national budgeting is that each level of the government should have its own budget to cover its own sphere of activity and responsibility. Most countries, including those in Africa, generally have and enforce clear revenue and expenditure assignments. However, in a few African countries (and in several transition economies of the former Soviet Union), the division of revenue and expenditure responsibilities is either unclear or not observed in practice: parallel systems of revenue collection or of informal expenditure are superimposed on the formal systems. In these cases, the distribution of responsibilities among the different levels of the government must be clarified, because stable and transparent arrangements are needed to ensure respect in practice.

A sound analysis of a country’s fiscal stance and prospects calls for looking at general government rather than only the central government. Indeed, attention to central government generates the temptation to devolve fiscal difficulties onto subnational levels of government, decentralizing expenditure responsibilities without decentralizing the revenue to go with them. This devolving masks real problems for some time, until they surface in more virulent form owing to the lack of policy attention. The risk is especially acute in African countries, where fiscal data from levels of government below the central government may not be available in a timely and reliable fashion. Attempts should be made to estimate the fiscal situation of subnational government entities, even if approximately and for internal use by the executive branch, when assessing the overall state of the public finances.

The public sector includes general government plus all entities that are majority owned by the government, such as state-owned enterprises or state financial institutions. In market economies, state enterprises should be commercially oriented and thus have a separate legal persona and full operational autonomy. As such, their expenditures and revenues cannot be submitted to the same scrutiny and approval mechanisms as the government budget. The government budget should therefore include the financial transactions between the state enterprises and the government but not their transactions with the rest of the economy, for which the government is not directly responsible. However, a financial approach should be developed for the public sector as a whole. Thus, the budget can show the consolidated account of the public sector (sometimes called the consolidated budget, although it does not have the legal status of the government budget itself, because it is not formally approved by the legislature) in a table presented for information. In any event, for accountability and transparency, the government should report regularly on the performance and financial situation of both financial and nonfinancial state enterprises, in addition of course to the transactions of the government itself.

The basic budgetary rules
Because the budget, as noted, should be the mirror of society’s choices, the expenditure management mechanism should include strong links between the policies decided by government and the budget which is intended to implement them. To successfully link revenues and expenditure allocations to government policies, the budget must follow a number of practical rules that apply to every program financed in whole or in part by public resources, and its coverage must be as comprehensive as possible.

The basic rules of budget presentation and classifications are as follows:

- Estimates of revenue and expenditures should be shown in the budget in gross terms. Netting out these estimates would give a misleading impression of the importance of the transactions—as when a very small net surplus hides huge expenditures and slightly larger revenues and thus prevents appropriate scrutiny of the transactions.
- Expenditures and revenues should be classified on the same basis as the overall budget,
to permit comparisons of relative efficiency and for accountability.

- All accounts must be subject to regular external audit.
- Financial reports of government activities should consolidate the operations of autonomous funds and agencies with regular budget operations.

The imperative to avoid “black boxes” and parallel budgets

In many countries, a significant share of public expenditure is managed through special arrangements that are set up outside the annual budget appropriations process. These are known as “extra-budgetary funds”, discussed in the next chapter, and should not be confused with the more troublesome practices of hiding revenues or setting up secret expenditure accounts. While there may be good reasons for setting up an extra-budgetary fund, there none for secret expenditure accounts.

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

In many countries, there is also a general tendency to allocate windfall revenues and some non-tax revenues to particular programs. This tendency hampers adequate prioritization of expenditure programs. From a fiscal sustainability viewpoint, the optimal (and safest) use of windfall revenues is to pay off the more expensive types of debt in the government’s portfolio. Under unusual circumstances and for specified and basic human needs (such as drought relief and crash vaccination programs), it may be appropriate to assign windfall revenues to those needs. Before the actual expenditures are made, however, sound and well-designed administrative arrangements must be in place.

Beyond direct expenditure

As mentioned in Chapter 1, a number of government objectives can be achieved without direct and immediate government spending, and the corresponding activities are thus not within the scope of the government budget. Nonetheless, they have important fiscal and financial implications for the country. We discuss first the category that is most relevant to African developing countries, for its significant potential as a policy instrument and also as a source of substantial fiscal and governance risks: government loan guarantees and other contingent liabilities.

Fiscal risk

In addition to legal commitments, governments have other explicit or implicit commitments that can have an immediate or future fiscal impact. Fiscal risks and uncertainties are increasing. The international integration of financial markets generates more abundant, rapid, and volatile cross-border flows and governments may become obliged to intervene to support the financial system. State guarantees and insurance schemes have become common. Privatization is often accompanied by implicit or explicit state guarantees.
Government liabilities can therefore be certain or uncertain (contingent), and explicit or implicit. In descending order of fiscal predictability, these liabilities are as follows:

» **Explicit liabilities and commitments** are legally mandatory and predictable. This category includes budgeted expenditure programs, multiyear investment contracts, civil service salaries, pensions, and debt obligations.

» **Explicit and contingent liabilities** are legal or contractual obligations triggered by a discrete event that may or may not occur. This category includes, for example, state guarantees for loans contracted by entities outside central government (subnational governments, public and private enterprises) and state insurance schemes (for banking deposits, floods, crop damage, and the like). Often the probability of the event that will trigger the guarantee is high, because these guarantees are typically granted to support ailing enterprises or sectors in difficulties.

» **Implicit liabilities** represent obligations or expected burdens for the government that are not contractual or prescribed by law but arise from public expectations. For example, governments are expected to maintain public infrastructure and to support a social security scheme, even when they are not strictly required to do so by law.

» **Implicit and contingent liabilities** are the least predictable category, representing a non-legal obligation triggered by a discrete event that may or may not occur. For example, the government is generally expected to intervene if the banking sector risks bankruptcy or the country faces a natural catastrophe. (The tragic earthquakes in Haiti in 2010 and Japan in 2011 are dramatic cases in point.)

Generally in budgeting, decision-making focuses on expenditure programs and on multiyear legal commitments, such as debt servicing. In most countries, no attention is paid in the budget to other long-term obligations or to implicit or contingent liabilities. When a country faces financial difficulties or is undergoing fiscal adjustment, it often tends to overlook non-immediate or non-explicit fiscal risks. Sometimes, to solve immediate problems, the country develops an evasion strategy of substituting contingent liabilities for direct spending or making promises for the future. This tendency makes future problems worse than they would have been had the risks been confronted in the first place.

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

Sound budgeting and policy formulation requires a wider approach, covering the fiscal risks governments face in the short term as well as in the long term. Good methodologies are needed, especially actuarial ones. Most important, however, are political determination, leadership, and effective communication of the fiscal realities to the public. Accordingly, the obligations arising from current or new expenditure programs and policy measures must be assessed realistically, whatever their nature (implicit or explicit, direct or contingent). Explicit liabilities, both actual and contingent, should be disclosed in the budget documentation. Implicit contingent liabilities, by definition, cannot be quantified or predicted accurately; however, the reality of their existence should add to efforts at fiscal prudence, and decision-making mechanisms should be in place to permit rapid and efficient response if and when such an event occurs.

Certain instruments reviewed later in this book can help in this assessment and disclosure. For example, multiyear expenditure forecasts permit governments to assess the fiscal sustainability of ongoing policy commitments over a medium-term period, as well as some implicit liabilities (such as the recurrent costs of investment projects). However, these instruments are nei-
ther necessary nor sufficient for assessing fiscal risk. The key requirements are as follows:

- Awareness of the existence of fiscal risks;
- Some form of assessment;
- Full disclosure;
- Explicit consideration of major fiscal risks during the budgeting process.

Table 5.1 illustrates the types of fiscal risk and possible mitigation measures. In general, transparency, candor, and good judgment can go a long way to help recognize and address fiscal risk.

Table 5.1: Dealing with Liabilities and Fiscal Risks

<table>
<thead>
<tr>
<th>Liabilities and risks</th>
<th>Possible measures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Explicit liabilities and commitments</strong></td>
<td></td>
</tr>
<tr>
<td>Budgetary outlays</td>
<td>Budget</td>
</tr>
<tr>
<td>Debt</td>
<td>Debt accounting</td>
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<tr>
<td>Data annexed to budget</td>
<td></td>
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<tr>
<td>Entitlements</td>
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<tr>
<td>Salaries</td>
<td>Multiyear expenditure programs</td>
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<tr>
<td>Pension liabilities</td>
<td>Modified accrual accounting</td>
</tr>
<tr>
<td><strong>Explicit and contingent liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Loan guarantees</td>
<td>Disclosure in financial reports and the budget</td>
</tr>
<tr>
<td>Assessment of risk of default</td>
<td></td>
</tr>
<tr>
<td>State insurance schemes (for floods, crop failure, and so forth)</td>
<td>Actuarial assessment of risk of event</td>
</tr>
<tr>
<td><strong>Implicit liabilities</strong></td>
<td></td>
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<tr>
<td>Forward costs of ongoing programs</td>
<td>Multiyear expenditure programs</td>
</tr>
<tr>
<td>Recurrent costs of investment projects</td>
<td>Public investment program</td>
</tr>
<tr>
<td>Hidden liabilities (for example, pensions in public enterprises)</td>
<td>Projections and actuarial assessment</td>
</tr>
<tr>
<td>Future health and social security financing</td>
<td>Projections and actuarial assessment</td>
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<tr>
<td><strong>Implicit and contingent liabilities</strong></td>
<td></td>
</tr>
<tr>
<td>Local government and public enterprise debts</td>
<td>Consolidated accounts and financial reports</td>
</tr>
<tr>
<td>Financial sector risks</td>
<td>Qualitative assessment and continuous dialogue with financial institutions</td>
</tr>
<tr>
<td>Social welfare</td>
<td>Qualitative assessment and continuous dialogue with main stakeholders</td>
</tr>
<tr>
<td>Environmental or natural catastrophe</td>
<td>Simulations of nature and range of damage</td>
</tr>
</tbody>
</table>

Note: The list is illustrative, not exhaustive.
Loans guarantees

The most common explicit contingent liability is a loan guarantee. The government can guarantee loans contracted by agencies, enterprises, and other autonomous agencies under its broad control as well as loans to private corporations in selected situations—whether from domestic or foreign sources of financing. In general, loans to nongovernment entities by international financial institutions such as the AfDB require a government guarantee.

Although guarantees have long been recognized as an appropriate government instrument, they can carry a significant risk to fiscal deficits, sustainability, and vulnerability. This impact became evident from the experience of many countries in Latin America and Africa in the 1980s, where borrowers defaulted on most loans. The government naturally had to assume debt servicing and repayment of those loans, thereby adding a lasting burden to an already stretched budget.

In general, government guarantees are justified if the purposes of the loan guarantee are consistent with government objectives and policies and the borrower lacks the required creditworthiness (or if its limited creditworthiness entails high borrowing costs). When imperfect information gives potential lenders an inadequate picture of a borrower’s creditworthiness, government guarantees serve to redress the market distortion, and are appropriate from both an economic and a policy viewpoint. In practice, however, government loan guarantees are too often granted without an assessment of the capacity of the beneficiary entity to reimburse the loan or as favors to well-connected borrowers. Moreover, they are not systematically recorded.

The expenditure equivalent of guarantees is difficult to estimate without a long series of data on the frequency of loan defaults. However, the budget should at a minimum include a list of the loan guarantees that the government intends to grant, and an aggregate monetary ceiling for those guarantees. In several countries, the government levies a fee when it guarantees loans. This procedure presents the advantage of automatically creating a mechanism for registration and monitoring, and it also constitutes to some extent an insurance payment in case of default. If the guarantee fee is proportionate to the risk of default (and the risk is assessed correctly), the fees will, in the aggregate, suffice to cover the eventual cost of defaults. (Of course, the implicit subsidy element will then disappear, but the purpose of loan guarantees is to offset lack of creditworthiness, not to subsidize credit.)

Effective budgeting calls for tight management of guarantees, including the following. First, include a mechanism to compel consideration of the implications of each proposed guarantee and allow the subsidy element in such guarantees to be calculated. Second, procedural safeguards should minimize the adverse impact of guarantees on the fiscal position. Third, the financial performance of the recipients of guarantees should be monitored. Fourth, there should be sufficient scrutiny and accountability to prevent the misuse of this instrument. And finally, the maximum possible transparency should be assured.

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

Finally, monitoring of guarantees, in parallel with the budget system, would require a periodic review and anticipate possible defaults and ways of financing them. An initial important step would be publication of data on guarantees as parts of both the budgetary information and the completed accounts of the government.
**Quasi-fiscal activities**

Quasi-fiscal activities are financial transactions undertaken by the central bank or state-owned banks to achieve government policy goals (Mackenzie and Stella 1996). These operations include interest rate subsidies, support for ailing enterprises and financial institutions, payment of government debt, and financing of exchange rate losses incurred by the government. Accomplishing the desired goal through transparent subsidies in the budget rather than through quasi-fiscal operations is generally preferable. Also, a country’s monetary authorities should concentrate on monetary policy and operations: they should not get involved in activities that in effect substitute for fiscal operations through the budget. In any case, the quasi-fiscal operations of the central bank and other banking institutions should be scrutinized, as should direct government expenditure programs, and should be shown in the budget documents. At a minimum, a statement on the quasi-fiscal activities of the banking sector should be annexed to the budget. The production of transparent accounts from the central bank is also important, because estimating the cost of quasi-fiscal operations is not a simple matter.

**Government lending**

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

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

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

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

- Because lending must be traded off against expenditure decisions, the lending program should be reviewed together with the expenditure programs during budget preparation.
- Loans should be included in the budget, with full explanations of their terms, and submitted for the authorization of the legislature.
- Interest subsidies must always be budgeted as expenditures. Two approaches may be considered: (a) budgeting the discounted value of the subsidies when the loan is granted (as in the United States) or (b) budgeting the subsidy according to the interest schedule. The first approach is preferable, because the subsidy is budgeted in the year the decision is made, but this approach requires adequate technical capacity in financial analysis and accounting.
- To ensure accountability and allow review of lending programs together with expenditure programs, lending must be included in gross terms in the budget.

**Tax expenditures**

Tax expenditures are defined as the revenue forgone because of preferential tax provisions. Like government lending and any other instrument of fiscal policy, they should be transparent and included in the budget. Tax expenditures cover the following:
Chapter 5: Budget Coverage, Fiscal Risk and Legal Framework

Exemptions, which exclude the revenues of a group of taxpayers from the tax base;

Deductions, which reduce the tax base by some expenses or a lump sum;

Credits, which are deducted from the tax due (as opposed to deductions, which reduce taxable income);

Deferrals or postponements of the deadline to pay taxes, without interest or penalties;

Reduced tax rates for certain categories of taxpayers or activities.

Tax expenditure is aimed at achieving certain public policy objectives by providing benefits to qualified individuals or entities or by encouraging particular activities. They may also be intended to improve tax equity or offset imperfections in other parts of the tax structure. The same set of objectives (for example, financial assistance to families) can be achieved either through direct spending or through tax waivers or exemptions. In principle, spending a given amount is exactly equivalent to reducing the tax on the beneficiary by the same amount. In practice, tax expenditures and direct expenditures are handled separately.

To determine whether a particular tax measure generates tax expenditure, it is necessary first to identify the normal tax structure from which the measure departs. Such identification is relatively easy when the tax expenditure corresponds to specific exemptions (for example, a special income tax rate for agriculture activities). However, when the whole tax structure is affected (for example, differentiated income tax rate according

Box 5.1

**Morocco: Reporting on Tax Expenditure**

In 2005, the government of Morocco prepared a report on tax expenditure, which was included in the budget document. The report is organized as follows:

- Chapter 1 presents the methodology used to estimate the tax expenditure:
  - Definition of the scope of the study
  - Definition of the baseline for each main category of taxes: (a) corporate income tax, (b) individual income tax, (c) value added tax, (d) registration fees, (e) customs duties, and (f) excise taxes
  - Definition of the methodology for estimating the tax expenditure

- Chapter 2 presents the tax expenditure estimates. It includes both summary and detailed presentations of tax expenditure according to the tax category
  - The economic activity that benefits from the tax expenditure
  - The objectives that the tax expenditure aims to achieve (for example, promoting access to housing, encouraging teaching)
  - The beneficiary group (enterprises, households, international organizations, and so on)

The 2005 report identified 337 exceptional measures that depart from the normal structure. The total tax expenditure related to 102 of these measures that have the most significant impact accounted for 3.4 percent of gross domestic product and 15.7 percent of collected taxes in 2004.

*Source: Ministère des Finances et de la Privatisation 2005.*
to family status), the existence of tax expenditure may be debated. There is also debate about the methodology for assessing the impact (impact is the customary technical term) of tax expenditure, because some tax expenditure may have an impact different from that of direct spending if changes in the behavior of taxpayers are taken into account.

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

Tax expenditure should be subject to an explicit tradeoff against new spending initiatives and should be as transparent as possible. Ideally, as for government lending, the direct impact of tax expenditure should be budgeted in gross terms. This procedure is possible for tax expenditure that is easy to measure and monitor (such as tax refunds or tax offsets granted according to the provisions of a contract). However, because measuring most tax expenditure is difficult, this approach cannot be generalized.

Even though explicit budgeting of tax expenditure can be considered only in specific cases, an assessment should be included in the regular process of budget decision-making. For this purpose, a statement of tax expenditure should be produced regularly, to allow a review of tax expenditure policy during budget preparation and to make tradeoffs between tax expenditure and direct spending. Some industrial countries (for example, Belgium, France, and the United States) append such a statement to the budget document. This approach enhances legislative scrutiny of government policy. Periodic reports on tax expenditure are also useful, as done in Morocco (Box 5-1).

The legal framework

Because the budget is a fundamental legal instrument and the rule of law is a pillar of good governance, the budgetary principles and rules must be codified—in a form appropriate to the legal and administrative culture of the country concerned.

A hierarchy of laws

Depending on their importance, the budget principles and rules can be enshrined in descending order of legal hierarchy, in the constitution, a framework law, other laws and regulations, administrative instructions and circulars, and—of course—the annual budget law. These are the general criteria:

» It should be difficult to modify the basic rules, but easy to modify the detailed rules, because they are likely to require frequent modifications as circumstances change.

» Effective legal changes require consultation with the key stakeholders, because unenforced law is no law at all and the effectiveness of enforcement depends largely on the voluntary cooperation of those affected.
Therefore, only the most fundamental principles should find their way into the country’s constitution, in which changes are designed to be very difficult to make. Subject to and consistent with those fundamental principles, a framework law—often called an organic budget law—contains the basic rules for managing public finances, allocating powers and accountabilities, providing financial oversight, and the like. Subsidiary legislation will then regulate implementation of the organic budget law and define the operational parameters. Administrative budget instructions follow in the legal hierarchy, primarily instructions to formulate the macroeconomic and fiscal framework and the budget circular that starts the budget preparation process. Finally, provisions and resource allocations for the coming fiscal year are incorporated in the annual budget law that is presented to the legislature and in supplemental allocations or other amendments during the course of the year.

A basic public financial management law (PFML)

The contents

Generally, a PFML (also called “organic budget law”) defines four things:

» The objectives of public financial management—fiscal control, strategic resource allocation, operational effectiveness, service orientation;
» The principles—accountability, integrity, transparency, compliance with rules, participation;
» The process—budget preparation, execution, reporting, and audit;
» The responsibilities—of whom, for what, how, and when at various stages in the process—primarily the division of powers between the executive and the legislature, although both are jointly accountable vis-à-vis the population.

Specifically, the basic law should contain the following elements:

» An introduction stating the objectives and principles;
» Definitions, including a definition of fiscal deficit;
» General provisions, such as the basis of accounting and financial reporting;
» Rules of budget coverage and presentation, including treatment of extra-budgetary funds and fiscal risks;
» Stages and rules for budget preparation;
» Procedures for budget debate, approval, and legislative amendment;
» Stages and rules for budget execution, including commitment and payment regulations, internal control, monitoring, and evaluation;
» Principles and rules of external audit;
» Accountability provisions;
» Relations with local government.

The key principles

The following statement of the fundamental principles of good governance and of public finance, to be included in the first section of a PFML, also recapitulates the major points made in this chapter:

» No moneys to be collected from natural or legal persons, nor any moneys expended, nor services provided, nor exemptions granted, except as duly authorized by the law and other legal instruments;
» Transparency of fiscal and service information, requiring not only openness but an affirmative effort to provide to the public in usable form the basic budgetary information and government plans and programs, in accordance with international standards on fiscal transparency;
» Conformity of fiscal policy with macro-economic and social objectives, requiring, among other things, the placement of the annual budget process in a multiyear perspective;
» Individual responsibility of ministers, heads of agencies, and other senior managers for the acquisition, use, accounting, and reporting of public resources and for the taking of necessary measures to prevent abuses of such resources;
» Equal obligation of all government employees to comply with the rules and regulations.
of public financial management, and equal application of sanctions to violators of said rules;

» Maximum feasible participation by government employees, members of the legislature, and other concerned persons, in the budget preparation and budget execution process, as may be appropriate and realistic;

» Public financial management conducted to ensure expenditure control, efficient resource use, effective service provision, and high integrity;

» Unity of the budget and the treasury, mainly to allow comparisons of the relative effectiveness of different types of proposed expenditures;

» Conformity with or progress toward accepted international standards in budget preparation and execution, financial management and control, and audit.

Box 5.2 shows the contents of a basic budget law in an African country.

Box 5.2: Contents of an Organic Budget Law: Illustration from a Francophone African country

Part I General Provisions
Articles 1+2 Object of the Organic Law and Definitions
Articles 3+4 The Scope of the Law and General Guiding Principles
Article 5 Establishment, Coverage, and Control of the Consolidated Fund
Article 6 Withdrawals from the Consolidated Fund

Part II Powers for Budget Management
Article 7 Powers of Parliament, Local Government Councils, and Other Public Bodies.
Article 8 Powers and Responsibilities of the Council of Ministers
Article 9 General Responsibilities of the Minister
Articles 10+11 Specific Powers of the Minister and Powers of the Minister to Delegate Authority
Article 12 Powers and General Responsibilities of the Secretary General and Treasury Secretary
Article 13 Specific Powers of the Secretary to the Treasury
Article 14 Powers and Missions of Budget Managers
Article 15 Delegation of Budget Managers’ Responsibilities
Article 16 Powers and Duties of Local Government Councils

Part III Preparation, Presentation, and Approval of Budgets
Article 17+18 Revenues and Expenditures
Article 19 Unforeseen Expenditures for Emergencies
Article 20 Deficit or Surplus
Article 21 Estimation of Revenue of the Central Government and Local Governments
Article 22 Estimation of Expenditure of the Central Government and Local Governments
Article 23+24 Documentation for the Annual Budget and Budget Annexes
Article 25 Approval of the Central Government and Local Government Budgets
Article 26 Supplementary Budgets
### Box 5.2, continued

**Part IV  Budget Execution**  
Articles 27+28  Authorization to Spend Appropriations and Authority to Limit Appropriations  
Article 29  Expenditure before the Annual Budget Is Passed  
Article 30  Virement of Central Government Expenditures

**Part V  Government Borrowing, Debt Management, and Banking Arrangements**  
Article 31  Authority to Borrow  
Article 32  Debt Payments  
Article 33  Limits for Borrowing  
Articles 34+35  Purposes and Types of Borrowing and Powers to Modify Debt Agreements  
Article 36  Lending and Equity Participation  
Article 37  Recordkeeping  
Article 38  Publication of Debt Strategy and Debt-Related Transactions  
Article 39  Collaboration and Agreement with the Central Bank  
Article 40  Banking Mechanisms, Collection, and Custody of Public Money  
Article 41  Investment of Surplus Balances of the Treasury Single Account

**Part VI  Accounting, Reporting, and Auditing**  
Article 42  Uniform Accounting Standards for the State  
Article 43  In-Year Reporting on Budget Execution  
Article 44  Review of Reports by Cabinet  
Article 45  Closure of Annual Accounts  
Article 46  Preparation and Submission of Annual Accounts and Annual Reports  
Article 47  Format of Annual Accounts and Annual Reports  
Article 48  Coverage of Annual Report and its Publication  
Article 49  External Audit  
Part VII  FINAL PROVISIONS  
Article 50  Penal Provisions  
Article 51  Transitional Provisions
NOTES

1 In centrally planned economies, the distinction between the activities of state enterprises and those of government is fuzzy, because state enterprises are also heavily involved in the delivery of public services. The virtual disappearance from Africa of the centrally planned mode of economic management restores the need to differentiate between activities carried out by the government and those carried out by publicly owned but autonomous entities that presumably are managed on commercial principles.

2 This section is based largely on the original taxonomy by Hana Polackova-Brixi, first outlined in Polackova (1998) and then elaborated in Polackova-Brixi and Schick, 2002.
Chapter 6:

Extra Budgetary Funds
What to expect

With the continuing importance of foreign aid, the need for special management arrangements in this and other areas of public expenditure is common in most countries. The chapter defines “extra budgetary” funds (EBFs) and lists the good, doubtful and bad reasons for their establishment. Pragmatic advice is provided on how to minimize the risks associated with EBFs while improving their use in practice—with particular reference to the oldest and largest of such funds, the “road funds” established in many countries to assure financing of road maintenance.

The Issue

As many government expenditures as possible should be included in the formal government budget to be presented for approval by the legislature. To the extent that certain government transactions cannot be approved annually, adequate information must be presented to the legislature at the same time as the formal government budget. Even when the annual budget is reasonably comprehensive, it does not include a variety of expenditure—the principal category of which is known as “extra budgetary funds”. These funds are not extra budgetary in the sense that they need not be approved by the legislature, but in the more limited sense that their operations need not be approved every year. Usually, this is related to the nature of the organization (e.g., public universities) or special requirements for management (e.g., donor-funded projects accounts.) The legislature, however, needs to have the information on the operations of extra budgetary funds—raising the important distinction between the formal budget, of which legislative approval is required, and the more extensive budget documentation that includes the budget itself and other information that should be presented to the legislature.

What is an extra budgetary fund?

In many countries, a significant share of public expenditure is managed through special arrangements outside the normal budgetary management arrangements. These special arrangements, which are known as extra budgetary funds (EBFs), are used, for example, when existing budgetary procedures are inappropriate for managing particular types of activity, when such procedures do not allow spending agencies to use revenues from cost recovery, or when certain priority expenditure need protection. In the definition provided by the IMF Code of Fiscal Transparency, EBFs are government operations that are set up outside the annual budget appropriations process.

The dividing line is thus clear: if transactions involving public financial resources are not subject to the same legislative approval process as the annual budget, they are “outside” the budget. However, they are not outside the bounds of legislative authority and oversight. The fundamental requirement of authorization by the people’s representatives is still met if the legislature approves the establishment of the EB, provided that: (a) the delegation of revenue and spending authority is made for specific purposes and under clear criteria; (b) EBF governance arrangements are satisfactory and explicit; and (c) transparent information on the financial operations of the EBF is regularly included in the annual budget documentation, although it is not subject to annual approval.

Reasons for creating EBFs

The reasons for creating EBFs depend on the country. Some reasons are valid, others questionable,
and still other reasons unacceptable. EBFs may be created to protect priority expenditure from budget cuts, to avoid implementation problems in budget execution, to sidestep some appropriation management rules in the interest of powerful politicians or lobbies, to insulate donors’ projects and programs in priority sectors at their request, and in some cases, to hide transactions from public or legislative scrutiny—usually to permit theft and abuse. Specifically, there are four main categories of reasons to create EBFs:

» To bypass budgetary procedures when the procedures are not suitable to a particular category of expenditure. In many African countries, traditional appropriation rules such as “virements” (transfers between line items) or the cancellation of appropriations at the end of the fiscal year, are too rigid for efficient management of certain types of programs. EBFs may be acceptable alternatives; however, the optimal response would instead be to introduce greater flexibility in the budgetary rules, which would reduce the need to set up special arrangements in the first place.

» To purchase goods that will be delivered at some future time, for which the payment would otherwise be jeopardized by the need to seek legislative approval on an annual basis. Departmental enterprises, for example, need such revolving funds to carry out their trading activities.

» To allow managerial flexibility and/or for institutional reasons, such as the special status of certain professions or activities. Autonomous public entities exist in many countries to accommodate these purposes. These entities are financed mainly by transfers from the budget of the central government, but usually also have their own resources and their own budgets (called annexed budgets in some countries). Universities, with their own resources from tuition and other fees, fall in this category.

» To improve service delivery by separating it from policy formulation. Thus, a few industrial countries have created autonomous agencies (sometimes called executive agencies) that have established contractual relations with the competent line ministry. In these cases, the agency needs its own budget rather than to depend on the annual budget. This approach generally has not proven suitable to many industrial countries, let alone to the institutional landscape and administrative capacity of developing countries. In very specific instances, however, setting up a separate agency could improve operational efficiency, provided that the arrangement is designed with great care and is monitored very closely.

Costs, risks and approaches

The costs and risks of EBFs
Earmarking funds can be desirable in specific cases and under specific conditions; but regardless of the reasons for their establishment, EBFs pose a variety of problems and risks for the allocation of resources, for the integrity of the budget and for fiscal transparency and corruption:

» Transactions outside the budget are not subject to the same kind of fiscal discipline as budget operations, partly because they “carry their own money” and partly because they are not explicitly compared with other expenditure. Consequently, activities that would not normally survive the scrutiny of a regular budget process often continue because of inertia or vested interests.

» Transactions made from EBFs are often not classified according to the same system as budgetary expenditure, which hampers a sound analysis of the overall government expenditure program. This difference in clas-
The proliferation of EBFs leads directly to an important operational implication. Especially in low-income countries, there is a need to build robust gatekeeping mechanisms, both political and technical ones, to reduce the probability that unjustified EBFs will slip under the radar and eventually weaken the integrity of the budgeting system. Once again, there is a connection between the overall quality of governance in the country and the EBF issue. In conditions of perfect governance, even a plethora of EBFs may not be a major problem; and in conditions of extremely weak governance, even a fully unified budget would not be a solution. However, the tendency of EBFs to proliferate presents a clear risk, over time, even to a good governance system.

**Approaches to dealing with EBFs**

For all these reasons, the standard advice of international organizations to developing countries has been to avoid creating EBFs, and to eliminate them as quickly as possible when they do exist. In principle, when the normal budgetary arrangements are unsuitable for managing certain types of transactions, the optimal policy response is to improve the budgetary procedures and/or to set up specific procedures for those particular transactions, rather than placing the transactions themselves outside the annual budget process. In practice however, earmarking arrangements, separate funds, or autonomous management may be inevitable or desirable to improve efficiency in public spending, especially in developing countries.

Despite the advice of international organizations, EBFs are a common feature of budgetary systems almost everywhere. In industrial countries, nonbudgetary functions account on average for about one-third of total government expenditure (mostly for pensions, which account for about 90 percent of nonbudgetary expenditure). In African low-income countries, the importance of pension EBFs is much lower, but other extra budgetary expenditures are much higher and EBFs account for between one-fifth and two-fifths of total spending. Also, the variation in the importance of EBFs is much greater among low-income countries than among industrial countries. The exact proportions of expenditure are not easy to estimate, because some EBF expenditures are in fact internal financial transactions. When the accounting system does not fully preclude duplicate accounting, as in many African countries, the real size of transactions made through EBFs is lower than the recorded amount—by some margin that is probably substantial but is impossible to determine without a costly dedicated exercise. What is clear is that EBF transactions in African countries add up to an amount sufficiently large to generate substantial concern and to justify policy and management attention.

Thus, instead of preaching against EBFs, it is better to make appropriate distinctions between different types of EBFs and make provisions to manage them well and reduce their attendant fiscal and integrity risks. (This is the pragmatic and sensible approach taken in a study by Richard Allen and Dimitar Radev, 2007, to which readers
are referred for a more in-depth discussion and set of recommendations.)

The “non-negotiable” bottom line is that budgetary management autonomy must not be allowed to lead to overall loss of expenditure control or erosion of financial integrity. Thus, the standards of scrutiny and accountability for expenditures financed from funds, autonomous agencies, or special accounts should be no lower than those applied to other expenditures. To verify that EBFs meet these standards, their gross financial transactions must be regularly included in the budget documentation even if no legislative approval is sought.

Types of EBFs

EBFs come in many forms, the three main types of which are discussed in turn below.

**Social security funds**

Social security covers a variety of services classified into three broad categories:

- Social insurance, which is generally financed with contributions from employers and employees and yields benefits linked to the contributions;
- Direct provision of a service or cash payment to a defined group of beneficiaries, such as family allowances, pensions, and maternity grants;
- Social assistance—that is, payments or services contingent on investigation of the needs and financial status of the beneficiary (assistance to the elderly, handicapped, jobless, and so on).

The compulsory nature of social insurance and its far-reaching social, economic, and financial implications call for the inclusion of social security funds in the budget. A possible exception exists for countries in which management of these funds also involves employers and employee unions. It could be difficult to integrate into the budget those social security funds that are not directly managed by government entities. Nevertheless, because social security funds may cover a significant share of government expenditure, they should at least be consolidated in a financial report, and their budget should be annexed to the budget of the central government.

**Aid-financed expenditure**

In the 1970s and 1980s, expenditures that were financed with tied external loans or grants were routinely omitted from the budgets of aid-recipient countries. Progress has been made toward better coverage of externally financed expenditure in the budget, although in many African countries the budgetary coverage of grants, technical assistance, and expenditure financed by external loans often remains incomplete. The motivation—or rationalization—for ring-fencing project aid funds in a country is allegedly the ineffectiveness of the budget system. In practice, however, the ring-fencing itself (and the problematic project implementation units it requires) is often ineffective even at protecting the aid resources and is itself a cause of continued budgeting weaknesses.

“Enclaving” a large portion of aid moneys outside the budget weakens the incentive for the recipient government to improve its budgeting system. And enclaving does not motivate donors to move away from ring-fencing their project aid, when they can live under the delusion that the ring-fencing fully protects the resources and their use. In any case, project aid can and should be accounted for in the budget—as has been shown most recently in a budget system as conflict-damaged as Burundi’s—even if separate arrangements are made for its administration.
In sum, there is bound to be a need, in many countries, to continue special arrangements to manage certain project aid funds. These arrangements must be considered strictly transitional, however; they must not be allowed to interfere with the clear priority to support the improvement in the budget system that will render them unnecessary. Donors have a key responsibility to facilitate the incorporation of these expenditures into the budgets of recipient countries.

Expenditure financed from counterpart funds generated by sales of commodity aid also must be managed under specific procedures, mandated by requirements of the donors. That such tying of counterpart funds is generally inefficient does not relieve the recipient country of the burden of satisfying donor requirements. (Whether the aid should be accepted in the first place, given these restrictions and the risk of adverse impact on local production of close substitutes for the

Box 6.1

Ghana: A First-Generation Road Fund

The road fund in Ghana was established in 1985, as part of a program of road maintenance and rehabilitation supported by the World Bank. At the end of the century, the country still had not been able to create the basis for sustainable road maintenance financing.

Financing from the fund was unstable, generating unpredictability in funding that has made it difficult to plan properly and issue contracts on a timely basis. In turn, some have used the lack of funding predictability as an excuse for inaction or as a way to short-circuit the procurement procedures for various vested interests. As a result, significant portions of the road network in Ghana remained in very poor condition at the end of the century.

In the mid-1990s, the government decided to increase the fuel tax sufficiently to fully finance the road fund. Overcoming the internal difficulties, including getting the treasury to agree to this graduated path of sustainable financing, was a significant accomplishment. Thus, to avoid passing all the proposed increase in the fuel levy directly and immediately on to consumers, the treasury agreed to cede some of its other excise tax revenues to the road fund, thereby keeping fuel taxes at basically the same level even though the proportion earmarked for the road fund increased. After 2005, the Government introduced further major changes with substantial positive impact, learning from the earlier experience.

A key lesson from the Ghanaian experience—shared by many other African countries—is that setting up a fund is insufficient in itself to ensure financing for road maintenance. It is essential among other things to create a board of directors with enough authority and independence to resist raids on the fund by other government entities. Moreover, when contrasted with experiences in some other African developing countries, Ghana’s road fund experience seems even more disappointing. For example, Burkina Faso was able to finance virtually the entirety of its road maintenance requirements through the regular budget process, without a dedicated road fund. It appears that when the budget system works reasonably well, it can meet priority expenditures without the need for a separate EBF to finance them.

Source: Adapted and updated from Mwale 1997.
imported commodities, is a different issue.) Ex-
penditure financed from counterpart funds must be included in the budget, but specific rules are needed to manage them (for example, exemption from the annuality rule and a flexible spending limit linked to the amount of revenues collected from the sales of commodities).

Road funds
Road funds are the kings of extra budgetary funds in developing countries—and particularly in Africa, where land transport is a critical priority and rural-urban connectivity is important for a variety of economic, social and political objectives. The fact that road users are identifiable and

Box 6.2  
Tanzania: A Promising Second-Generation Road Fund

Tanzania’s Road Fund in its current form came into operation in 2000. Its Board is composed of: a chairman from the private sector; the permanent secretaries of the Ministry of Works, Ministry of Finance, and Prime Minister’s Office for Regional Administration and Local Government (PMORALG); a senior civil servant; and several representatives of the private sector and of civil society associations, who were appointed by the Minister of Works. The Road Fund has its own dedicated secretariat.

More than 95 percent of the resources of the fund come from a fuel tax (about US$0.08 per litre). The fund is mandated to use at least 90 percent of its resources for maintenance and emergency repair. It allocates 63 percent of its funding to TANROADS (the Tanzania National Roads Agency) for maintenance of the national and regional roads, 7 percent to the Ministry of Works for development projects on those roads, and 30 percent for local roads. The latter funds are mostly passed through to the 100 or so local councils, according to a formula agreed with PMORALG, which takes into account population, road length, and division into equal shares. Of the local road funding, PMORALG itself controls directly only 1 percent for administration and 3 percent for development projects.

All these transfers are governed by performance agreements between the Road Fund Board and the implementation agencies. The agreements specify the respective responsibilities of each party, policies, definitions, performance indicators with means of verification, agency action plans, reporting requirements, and budgets, giving details of works to be undertaken during the year.

Tanzania has made good progress, following the creation of a Road Fund Board and TANROADS. The road network has improved and funding has increased from Tanzanian Shilling (T Sh) 47.3 billion (about US$58 million) in fiscal year 2000/01 to T Sh 73.4 billion in fiscal year 2003/04 (about US$67 million). The performance agreements between the Road Fund Board and the implementation agencies have contributed to improved accountability. Local roads now receive significant funds for maintenance, and the country’s decentralization has been enhanced by disbursing the funds directly to the local councils. Because funds are still insufficient to maintain the roads, owing to a large backlog of maintenance works, legislative revisions are under way—among other things, to establish road boards at the national and regional levels to cater specifically to development and management.

that they bear some taxes (such as gasoline taxes) is used to justify revenue-earmarking arrangements for road maintenance or construction.

Road funds have been set up in many developing countries. Some are simple accounting arrangements, while others finance the provision of services. The main objective has been to insulate from the vagaries of annual fiscal pressures the expenditures for maintenance and development of roads—a crucial priority, especially in Africa. Unfortunately, the generally disappointing early experience with road funds in the 1970s and 1980s led to the conclusion that they ought to be avoided (McCleary 1991). Not only did those road funds reduce fiscal transparency and provide openings for misappropriation and inefficiency, but, when funds were particularly limited, the earmarked funds were also often diverted to other uses and thus were no longer available for their original purpose. Besides, the knowledge that there were substantial sums sitting in a road fund account proved an irresistible temptation for well-connected individuals to raid the account. Thus the existence of road funds did not even guarantee funding for an appropriate mix of maintenance, rehabilitation and new investment in roads—as illustrated by the unfortunate early experience of Ghana (Box 6-1).

Taking that experience into account, the World Bank helped develop the concept of second-generation road funds, again with special focus on Africa (Heggie 1995, Pennant-Rae and Heggie 1995, Potter 2005). This concept was inspired by the “agency model” developed in some member countries of the Organisation for Economic Co-operation and Development (OECD—the “rich countries’ club”). The main features of second-generation road fund are to:

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**Box 6.3**

**Malawi: A Disappointing “Second-Generation” Road Fund**

Malawi’s road fund was created in 1997 under the National Road Authority (NRA) Act as an integral part of the NRA itself. Initially, following the establishment of the fund, the management and financing of Malawi’s paved road network improved. It was not long, however, before the flaws in the institutional setup of the NRA became apparent. Whereas at first the governing board was selected on the basis of technical competence, in the early 2000s many of the members were chosen on the basis of political influence, de facto eliminating the board’s formal independence.

In particular, the board chairman appeared to come under the control of the chief executive, who paid him “board sitting” allowances for every day of the month. Critical decisions were made by the chief executive, board chairman, and roads minister without the participation of the other board members, with their concerns being not heard or being largely sidelined. Private sector participation and consultation with civil society were perfunctory when they took place at all.

Thus, although on the surface the Malawi road fund that was created in 1997 appears to be an illustration of a second-generation road fund, in reality it operated with much the same handicaps of politicization and patronage, as did the old road funds of the 1970s and 1980s and with equally disappointing results.

*Source: Adapted and expanded from Andreski 2005.*
- involve road users in the management of roads;
- clearly define responsibilities for all parties;
- set up an autonomous and independent board with private participation;
- establish clear accountability rules; and
- set up and devise charging instruments related to road use that are easy to separate from other taxes and simple to administer (such as tolls).

The effectiveness of this approach depends on several critical issues: whether good governance and anticorruption requirements are met; whether the board of directors represents consumer and public interests rather than being captured by contractor and producer interests; the degree to which the funds are fully protected for roads rather than merely being a convenient parking place for money that can be diverted elsewhere; how the more demanding financial management requirements are handled; whether there is robust independent audit of fund operations; and, of course, whether the rules are observed in practice. So far, the simulation of market discipline in second-generation road funds appears to have improved the management and maintenance of African roads, albeit not uniformly in every country. Not surprisingly, however, experience differs: while the experience in Tanzania has been positive so far (Box 6-2), that of Malawi has not (Box 6-3).

Financing EBFs: Revenue earmarking and user fees

Although EBFs can be funded in a variety of ways, tax earmarking and user fees are the most common sources of financing.

**Tax earmarking**

Different tax earmarking arrangements may be found (McCleary 1991):

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

In most cases, arrangements that earmark a share of total revenues from general taxes are questionable (issues of social security are reviewed later). Concerning other specific taxes and fees, a distinction is generally made between: (a) strong earmarking, in which the link between the payment of a user charge and the associated expenditure is close (for example, fees for attending courses of a university); and (b) weak earmarking, in which the link between the benefit and the fees or the taxes is less clear, for example, the use of lottery proceeds for investments (Hemming and Miranda 1991).

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

**User fees**

The issue of user charges is very complex, especially in low-income countries. As a general principle, the benefits need to be weighed against...
the additional transaction costs of defining and collecting the charges. Thus, in most African countries, it would not be cost-effective to levy user fees on essential social services such as basic health and primary education—even aside from the adverse moral and social implications of attempting to do so. In other parts of the world, governments providing quasi-private goods and services should charge, if practical, a fee commensurate with users’ ability to pay and should allow the agencies that collect the revenue to retain at least a significant portion of it. Doing so would meet both revenue and technical efficiency objectives. A hospital or a university, for example, would have no incentive to improve its efficiency if it could not use freely some of the revenue from selling its services.

In any event, when user charges are both cost-effective and desirable, an estimate of the revenue and the corresponding expenditures must be provided in the budget. Also, user charges must be transparent and efficient. The following principles, drawn up by the OECD (1998), should be adopted:

» **Clear legal authority.** The legal basis to charge for services should be clearly defined but limited to the general framework, without setting the precise amount of the fees, so that they can be adjusted without further legislative authority.

» **Consultation with users.** Consultations serve both to prevent misunderstandings and to improve the design and implementation of the charging system.

» **Full costing.** The full cost of each service should be determined, regardless of whether the intention is to recover costs fully or only partly. For partial cost recovery, this information will make transparent the subsidy granted for the service.

» **Appropriate pricing.** Wherever relevant, pricing should be based on competitive market prices, or reflect full cost recovery, or take into account studies on variations in demand to limit congestion. Prices set in this manner will allow efficient distribution of the services.

» **Competitive neutrality.** When pricing services, the costing should be accurate and should incorporate all cost items faced by the private sector entities operating in the same sector.

» **Equity considerations.** Reduced or zero fees can be applied to lower-income individuals, users located in remote areas, and the like. The criteria for reduced charges must be transparent and difficult to manipulate. Different ways of meeting these equity objectives should be considered, because providing benefits directly is generally more transparent and efficient than providing benefits through reductions in user fees.

» **Effective collection system.** The efficiency of user-fee collection can make or break the system. If the fees have been set efficiently and equitably, a failure to pay should be followed up immediately.

» **Audit.** As always, regular external audits of the organization that levies and collects the charge are required.

» **Performance.** The performance of the organization should be monitored regularly to ensure appropriate levels of efficiency and service quality. User fees cannot be allowed to serve as indirect financial support for continued inefficiency.

Several countries include in the budget only the net expenditures of agencies that exercise commercial activities or recover costs, and the budget appropriation corresponds to the difference between planned expenditures and expected revenues. As noted at the outset, revenues and expenditure must be shown in gross terms. If the gross amounts are large, netting out impedes sound analysis of the government activities, accurate estimates of economic costs, and valid comparisons between countries. Convenience cannot supersede the need for the executive to know how the services are performed or the right of the legislature and the public to know what public agencies are doing.
Part III: 
Programming Expenditure and Preparing the Budget
Chapter 7: Multiyear Fiscal and Expenditure Perspectives
What to Expect

This chapter deals with the application and applicability to low and middle-income countries of the different variants of a multi-year expenditure perspective to frame the annual budget preparation. Although the need for such a perspective has been recognized for a long time, it has come to be associated since the early 1990s with a particular approach known as the Medium Term Expenditure Framework (MTEF). After a brief account of the genesis of the approach and its widespread adoption by the donor community—led by the World Bank, the chapter summarizes the current situation and the meager results of the MTEF so far in most African countries, unbundles the concept into its several variants, gives some guidance on how to implement the specific variant that is suitable to different situations, and concludes with a scorecard of the positive and negative aspects of the MTEF. The main theme of the chapter is the need to keep a clear distinction between a multiyear perspective for the annual budget, which is always necessary, and the specific approach to be taken, which depends on the circumstances and objectives of the specific country. In all low-income countries and most middle-income countries, a simple forecasting MTEF—i.e., an aggregate projection of the medium-term economic and functional composition of expenditure—is far preferable to attempts at introducing complex and costly programmatic MTEF versions.

Genesis and evolution of the approach

The historical context

First, it is well to note that the problems multiyear expenditure projections are intended to address are among the oldest in the economic development literature: to reconcile short-term urgencies with longer-term priorities, to prevent fiscal stability from degrading into economic stagnation, to find paths to sustainable growth with financial stability, and to complement growth with equity. These issues were at the center of the debate on development planning during the 1950s and 1960s, the years of what Paul Krugman has called the “High Development Economics”. Second, much of the confusion and frustration associated with the MTEF in developing countries is understandable, and arises mainly from a failure to explain the distinction between the genuine need to place the annual budget decisions in a fiscal perspective longer than just one year, and the unnecessary introduction of complex methodologies to do so—many of which were quite unsuitable to realities on the ground.

In more recent times, developed country governments had become too expensive, too big, and too intrusive by the mid-1970s. The period from the mid-1970s to the late 1980s consequently witnessed a first wave of reforms focusing on expenditure reductions, public sector downsizing, and privatization. These reforms for “smaller/cheaper government” took place in response to fiscal necessity and thus under strong direction and control from the center of government, particularly the ministry of finance. From the late 1980s to the 1990s, after fiscal deficits had been reduced in most OECD countries, there came a second phase of reform aimed at addressing the goal of “better government” by improving service delivery, deregulation, devolution of responsibilities to subnational levels of government, greater transparency and better access to information.

During about the same period, aid donors’ concerns evolved from an exclusive project focus to consideration of their entire investment portfo-
lios—“public investment reviews”. In later years, these grew into profiles of public expenditure as a whole—“public expenditure reviews.” After 2005 they further expanded to assessments of the soundness of the overall public financial management system—“public expenditure and financial accountability reviews”—see Chapter 16 for a full discussion. In particular, the need for a “public investment program” (PIP) was justified by the reality that money is fungible and donors of aid money to finance a large project therefore needed assurance that the investment portfolio as a whole was acceptable. Unfortunately, in most developing countries PIPs quickly degenerated into shopping lists to attract aid, and theatrical scripts written by external consultants to be presented at international donor meetings. (These and other issues on public investment programming are discussed in the next chapter.)

By the early 1990s, with the loss of credibility of these “first generation” PIPs, the donor community was ready for a “new approach”: the MTEF, which would allow them to avoid the real needs of improving the nuts and bolts of public expenditure management. Acceptance of this new approach was based in large measure on the untenable assumption that the medium-term expenditure programming methods introduced in highly advanced countries could easily be transplanted to the developing world and Africa in particular.

The uncritical acceptance of the MTEF methods elaborated in developed countries as an all-purpose remedy for African countries’ budgeting weaknesses stemmed from the failure to recognize that the problems with PIPs in the 1980s were due to bad practices rather than to the concept itself. The response should have been to remedy those bad practices and ensure that PIPs would become the realistic programs they are supposed to be. Clearly, revenue-constrained and programmed expenditure on sound investment projects is far preferable to unconstrained and uncoordinated expenditure on weak investment projects—as discussed in Chapter 8.

**Australia’s forward estimates**

Medium-term expenditure forecasting was pioneered by the United Kingdom (Premchand 1983), but the current paradigm can be traced mainly to Australia, a leader among developed countries in reforms to control expenditure growth. Australia’s approach aimed at strengthening the link between government policy and expenditure programs and improving the affordability of policies by combining projections methods with institutional arrangements to enforce the outcomes. Between 1985 and 1990 this resulted in turning a fiscal deficit of 4 percent of GDP into a 2 percent surplus, while at the same time reorienting the composition of expenditure and providing incentives for greater efficiency. The approach replaced the earlier review of only the budget requests for the coming fiscal year with a practice of rolling “forward estimates”. By this practice, the ministries agree with the ministry of finance on “baseline” projections of expenditure on their ongoing programs for three future years, and the ministry of finance thereafter updates these projections according to changes in economic parameters or government decisions affecting costs. Given the original agreement, the process reduces uncertainty over future funding levels for ongoing programs. The same process is followed regarding new programs, which must project their full costs over the three-year period in order to be considered for funding. This practice eliminated the time-consuming bargaining over the baseline for each fiscal year and allowed attention to focus on the budgetary implications of policy changes or strategic decisions.

High-level political guidance and ownership was ensured by an Expenditure Review Committee (ERC) consisting of the Prime Minister, the Treasurer and Minister of Finance and a number of major line ministers. The ERC is responsible for approving the overall fiscal framework and managing strategic policy changes, as well as setting the expenditure ceiling for each sector ministry in the preparation of the annual budget. If the aggregate ceiling for the ministry is lower than the coming year’s cost of existing programs, the ministry concerned would need to find savings or take other efficiency measures; if higher, the ministry could use the fiscal space to introduce new initiatives. In any event, under the ERC system it is the responsibility and authority of the competent ministry to determine the allocation of resources among different programs in the
Chapter 7: Multiyear Fiscal and Expenditure Perspectives

sector, consistent with overall government policy and within a hard expenditure constraint. Analogously, within each ministry, line managers have flexibility with regard to both staff and money, again within the budget constraint applicable to their program.

The forward estimates system has worked well in Australia, as have similar mechanisms in several (but by no means all) OECD countries. The reason is the existence in these countries of the prerequisites for such mechanisms. Similar to those listed in Box 4-2 for full program budgeting, the political and governance requirements include:

- high quality of governance and high level of public integrity;
- high propensity for rule-compliance;
- robust administrative accountability;
- political discipline of a well-organized executive apparatus;
- an assertive, competent and representative legislature;
- contestability arising from a vibrant civil society possessing both exit opportunities and voice channels; and
- a population relatively homogeneous in cultural, religious and ethnic terms.

The economic and technical requirements include:

- macroeconomic stability and very low dependence on external financing;
- strong technical capacity of the finance ministry and core central agencies;
- capacity to enforce a hard budget constraint on line ministries;
- line ministries’ capacity in sector policy and program formulation and cost analysis;
- availability of a large pool of highly-competent government economists, accountants, econometricians, sector specialists, etc.;
- availability of reliable data on a timely basis; and
- a high degree of flexibility given to line ministries and budget managers regarding both personnel management and financial resource allocation.

Not many of these requirements for a full-fledged forward estimates practice of the Australian type are present in the average developing country. It is not very likely that the same approach could be successfully exported to developing countries (let alone fragile states). As McFerson (2007) demonstrated, public management innovations cannot be transplanted without changes to a different institutional soil nor can they be implemented successfully even with major adaptation—except gradually and over a long period of time.

The early experience with MTEFs in Africa

The multi-year expenditure estimate practices developed in advanced countries were relabeled as “MTEF” and exported to African countries, with some changes in terminology and justification but essentially under the same assumptions concerning accountability, transparency, public integrity and above all, capacity. Brumby (2008) first recalled the potential of the MTEF construct to “... help create [a] textbook world of public finance...” and then highlighted the problems that emerged in practice in the early period, including:

- the intense activities of the MTEF units set up in most African countries to develop the new processes have not led to improvements in budgeting;
- budget behavior has not actually changed;
- the political leadership has little understanding of or interest in the MTEF;
- MTEF can even become a means to present an unrealistic budget.

Brumby thereafter gives the following scorecard of MTEF results in Africa, with similar findings applying in South and Southeast Asia, parts of East Asia, and in some countries of Latin America and the Pacific:

- virtually no evidence of improved macroeconomic balance;
- some limited evidence of reallocation to priority subsectors (although more likely as a result of the Poverty Reduction Strategy (PRS) process rather than the MTEF itself;
- no evidence of a link to greater budgetary predictability;
no evidence of efficiency gains in spending.

This disappointing record contrasted with the high expectations. Combined with the vast resources and efforts invested in complex MTEF exercises, mounting skepticism of all MTEF concepts has resulted. An MTEF is currently viewed as an exhausting and expensive initiative, promoted by donors and carried out as a supply-driven self-propelled exercise conducted mainly by external consultants. This very much resembles the criticism of the first generation PIPs of the 1980s. This reaction is understandable, but abandonment of MTEF now would be as unfortunate as abandonment of the PIP was then.

The lesson from the discouraging MTEF experiences so far in Africa and elsewhere is not to forget the need for a medium-term perspective for the annual budget, but to re-size, redefine and reformulate the approach in a manner suitable to the possibilities and constraints of the different countries. If the right variant of a multi-year expenditure perspective is introduced, with an eye to conditions on the ground, in close cooperation with the government, with the right sequencing and in deliberate and realistic manner, it can substantially improve the control, allocative and use efficiency of a government’s financial resources and thus, ultimately, access to and quality of public services.

The need for a multi-year perspective
Although the wasteful supply-driven aspects of the complex forms of MTEF must be stopped, the need for a fiscal perspective beyond the coming year remains critical. Eighteen years ago Wldavsky (1993, p.317), advanced the argument that isolated annual budgeting leads to: “... short-sightedness, because only the next year’s expenditures are reviewed; overspending, because huge disbursements in future years are hidden; conservatism, because incremental changes do not open up large future vistas; and parochialism, because programs tend to be viewed in isolation rather than in comparison to their future costs in relation to expected revenue.” The argument was formulated in the context of developed economies, but it is even more relevant for poor developing countries.

To be an effective instrument of financial management, the government budget must in the first place be credible. To be credible, the expenditure level and composition must be sustainable at least over the medium term. Moreover, the budgeting system should provide a link between government policies and the allocation of financial resources, and a fiscal perspective covering the medium term is necessary because most policies cannot be implemented in the short term. (In practice, given the fluid situation in developing countries, a perspective covering two years beyond the budget year is probably appropriate.)

Clearly, the feasibility of a multiyear perspective is greater when revenues are predictable and the mechanisms for controlling expenditure are well developed. These conditions are not fully met in many African countries. Nevertheless, some sort of medium-term forecast of revenue and expenditure remains essential to frame the annual budget preparation process. Specifically, the annual budget must reflect three paramount multiannual considerations:

» the future recurrent costs of capital expenditure (whose costs and benefits, by definition, extend beyond one year, and which constitute the largest single category of public expenditure in most developing countries);
» the funding needs of entitlement programs, where expenditure levels may change even though basic policy remains the same. This consideration is relevant for industrial countries, with large social security and public health obligations, but much less so in Africa;
» contingencies that may result in future spending requirements, e.g., government loan guarantees.

A medium-term outlook is especially necessary because the discretionary portion of the annual budget is small. At the time the budget is formulated, most of the expenditure is already committed. Salaries of civil servants, debt-service payments, pensions, and the like cannot be changed in the short term, and other costs can be adjusted
only marginally. The true discretionary margin, in African countries, is no more than about 10 percent of total expenditure. Additional revenue can be mobilized, of course, but this, too, takes time. As a result, any real adjustment of fiscal stance and expenditure priorities, if it is to be successful, has to take place over a time span of several years.4

Multiyear spending projections also have a “signaling function” to show to the administration and the public the government’s intentions and give the private sector time to adjust. Moreover, in the absence of a medium-term perspective, adjustments in expenditure will tend to be across the board and ad hoc, focused on inputs and activities that can be cut in the short term. However, activities that can be cut more easily are often also the more important ones, such as operations and maintenance (O&M) or the implementation of major public investment projects. A typical outcome of isolated annual budgeting under constrained circumstances is that O&M and public investment are defined in practice as a residual—harming the efficiency of current activities and the rate of return on investment, respectively. Finally, by illuminating the expenditure implications of policy proposals on future budgets, even approximately, a government can evaluate the cost-effectiveness of the policy and determine whether it is attempting more than can be financed.

Unbundling the MTEF

A major issue with the MTEF is that the term is used to refer to very different ways of stretching the time perspective of annual budgeting. Accordingly, to make progress and retain the valid objective of a medium-term perspective while abandoning the unsuitable variants, the first order of business is to unbundle the term into its four main variants: traditional planning, economic forecasting, functional forecasting, and full programmatic MTEF.

**Traditional planning**
The well-known traditional planning approach identifies in advance all major programs and their funding over a fixed multi-year period. Some plans—as the Five-Year Plans of the late and unlamented command economy system—never had much to commend them. Other plans, inspired by the 1950s and 1960s paradigm of mixed-economy development policymaking, did provide vision, policy direction, and internal coherence. (For the classic treatment of development planning, see Tinbergen, 1958.) However, especially in developing countries, changing circumstances invariably make even the best fixed-term projections quickly obsolete. Also, because expenditure programs are normally not prepared under a revenue constraint, they become overloaded, harming the credibility of the overall plan.

These multi-volume plans absorbed substantial capacity at the center, gave interesting short term employment to hundreds of economists and, when completed, collected dust on thousands of government and academic shelves. They were technically impressive, internally consistent and complete in every detail except for consideration of the institutional context and attention to the question of who was to implement the plans, how, when, with what, and under what incentives.5

Still, whatever their failings in practice and the top-down centralizing frame of mind that produced them, the traditional plans were closest in spirit to the main objective of an MTEF to integrate investment and current expenditure into coherent programs consistent with resource availability over the medium term: “Plans encompass a recognition...that by systematic examination of both policies and investment
projects as parts of a whole, one can improve their total efficiency by forming consistent and complementary ‘packages’ [...] They increase the consistency between short-run decisions and long-run choices [...] force a less developed country to think in terms of a balance between resources which are available, including those from foreign sources, and national economic goals [...] although this direct confrontation of means and ends is often evaded in actual development plans [...] an advantage of serious development planning is decreased uncertainty” (Schiavo-Campo and Singer 1970).

In countries where the traditional fixed-term plans still exist, they cannot be replaced at one go with a rolling set of medium-term and revenue-constrained expenditure projections for many reasons, including political ones. However, they can be brought fairly close to the new system by progressive mutations. Thus, the problem of lack of any constraint can be addressed by starting the planning process with a reliable projection of domestic and foreign revenue. The resulting top-down nature of the approach can be mitigated if genuine participation of the key stakeholders is obtained from the very start. Next, if the old practice of mid-plan review is changed to an annual review, adaptation to intervening changes can be made every year, thus bringing the plan close to a rolling MTEF. Still missing, however, would be the core MTEF feature: a distinction between “ongoing” programs under existing policies and “new” programs—the genuinely new elements in the contemporary MTEF approach.

Medium-term projections of the economic composition of expenditure

These are necessary, but are not new, and are what the International Monetary Fund (IMF) has done for over 30 years, in conjunction with the 1974 introduction of the three-year Extended Fund Facility (EFF). Because the EFF was established to assist countries in dealing with problems requiring a longer period of adjustment than the conventional one-year Stand-By Arrangement, it became necessary to demonstrate balance-of-payments viability after the end of the three-year EFF period, and hence to formulate medium-term macroeconomic projections. We can call the expenditure component of such projections a first form of MTEF: a medium-term projection of the aggregate economic composition of expenditure, updated annually as part of the budget preparation process. Moreover, given the regular IMF reviews of recipient countries’ policies and financial outturn (at least annual and more often semi-annual), the medium-term projections were regularly pushed forward—coming closer to the “rolling” projections of the MTEF approach. (In practice, this weakened the focus on the out-years and produced a certain tolerance for rosy optimism, with viability or sustainability routinely expected for the year after the end of the arrangement.)

The GFS economic classification (see Chapter 4) is the basis for this first and simplest variant of an MTEF. For this variant, the issue of implementation capacity does not arise—the components of the projections are either straight forecasts based on real numbers, or embody negotiated agreements on the wage bill, or transfers, or investment expenditure, or whatever.

A forecasting MTEF: Projecting the functional composition of expenditure

A projection of the functional and organizational composition of expenditure should be made in accordance with the UN Classification of the Functions of Government (COFOG), see Chapter 4. When the medium-term functional projections are articulated around aggregate estimates for each ministry and spending agency, and are constrained by revenue forecasts based on estimates for various taxes and other revenues sources, we have the first major form of MTEF, a forecasting MTEF.

Although not a programming exercise, a forecasting MTEF gives a weak indication of future resource availability for the different ministries and also retains the “signaling function” that the private sector needs to help guide its own decisions—provided that expenditure indications for the out-years are not merely a mechanical extrapolation of the current year’s budget. (If this is the case, the exercise serves no useful purpose, and it is not surprising that little ef-
A forecasting MTEF consists of an estimate of overall government expenditure for each year over the medium-term (consistent with the macroeconomic framework), disaggregated into indications of aggregate expenditure for each ministry and agency. It is top-down and prepared largely by the Ministry of Finance, but must embody substantive considerations of sector policies and their resource implications. Thus its preparation entails meaningful consultations with the line ministries and agencies.

A good forecasting MTEF is an urgent priority for all countries, and should be introduced as rapidly as possible—with foreign assistance as needed—and deepened, improved and refined over time. Controlling expenditure is more difficult in the absence of a medium-term expenditure perspective disaggregated by ministries and agencies; and without expenditure control neither allocative nor use efficiency are achievable.

**A programmatic MTEF**

Estimating and allocating fiscal space

A full-fledged programmatic MTEF is the most complex form of a multi-year expenditure perspective. Following the precedent of the Australian forward estimates system, it includes a strong indication of future resource availability to each ministry, and within such allocation it calls for a clear distinction between ongoing and new expenditure programs as well as measures to produce savings in low-priority programs to create fiscal space for new higher-priority programs. In contrast with a forecasting MTEF, a programmatic MTEF can only be developed gradually, selectively, and slowly over a long period, as outlined in the next section.

The programmatic MTEFs can be illustrated in Figure 1. (The scheme is originally by Daniel Tommasi.) In the figure, aggregate expenditure under existing programs is assumed to decrease through time because a number of projects come to an end and also from programmed savings in ongoing low-priority activities. The difference between estimated revenue and expenditure projected under existing programs is available—not earmarked—to finance expenditure under new programs. (If it were earmarked, adjustments could only come from the revenue side, as discussed in the next section.) The resulting fiscal space for new spending is then filled by specific expenditure programs formulated by the line ministries themselves—thereby giving them increased ownership along with greater predictability of funding. (The scheme can also be used to illustrate situations where aggregate expenditure is to be cut, either because revenue prospects have become unfavorable or from unsustainable ongoing expenditure programs. In this case, the “negative” fiscal space would become a guideline for the overall degree of downward adjustment needed.)
Figure 7.1
Illustration of a Four-Year Programmatic MTEF (*)

(*) In year t, for simplicity, revenue is assumed to incorporate the target fiscal balance. In out-years t+1 through t+3 the “available resources for new programs” may be partly dedicated to improving the fiscal balance, or if fiscal prospects permit, be augmented by a programmed deficit increase or budget surplus reduction. Also, the out-years may include a contingency reserve (not shown), depending on the reliability of revenue projections and the strength of the entitlement culture.

What is a program?
Programmatic MTEFs in turn have two basic variants, revolving around the definition of “program”. In French, South African or Canadian practice, a program is coterminous with a major division of a ministry, e.g., primary health care, and only a few large “programs” exist in each ministry. These parameters permit defining broad objectives and very general indicators for each large program. To the extent that it generates a genuine post-budget dialogue on achievements, the initiative is useful and can be implemented relatively quickly. This definition is also consistent with an administrative environment characterized by substantial technical and programming capacity within each ministry and agency and a high degree of autonomy of the ministries and agencies—where the locus of accountability is the top leadership; hence, broad definitions of “program” are appropriate.

The other definition of “program” is much narrower—“a set of concrete activities designed for a common specific outcome”, e.g., pre-natal care. This definition can generate much stronger accountability for results and stimulate operational efficiency—but of course has a narrower impact. (See the “accountability tradeoff”, discussed in Chapter 15.) It is more consistent with a limited-capacity environment, and can thus be implemented selectively, gradually, with constant attention to the risk of unintended consequences and unnecessary red tape, and with the benefit of user feedback on service quality and access. (See also the discussion of program budgeting in Chapter 4.)

Not a binary choice
These two programmatic approaches are not mutually exclusive, but in the long term are complementary. On the one hand, national priorities and sector strategies cannot have operational meaning in the absence of concrete programs to translate them into actual services and works. On the other hand, resources cannot be allocated to ministries exclusively on the basis of which specific programs appear most efficient, without regard to sector strategies and national priorities. Thus, fiscal space must be allocated to individual ministries in a manner consistent with sector strategies and priorities for overall resource allocation—and hence centrally, albeit after consul-
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clusion. But also, the fiscal space must be filled by realistic and specific expenditure programs—and hence by the line ministries, albeit after central approval. On these bases, the inter-ministerial resource allocation can then be modified to provide sufficient resources to the best-conceived expenditure programs—thus giving the line ministries increased ownership along with incentives to develop better-quality programs.

In reality, therefore, the programmatic MTEF approach is symmetrical with the approach to annual budget preparation discussed in Chapter 9—whereby ministerial expenditure ceilings are decided centrally and communicated from the top down to the ministries, which are then responsible for preparing their budget requests within the assigned ceiling. The symmetry also applies to the capacity-building challenge. Of necessity, the ministries of finance and planning are almost invariably the initial focus of capacity building, while efforts to build the requisite capacity in the line ministries and agencies follow thereafter in a gradual manner and—hopefully—with the guidance and active support of the center. The obvious priority, however, when the annual budget process is still shaky and in need of major improvements, is to introduce the programmatic MTEF approach in the annual budget preparation process and anchor it firmly into the rules and incentives of the system—rather than imposing it several years into the future.

A “pilot ministry” approach to developing a programmatic MTEF is often recommended—but there is a problem when a programmatic approach is forced onto an entire ministry that has barely enough capacity to carry on its routine business, as is the case in many line ministries in low-income countries. The logic of capacity building calls instead for shifting the programmatic focus to “pilot programs” within a ministry, in order to minimize transaction costs and the risk of red tape and to maximize the probability of learning by doing, and ultimately, to improve the access to and quality of specific public services.

Giving space to “voice”
To insert specific programmatic elements in the budgeting system may help unite allocative and use efficiency; make accountability a little tighter; get people to start thinking about actual results; and—most importantly—open the door to genuine “voice” by service users and citizens in general. It does no good to elicit citizens’ views about an entire ministry, for they don’t have the necessary information and their view would not carry operational implications in any event. Voice is heard only when it relates to specific services, particularly in countries without well-organized civic pressure groups.

It may be argued that it is difficult to foster voice at the time of the budget preparation process, because of its tight calendar and pressures from the MOF and external donors. The answer is not to separate social accountability from the budget process (which is the main vehicle to give voice force), but to modify the budget timetable to include space for a systematic element of external consultation. The budget timetable must be adapted to the objectives, not the objectives constrained by the timetable.

It is true, however, that better consultation requires a stronger role of the legislature and closer interaction between external donors and parliaments than has been the case so far in many African countries. This touches on delicate issues of governance, but given the political will, it should be possible to provide recognition and rewards (not necessarily monetary) to budget managers who have a demonstrated record of seeking and responding to user views on program design and feedback on its implementation.

Moving from a forecasting to a programmatic MTEF
As argued above, a forecasting MTEF is a top reform priority for all countries, but a full programmatic MTEF is wholly incompatible with the circumstances and capacities of developing countries and most middle-income economies. It is also highly unlikely to yield actual improvements in public expenditure management remotely commensurate with its costs. In some cases, it may even reduce effective fiscal transparency and expenditure control by adding procedural layers and complex reporting that impede assessment and monitoring of public expenditure, while diluting the protection of public moneys—the first
requirement of any budget system. Nevertheless, the introduction of selected programmatic elements and simple ways to foster a dialogue on the results of spending may in time improve public services—provided that it is undertaken prudently, step-by-step, and without changing either the line-item budgeting system or the cash basis of accounting.

The process of moving beyond a forecasting MTEF to a programmatic MTEF entails progressively “filling-in” the aggregate expenditure projections for ministries and agencies by bottom-up estimates of the medium-term costs of selected specific programs. This would allow the ministries concerned and the government as a whole to learn from experience and gradually extend the practice to cover other expenditure programs—while minimizing the risks. In the meantime, ministries can also be requested to begin making a distinction in their budget requests between “existing” and “new” activities. So long as the ministries are allowed to do so in general terms and without complicated reporting templates or detailed cost-analysis, the exercise can be consistent with existing capacity and the transaction costs will be kept down. However, attention will begin to focus on the efficiency of existing expenditure programs, the financial implications of new programs, and the results of spending rather than just the manner of spending.10

Evidently, the gradual evolution of a programmatic MTEF requires very substantial capacity building over the long term. The implications for civil service employment, compensation and new flexibility in financial resources and personnel management are considerable too. To move toward a programmatic MTEF without a concurrent capacity-building effort and steps to give much greater flexibility in virements and in personnel management guarantees eventual failure.

Balancing macro-predictability and meso-flexibility

The critical difference between “framework” and “budget”

Too often, one hears an MTEF referred to as “medium-term budget”. This is wrong on both conceptual and practical grounds. With the single exception of one small high-income country (Slovenia), the budget is on an annual basis everywhere in the world, even if certain expenditure categories receive multiyear legislative approval. Thus, whether of the forecasting or programmatic variety, a medium-term expenditure framework provides the multi-year perspective that is necessary for preparing a good annual budget, and should be discussed with the legislature—but must not be confused with a medium-term budget.

Confusing “framework” and “budget” can have severely misleading implications. Thus, the argument in favor of setting legally binding sector ceilings for the out-years of an MTEF is invalid on its face, because such legally binding ceilings could only be approved by the legislature (in which case, the country would have a multiyear budget). The only hard ceilings are those for the current year of the MTEF and working within these is of course the start of a sound annual budget preparation process.

Moreover, to argue for binding sector expenditure ceilings over the medium term is equivalent to going back to the rigid multi-year planning approach of yesteryear. As noted, to set hard expenditure ceilings over the medium term would in practice abandon one half of the government’s panoply of fiscal adjustment tools. Because each ministry would inevitably view the expenditure ceilings as expenditure floors, the fiscal space
would disappear and the entire burden of adjusting to intervening changes would fall on the revenue side. On the other hand, neither should the sector ceilings for the out-years be loose and casual indications—to be readily discarded when the annual budget process comes around again. In this case, the line ministries and agencies would gain no added predictability from an MTEF and the exercise would be treated as a futile formality to be ignored. (This is in fact what has happened in many African countries.)

The challenge therefore is to navigate between macro-level flexibility and meso-level predictability. The MTEF procedures should be designed to allow line ministries and spending agencies to plan on the basis of a reasonable presumption of availability of financial resources, while preserving the government’s flexibility to adjust to changes. In effect, the objective is to shift the burden of proof, giving greater confidence to ministries that present strong expenditure programs and weakening the position of ministries with a flimsy programmatic basis. Indeed, the dynamic payoff of a realistic programmatic MTEF process lies precisely in providing the basis for constructive emulation and for stimulating greater efficiency by the line ministries and agencies—without sliding into bean-counting and mechanistic links between “results” and budget allocations.

**The link of an MTEF to the annual budget preparation**

While medium-term projections can improve the annual budget preparation process and the quality of expenditure decisions, they are neither necessary nor sufficient. It is quite possible to have some form of MTEF in place even though the annual budget preparation consists of assembling unconstrained ministries’ requests that invariably add up to much more than the available resources. In consequence, the ministry of finance is forced to make arbitrary cuts, weakening ministerial ownership and accountability, opening up the process to the interplay of personal pressures, and giving free rein to bargaining and influence peddling. In a nutshell, a forecasting MTEF can help make good annual budget decisions but cannot make up for the absence of a good budget decision-making process. On the contrary, experience has shown that introduction of an MTEF has served in some African countries to divert attention away from basic problems in their annual budgeting process, and to that extent has perpetuated the problems instead of helping resolve them.

**Medium-term expenditure frameworks: An African scorecard**

The “scorecard” of the MTEF as implemented in Africa during the last fifteen years is on balance negative, although the introduction of the concept has also produced a number of very significant advantages.

**The positive**

**Awareness of the need to look beyond immediate urgencies**

The very attempts at introducing a medium-term fiscal and expenditure perspective have generated an awareness of the need to think beyond the current budget, even if the resulting medium-term framework is weak or rudimentary. In turn, such awareness is the necessary first step to improving the link between policy and the budget, especially critical in developing countries.

**Encouragement of coordination**

When expenditure projections go beyond purely mechanical top-down exercises by the ministry of finance, the involvement of line ministries and agencies becomes inevitable, and with it,
inter-ministerial coordination is encouraged. This can, in time, break down bureaucratic silos and help produce substantial improvement in overall administrative efficiency, especially in a weak governance climate where public information is viewed as a private asset.

**Attention to the efficiency and effectiveness of public spending**

With the implicit emphasis on expenditure outcomes, rather than solely on expenditure processes, introducing programmatic elements in the budget process can spur greater attention to the results of public expenditure, and to that extent enable an improvement in line ministries’ budgeting capacity and thus their gradual empowerment. If it doesn’t degrade into a plethora of indicators and a mechanistic link between “performance” and budgetary allocation, elements of a programmatic MTEF can, in time, improve the quality of expenditure. Moreover, because external validation of outputs or outcomes will become necessary, an MTEF can open the door to user feedback and broader participation.

**The negative**

**Little or no ownership**

Most MTEFs have been pushed onto reluctant African countries by international donor institutions. In a majority of cases, host governments simply had to accept the initiative as part of the price of a policy-based loan or technical assistance grant. In several cases, they were persuaded that the initiative would help fix their basic budget problems; and in a few cases they were influenced by the same desire for “modernity” that motivated donor agency staff and their managers. In almost all cases, the mantra of “ownership” turned out to be either inoperative or manufactured.

In most countries too, limited local capacity meant that MTEF introduction and elaboration was done primarily by external technical experts, assisted by a few junior local staff. When grant-financed, the net monetary cost to the recipient country has been minor. The heavier costs have instead been indirect, and fall in the two following categories.

**Distraction from fixing the basic plumbing of the expenditure management system**

When an MTEF, even in its simplest variant, absorbs policy-makers’ attention and dominates the dialogue on public expenditure management, it can lead to continued inattention to expenditure control and lax financial management systems. Inappropriate sequencing compounds the problem. In one African country, MTEF introduction was among the “triggers” for the first year of a multi-year development policy reform matrix, with critical improvements in annual budget preparation left to the third year. In another African country, a new macroeconomic and fiscal analysis unit was to be formed the year after MTEF introduction. (It is clearly impossible to formulate expenditure projections before good fiscal projections, which, in turn, must derive from a consistent medium-term macroeconomic framework—all of which require existence of a macro-fiscal unit.)

**Heavy strain on limited budgeting capacity**

In its demanding programmatic form, the introduction and elaboration of an MTEF necessarily requires significant involvement of higher-level government staff, in both the ministry of finance and selected line ministries, with the resulting transaction costs placing a heavy burden on local capacity. In some cases, this has even made the capacity situation worse. The critical recognition that capacity is inherently relative to the complexity of the tasks the system is asked to perform has been conspicuous for its absence. Pushing complex new budgeting practices onto a simple but reasonably well functioning system creates capacity constraints where none may have existed.

The positive experience with an MTEF process in Africa is exemplified by South Africa—see Box 7-1. It is clear that the positive experience was largely made possible by the substantial institutional capacity and robust systems in the country. By the same token, lack of capacity and weak systems go a long way toward explaining the disappointing experience of Malawi—see Box 7-2.
Box 7-1

**Learning from Experience: The Case of South Africa**

In South Africa, the initial MTEF experiment begun in 1994 lasted less than two years, owing to lack of involvement by the political leadership and no clear linkage with the budget process. Learning from this experience, a new MTEF and budget preparation procedure was put in place with the 1998/99 budget, and progressively refined to include the following:

**Initial policy review** (May-September). Policy review involves the Minister’s Committee on the Budget (MinComBud), which groups key ministers and the Budget Council, which is a consultative body consisting of the Minister of Finance, the nine provincial members of Executive Council for Finance, and the Cabinet.

**MTEF/Budget submissions** (by August). Line ministries’ proposals should include:
- A baseline allocation for the medium-term;
- Identified savings and reprioritisation, within the baseline;
- Policy options which entail changes in the baseline allocation. These options should be consistent with the strategic priorities of the ministry. Estimates of investment expenditure should cover five years (two years beyond the 3-year MTEF period);
- Documentation and statements (e.g. personnel numbers, analysis of risks, etc.).

**Review of MTEF/Budget submissions** (August-October). In August-September the national and provincial Medium Term Expenditure Committees, comprising senior officials from the MoF and other ministries, evaluate the MTEF/budget submissions of line ministries and make recommendations to the MoF. In October, The MinComBud discusses the outline of the Medium Term Budget Policy Statement (MTBPS); the MoF submits to the Cabinet the draft MTBPS and “adjustments estimates,” which are tabled in Parliament at the end of October. The MTBPS includes, among other things, the three-year macroeconomic and fiscal framework, as well as medium-term expenditure aggregates for each ministry. (Of course, the MTBPS is not binding and is submitted for purposes of information and debate.)

**Final Stages:** In early November, the Cabinet approves the allocations to ministries and the conditional grants to subnational government. On this basis, the line ministries prepare their draft MTEF/Budget, which includes under the same format both the estimates for the budget year and the indicative estimates for the second and the third years of the MTEF.

**Reporting:** In addition, beginning in 2005 the line ministries are required to prepare a five-year strategic plan, tabled in Parliament in November, after the budget.

*Source: Adapted from Fölscher and Cole 2004*
Box 7-2
One Step Forward, One Step Back: The MTEF Experience in Malawi

Malawi’s experience in reforming its public management system highlights the necessity of placing individual technical reforms within the larger context of budget management and taking into account local realities, ownership of reforms and political will, capacity, and sensible sequencing.

Phase I of the MTEF reform program began in 1995. The main components of this reform program were the reallocation of expenditures to priority activities, the preparation of activity-based budgets, and the integration of the development and recurrent budget. A bottom-up approach in expenditure programming was developed.

These reforms had some benefits—for example, improved capacity at line-ministry level to link policies and budgets. However, as an unintended result of the bottom-up approach developed in expenditure programming, detailed activity costing did not take into account the overall resource envelope, and unpredictable funding undermined the credibility of the exercise—thus undermining overall expenditure control. Sector development of detailed activity-based budgets and efforts to prioritize activities happened in a vacuum and largely amounted to empty annual compliance with procedural requirements—with only limited effect on spending outcomes—rather than robust engagement with problems. The Public Sector Investment Programme (PSIP) was discontinued in 1997, under the assumption that it would be replaced by the MTEF. As a result, for several years the Ministry of Finance had little information about ongoing investment projects, and few of them were included in the development budget.

An MTEF II program was prepared in 2003 and 2004. The second phase of the MTEF reforms is aimed at strengthening the basis for reviving the MTEF. The objectives of the MTEF II program include improving macroeconomic and revenue forecasting capacity; improving cash management; strengthening financial control and accountability; streamlining the budget preparation process to provide timely hard budget constraints; and improving institutions for economic governance, including mechanisms for political involvement, transparency, and accountability. A few improvements have already been achieved. For example, cash planning has been streamlined to provide line ministries with a modicum of predictability. The legal framework has been streamlined. The PSIP was revived in 2004, to prioritize projects according to the objectives of the poverty reduction strategy. However, the initial objectives of the MTEF reform are far from being achieved. In the meantime, important information has been lost, and substantial transaction costs have been incurred.

Summing up

A forecasting MTEF to frame the annual budget preparation is essential in every circumstance and in any country, to inject into the budgeting system an awareness of the future and provide for the beginning of a systematic dialogue on the results of public spending. The formation of a macro-fiscal unit is therefore a priority. However, the form of the forecasting MTEF should not conflict with the organizational architecture of the government or the basic features of the existing budget system, and its level of detail must be mindful of local statistical and capacity limits.

Concerning a programmatic MTEF, costly failures have demonstrated that—as with any other complex institutional reform—successful introduction takes years of persistent efforts consistent with capacity, resources, awareness, incentives, and institutional realities. The two ingredients of a potentially successful MTEF approach are therefore gradualism and selectivity, and the main conditions of success are simplicity and communication. If prematurely introduced or badly implemented, a formal and detailed programmatic MTEF causes enormous waste, frustration, and illusion—for trivial or non-existent benefits. (The same is true of the informatics infrastructure for public financial management.)

If it is realistically constructed and developed, a forecasting MTEF cannot make up for basic budgeting weaknesses, but can help remedy them in time, especially in the direction of strengthening the link between government policy and the budget. Thus it can make the budget a more effective instrument of development and poverty reduction.

In the same vein, it must be emphasized that an MTEF in any form is only an instrument to support good political decision-making—whether by the full council of ministers, a cabinet committee, the president’s office, etc. In turn, this entails the existence of effective support arrangements for policy-making, which are hard to find in low-income countries, and rare even in middle-income countries. This is a major reason (along with capacity constraints and lack of ownership) why programmatic MTEFs have so often remained merely technical exercises, with the waste of resources directly correlated to the sophistication and elaborate nature of the techniques.

The role of donors is critical, either in facilitating improvements in budgeting or in complicating the situation by volatile aid or inappropriate advice. A healthier and more pragmatic approach to a medium-term expenditure perspective would require a consensus among all major donors to stop promoting inappropriate systems, and be mindful of both capacity constraints and the priority to be given to local capacity development.

Finally, strengthening the interface between government and the citizens is the key to future attempts at rebalancing the MTEF dialogue and fostering the advantages of a medium-term expenditure perspective while eliminating the unnecessary transaction costs. As previewed in Chapter 1, good PFM needs to be placed in the broader context of the pillars of good governance, of which accountability is the most important—including accountability of government to society. Thus, social accountability is the central theme of the next phase of public expenditure management reform.
NOTES

1 Actually, the recognition of the need for a multi-year perspective goes back much longer than that. The Roman architects of the Claudian aqueducts were instructed to take into account future recurrent costs for operations and maintenance when choosing route variants.

2 For a comprehensive description, see Corbett, 1998.

3 The government also makes a public commitment to the forward estimates, by including them in the budget documentation and by publishing fresh projections of expenditure and revenue in the three months prior to an election. The role of the legislature is correspondingly enhanced, and civil society as well as voters are given the information and “voice” to react to government budgetary decisions and intentions.

4 For instance, should the government wish to substantially expand access to technical education, the expenditure implications are substantial and stretch over several years, and the policy can hardly be implemented through a blinkered focus on each annual budget.

5 Albert O. Hirschman (see, for example, his Strategy of Economic Development, 1958) was one of the first development economists to understand that institutional factors are more important than the standard physical factors of production. However, he did not take into account (any more than other development economists did until the late1980s) that the ability to make good expenditure decisions is very different from the ability to implement them.

6 Pages 12-13, emphasis added.

7 This scenario is similar to the situation in Tunisia, for example, where the correspondence between 5-Year Plan and annual budget is close. A novel feature of the 11th Plan, covering 2007-2011, is that projections have been made through 2016 and then “backtracked” to the plan period for greater realism. Moreover, plan reviews are comparatively frequent.

8 The country would commit to certain policies for the whole period of the arrangement, and agree annually on the measures to be taken. The period was usually three years, and repayments would occur over 5-10 years. The performance criteria of EFFs were comparable to those of Stand-By Arrangements, but, in the late 1980s, the Enhanced Structural Adjustment Facility expanded the EFF by adding various structural measures, and further deepening was achieved later with the Poverty Reduction and Growth Facility. The goal of balance-of-payments’ viability was replaced with the broader one of macroeconomic sustainability, and consequently the requirement for a comprehensive medium-term macroeconomic framework became stronger.

9 This criticism is implicit in one of the conclusions of the reviews in the mid-1990s of IMF-supported adjustment programs, i.e that such programs would benefit from comprehensive and consistent medium-term scenarios of economic and financial prospects, which would in turn permit assessing the adequacy of fiscal adjustment and realism of the investment and growth targets. (Schadler et al., 1993, and 1996.)

10 A number of technical issues not discussed here would need to be addressed, too, e.g., the length of the MTEF period (current year plus two, at a minimum); the inclusion in the MTEF out-years of a contingency reserve (which should be small, in any case); the use of current or constant prices for the projections (current prices are on balance preferable); the inclusion of expected “efficiency dividends” (possible in advanced countries, but not in developing countries); and other technical points.

11 This has been a demonstrated MTEF benefit in Morocco, for example, among other countries.
In some cases, hopefully a small minority, this is a deliberate tactic to assure that the “reform” cannot be carried out without the continued participation of its proponents. Scott Adams’ cartoon *Dilbert* has a “consultick” character, who gives the sort of advice that cannot be implemented without him, burrows into the client’s wallet, sucks the cash and never leaves.
Chapter 8: Capital Budgeting and Public Investment Programming
What to expect

Owing to the different economic and financial impacts of capital expenditure and current expenditure, a separate presentation for each in the budget is necessary in most budgeting systems. However, the process of capital and current expenditure decisions must be integrated at all main stages. The annual capital budget should flow from a realistic medium-term public investment program—PIP—which is the most important building block for the preparation of a useful MTEF as well as central for development. The chapter describes the features of a good PIP for African development, outlines the major steps of its preparation, and recommends practical measures for improving the effectiveness of public investment and the selection of investment projects.

Capital budgets

As explained in Chapter 2, the government budget includes both current expenditure (government consumption) and capital expenditure (government investment), and fiscal programming needs to consider carefully the balance between the two and their different impacts on the economy and development. Current expenditure comprises the payments (or commitments) for all goods and services that are needed for the regular operations and functioning of the government during the fiscal year. Investment expenditure is associated with the production of new physical assets, which have a useful economic life beyond the fiscal year.

Reasons for a separate presentation of current and capital budgets

Historically, the preparation and presentation of a separate “capital budget” was aimed at either implementing a “golden rule” to allow borrowing only for investment (and thus require a balance or surplus in current fiscal transactions), or at setting up a mechanism to give higher priority to development activities. In developing countries today, it is conceptually and practically necessary to keep a distinction between the two major categories of expenditure and thus to have an identified capital budget. The argument has been very well articulated as follows:

Experience shows that in the absence of properly organized capital budgets, borrowing avenues proliferate, governments resort to borrowing without due consideration of the sustainability aspects (or inter-generational equity), assets are inadequately maintained, and major projects suffer from overall poor management and performance (Premchand 2007, p. 89).

The argument should not be stretched too far. Investment expenditure is not unique in contributing to future production. Indeed, in and of themselves, physical assets contribute nothing at all. What is important for development is the right mix of capital and current expenditure. For example, a few skilled nurses can have more of an influence on health outcomes than acquisition of new hospital equipment. Also, the mechanistic view of the relationship between investment and economic growth (usually identified with the Harrod-Domar model popular in the 1950s and 1960s), has long been shown to be simplistic and misleading, mainly because it focuses attention only on the volume of investment and away from its efficiency and implementation capacity (Schiavo-Campo and Singer 1970). Furthermore, government borrowing policy should not be related only to the desired volume of investment, but to the macroeconomic and fiscal targets in their
entirety. Finally, in the few countries that have adopted pure program budgeting, the financial resources are allocated to integrated expenditure programs, comprising both capital and current expenditure (See Chapter 4).

Nevertheless, in most countries and virtually all low-income countries a clear distinction between current and capital expenditure is necessary, for analytical purposes, fiscal transparency, and policy-making. In the first place, the distinction needs to be made for an assessment of the operating costs of government and the efficiency of government activities. Secondly, investment expenditure generates a stream of future costs and benefits and is conceptually and financially different from expenditure whose effects are extinguished within a short period. Finally, introducing some orientation to results in the budgeting system requires a separation between running costs and capital expenditure (See Chapter 15). Indeed, in some developed countries that traditionally have not made a clear separation between capital and current expenditure in the presentation of the budget, the possibility of creating a separate capital budget should be considered anew.1

As an illustration, imagine that a shop owner needs to enlarge the storage area in order to improve inventory management as well as remodel the shop for better customer access and thus higher sales. To fail to keep track separately of the expenditure necessary for the regular running of the shop (“current” expenditure) and the expenditure associated with expanding and renovating the shop (“investment” expenditure) would cause confusion and lead to wrong decisions, including on borrowing.

The hybrid nature of capital budgets

In most African countries, the capital budget also includes current expenditure managed within the investment projects rather than directly by the administrative divisions concerned.2 In some cases, this is merely a device to cover up a deficit in the current account by shifting a part of current expenditure into something that is argued to be more “developmental”. (The precursor of this practice was the British colonial government in India—see Premchand 2007).3 However, there are also legitimate reasons why a capital budget includes a recurrent expenditure component. Procedures for administering the regular current budget are generally not suitable for the management of expenditures financed by donors, which carry their own fiduciary and management requirements. It would also make no sense to attempt to include the labor costs of a specific investment project into the wage bill of any particular ministry—both because such labor costs are expected to diminish and terminate when the project is completed and because several government agencies may be involved in a single large investment project. It is therefore inevitable that the “capital budget” includes an element of current expenditure. On the other hand, there is always a temptation to reclassify current expenditure as investment, either to camouflage a weak fiscal situation or maximize the amount of foreign aid.

Worse, in many African countries regular government functions are entrusted to contractual employees located in and paid through a donor-funded project at much higher salaries than regular civil servants. This is harmful for long-term capacity development. The damage is compounded when a multiplicity of donors are active in the country, especially in post-conflict situations. Although the motivation to help a new government is honorable, the competition among donors to attract to their specific project the small pool of qualified locals leads to inflating salaries, creating dualism and resentment in the local labor market, and inducing scarce talent to leave regular government service. Such “robbing Peter to pay Paul” or, more accurately, improving implementation of temporary projects at the cost of permanent damage to government capacity is not development assistance but instead is development sabotage.

Under conditions of very limited capacity and inadequate civil service compensation, transitional mechanisms that allow critical functions to be performed by competent individuals may be inevitable—particularly in fragile states. These mechanisms, however, must be used as transi-
tions to something durable and sustainable. If not, using them risks creating engines of dualism that jeopardize the chances of meaningful civil service reform and the country’s own development in the long term.

The hybrid nature of investment budgets also creates loopholes. Line ministries may try to include alleged “projects” in the investment budget to finance regular recurrent spending and obtain additional resources. Or, projects previously financed by external sources may be kept artificially alive after the closure date of the aid agreements, to avoid either increasing regular personnel expenditure or dismissing the project staff.

Is expenditure reclassification desirable?
To transform hybrid capital budgets into “true” capital budgets would require a major reclassification of expenditures. In the small minority of African countries that finance public investment primarily from their own resources, such a reclassification should be systematically undertaken. This would facilitate analysis of the budget as well as eliminate the loopholes mentioned above. Even in these countries, however, it could be necessary first to improve the current budget preparation procedures before identifying the current expenditure component of the hybrid capital budget and move it into the current budget.

Instead, in the large majority of African countries that depend on aid to finance much of public investment, separating the “true” investment expenditure out of the capital budget would require dividing each project into two subprojects straddling two budgets. This would imply significant inconvenience for project management and would be costly as well as controversial, especially for projects in the social sectors, which typically include a high share of current expenditure. A reclassification exercise is unlikely to be worth the cost and the bother.

What is essential, however, is to take measures to prevent new reclassification and an expansion of the current expenditure component of “investment” whenever a reduction in current expenditure is agreed as part of a fiscal adjustment program. The intent of such reduction is to improve the fiscal and financial situation without damaging the country’s development prospects by cutting investment spending. However, in the absence of robust measures (with accompanying penalties) to prevent “favored” current expenditures from migrating into the investment budget for protection, the decline in current expenditure will in reality not occur and the weight of austerity will fall on necessary public investment.

The budgetary treatment of individual investment projects
Predictability of funding is especially important for the implementation of investment projects, and it is therefore necessary to have in place budgetary provisions appropriate to the multi-year expenditure commitment required for projects. This entails:

- authorization covering the entire project cost;
- commitment allocation setting the limit for commitments during the fiscal year (allowing the carryover of unused commitments to the following fiscal year); and
- payment allocation setting the cash limit for the fiscal year, but without any carryover, which would be risky and unnecessary.

Especially prudent would be a rule by which funds for new investment projects are included in the capital budget only when the entire project is “mature”, i.e., ready for launch—with all the required approvals in place, full financing assured, and implementation modalities defined. While such a rule has been criticized by some as old-fashioned and by others as cumbersome, it can be very useful to protect against premature inclusion in the capital budget of projects that are not fully ready for implementation. Waiting a few months until a project is fully ready for implementation constitutes sensible insurance against the risk that the ex-post rate of return of good projects may fall short of the ex-ante rate of return not because of any intrinsic weakness of the project but only because it wasn’t ready to launch. Delaying a good investment opportunity entails some cost, but in
general a far lower cost than wasting resources by rushing its implementation.

Also valuable is a provision, as in Tunisia, whereby projects cannot even be discussed with foreign donors for possible financing until they have been fully appraised by the competent line ministry and then vetted first with the ministry of planning and then with the ministry of finance. Although some of the motives for this practice were highly questionable, the provision worked well to keep the government in the aid management driver’s seat—as should always be the case but frequently is not.4

Integrating the preparation of the current and capital budgets

The need for integration

While separating the presentation of current and capital budgets is necessary for a variety of reasons, also necessary is integrating the processes of current and capital budgeting. To return to the earlier analogy, the shopkeeper must also consider the impact of the expansion of the shop on future current expenditure needs, and not make decisions on current and investment expenditure in isolation from one another. In a nutshell, without covering the current expenses there is no “today”; and without financing the investment there is no “tomorrow”. Shorn of its technicalities, the issue of “integration” between current and investment expenditure is an aspect of the fundamental need to reconcile the present with the future.

Thus, the main advantage of improved integration of investment and recurrent expenditure decisions is that it permits improving the quality of expenditure. It does little good to select investment projects with high ex-ante national economic profitability if the actual ex-post rate of return is much lower because the complementary resources to operate them after they are completed will not be available. Given the compression of the allocation for O&M, unfortunately typical of African countries’ fiscal picture, better capital-current integration is very important for raising the long-term productivity of the fixed assets created and thus the productive capacity of the economy.

Dual budgeting: The real issue

Frequently, confusion exists between the issues of separate presentation of current and capital budgets and the process by which those two budgets are prepared and made consistent. Because a separate presentation is needed, the term dual budgeting refers to dual and separate processes of budget preparation, whereby the responsibility for preparing the investment program and budget is assigned to an entity different from the entity that prepares the current budget, but with sufficient coordination between the two entities.

Historically in many countries, the organizational corollary of a separate capital budget was a split of budget responsibilities between two core ministries—the ministry of finance, responsible for preparing the recurrent budget and a ministry of planning, responsible for the annual capital budget and for medium-term planning. The two entities carried out their responsibilities separately on the basis of different criteria, different staff, different bureaucratic dynamics, and (usually) different ideologies. At the end of the budget preparation period, the ministry of finance would simply collate the two budgets into a single document and call it “the budget.” Clearly, such a practice impedes the integrated review of current and investment expenditures that is necessary in any good budget process.

In many cases, coordination between the preparation of the recurrent budget and the investment
budget is poor not only horizontally between the two core ministries but also vertically between each core ministry and the line ministries. The ministry of finance deals with the budget departments of line ministries, and the ministry of planning deals with their investment departments. This duality may even be reproduced at subnational levels of government. Adequate coordination is particularly difficult because the spending units responsible for implementing the recurrent budget are administrative divisions, whereas the investment budget is implemented through projects, which may or may not report regularly to their relevant administrative division. The introduction of rolling public investment programs, discussed later in this chapter, was motivated partly by a desire to correct these dual budgeting problems.

In many ways, therefore, the more serious dual budgeting problem is lack of coordination within the line ministries between the formulation of the current budget and the formulation of the capital budget. For example, if in the health ministry the hospital construction program is prepared separately from the current budget, possibly more efficient alternatives such as building fewer hospitals and buying more medicines cannot even be considered. Without integration or coordination of current and capital expenditure at the line ministry level, integration or coordination at central ministry level cannot be fully successful. A good budget is assembled at the center, but must be grounded on good and realistic budgets proposed by each line ministry and agency.

In Africa, aside from the legacy of central planning practices of the past, pressure from donors has been (and in many cases remains) a major factor contributing to dual budgeting. The desire of donors to “enclave” their projects, in order to minimize risks of mismanagement and maximize provision of counterpart funding, perpetuated or increased the fragmentation of the budget system. A tendency for project-centered assistance to enclave project implementation reduced the incentives on government to reform and weakened domestic systems by replacing them with donor-mandated procedures. To address these problems, the 2005 Paris Declaration made two important commitments: harmonize aid as much as possible among donors and increase their reliance on country systems and procedures. While there is evidence of progress in many African countries toward the objective of improved harmonization of aid, there is no evidence of progress toward the related but different objective of greater reliance on country systems. Most disappointing is the lack of progress toward the stated objective of improving national implementation, as shown by the approximate- ly constant PEFA score on the proportion of aid managed by national procedures and the slight decline in the corresponding Paris Declaration indicator (World Bank 2011).

The issue has been clouded by a superficial attribution to dual budgeting of other deep-seated budgeting problems, mainly the large expansionary bias in government expenditure during the 1970s and 1980s. Given the same governance, capacity, and political conditions prevailing in Africa during the 1970s and 1980s—including superpower competition during the Cold War—the same wasteful and often corrupt expansion of government spending would have resulted, with or without dual budgeting. (If only the massive economic mismanagement could be explained by a single and comforting “technical” problem of budgetary procedure!) The problems originated not from a visible dual budget, but from an invisible “third budget”: untouchable military expenditures, secret funds, casual guarantees to public enterprises, grand corruption, and so forth.

Investment budgeting is subject to strong pressures from particular or regional interests (so-called pork barrel projects) and because, in general, it gives more opportunities for corruption than current expenditures. Thus, in countries where governance is weak, vested interests may favor keeping the process of preparing the investment budget separate. However, under those circumstances of weak governance, to “integrate capital and current budgeting” may simply mean concentrating power and bribery opportunities in the hands of a unified-budget entity, and centralizing corruption and inefficiency rather
than reducing them. Indeed, it is precisely in countries with weak governance that to focus first on improving the integrity of investment programming process may be the only way to allocate some resources to economically sound projects. The appropriate organizational decisions on integrating investment and current expenditure can come later.

**Unified or separate ministries of finance and planning?**

Because the dual budgeting problem stems from the lack of integration between the investment and current expenditure processes, and not the existence of two separate government entities, the problem cannot be solved by simply merging two ministries (as it is often assumed). In a merger, if coordination between investment and current expenditure decisions remains weak, a former minister becomes a deputy minister, organizational “boxes” are reshuffled, a few people are promoted and others demoted—but dual budgeting remains alive and well within the bosom of the umbrella ministry. In contrast, even with two separate ministries, if coordination between the two decision-making processes is close at every major stage, the capital and current budgets end up consistent with each other and with government policies, and the dual budgeting problem does not arise.

Thus, in countries where the current and investment budget processes are handled by different ministries, whether they should or should not be brought under the same roof depends on the institutional characteristics of the country. Where the agency responsible for investment is weak and the ministry of finance is competent and not involved in ex ante controls or micromanagement, transferring responsibility for the investment budget to the ministry of finance would tend to improve budget preparation as a whole. (The alternative of course would be to strengthen the agency responsible for the investment budget in the first place.) Instead, where the investment agency is competent, a unified process would risk dismantling the existing network of civil servants who prepare the investment budget, without adequate replacement, and lose government’s capacity to “look out for the long run”. As noted, coordination problems may be as severe between separate departments of a single ministry as between separate ministries.

On balance, for African developing countries, there is a general argument in favor of having a single entity responsible for both the investment and current budgets (although that entity must possess the different skills and data required for the two tasks). Where coherence is at a premium, skills are in limited supply, and a single budget is difficult enough to prepare—it may complicate matters unnecessarily to have two budgeting processes and two responsible entities. Simplicity should be the organizational keynote in developing countries—especially in fragile African states. The more complicated the organizational structure, the less likely it is to work well. It is to be emphasized, however, that this argument is only a general presumption. The organizational choice must be country specific and politically as well as economically sound.

It is sometimes wrongly argued that a process of programming of public investment hampers capital-current integration, and/or retards the elaboration of a medium-term expenditure framework, and/or produces fiscally unsustainable expansion. The opposite is true—on all three counts—as we shall now discuss.

**Public investment programming**

Efficient public investment is essential for economic growth in most African developing countries, where conditions for large increases in domestic and foreign private investment do not yet
exist. Public investment is also a source of future expenditure commitments and thus of potential fiscal risk. Without realistic public investment programming, the economic growth potential cannot be realized and the fiscal risk cannot be mitigated.

Let’s first dispense with the erroneous notion that public investment programming is inherently fiscally expansionary. First, a good public investment program strengthens the coherence between policy and the budget, and thus advances the probability of growth with stability (if the policy framework is appropriate). Second, a good programming system raises the efficiency of investment and, by ensuring that the financing is available, it ensures the sustainability of investment and thus the country’s overall development. Third, the actual facts point in the opposite direction: sound programming of public investment reduces the need for investment resources. In the 1990s, in African countries participating in structural adjustment programs, which emphasized a public investment programming process as well as restraint on overall government spending, the ratio of capital expenditure to total government expenditure was slightly lower than in the other countries. (Countries under structural adjustment also had much lower military spending and civilian wage bill.)

Indeed, the causality runs the opposite way. It is the absence of a good public investment programming process that results in inefficiencies and lower growth, because the government expenditures that cannot be cut in the short term are salaries, interest and major subsidies. Cuts are thus concentrated in operations and maintenance expenditure, and in public investment. Given the macroeconomic and fiscal forecasts and objectives, the resources allocated to public investment have typically been a residual—estimated by deducting the recurrent expenditure needs from the expected amount of revenues. The residual character of the domestic funding of development expenditures may even be aggravated during the process of budget execution, when urgent current spending preempts spending on ongoing investment projects—which can be postponed more easily. The result is to compromise project implementation and thus its economic effectiveness.

“First-generation” public investment programs

After the mid-1970s, the approach to aid and development spending evolved from an exclusive focus on individual projects to consideration of the entire public investment portfolio (and then expanded further to the profile of overall public expenditure and an assessment of the soundness of the overall policy framework of the country.) In particular, the need for a “public investment program” (PIP) was justified by the reality that money is fungible: “If the project to which the aid is ostensibly linked is a high-priority project A…the aid given enables the recipient to release its resources from Project A…to add a new Project E…which may be neither technically sound nor economically right, nor generally the kind of thing that the aid donor would want to support” (Schiavo-Campo and Singer 1970). Therefore, aid to finance a specific large project needed the assurance that the investment portfolio as a whole was acceptable. This became even more necessary to justify program aid and untied budget support.

Un fortunately, in most developing countries, especially in Africa, PIPs quickly degraded into shopping lists to attract aid, theatrical scripts written by external consultants to be performed at international donor meetings, and occasionally even fig leaves for giving budget support to corrupt regimes. As a result, by the early 1990s the credibility of these public investment “programs” was in ruins.

However, the real problems with the “first generation” PIPs of the 1980s were due to pervasive bad practice rather than the concept of medium-term programming of investment. Regrettably, attention was diverted away not only from the bad practices but also from the valid concept itself. The challenge is instead to remedy those bad practices and assure that PIPs become the realistic programs they were supposed to be rather than the expansionary and unproductive wish lists of the past. That a realistic PIP is desirable is demonstrated by the simple proposition that
a well-programmed and revenue-constrained expenditure on sound investment projects is better for development and poverty reduction than uncoordinated and unconstrained expenditure on weak investment projects. The question is how to achieve a realistic PIP.

“Second-generation” public investment programs

Unlike first-generation PIPs, devoid of both rigor and ownership, a second-generation PIP can raise investment efficiency by bringing investment allocation in line with country policies and sector priorities, assuring consistency between investment projects and programs, and providing the foundation for financing at favorable terms. Also, if conducted with appropriate local participation, the process of PIP preparation can be important for capacity development—not only in the narrow sense of skills training but also in the more important sense of introducing cost-benefit attitudes in the administration, an awareness of financial constraints, and a measure of social accountability.

The question may be raised of whether a medium-term program of investments is better than a comprehensive medium-term framework comprising all expenditure. The choice is obviously the latter—but the question is not meaningful. The meaningful question is how to get to a comprehensive medium-term framework. The answer is to begin by programming the category of expenditure that has the largest financial and economic implications for the medium and long term. In developed countries, entitlements are such a category, and pensions, public health and the like deserve the bulk of medium and long-term policy attention. In developing countries, particularly African low-income countries, public investment remains the category of discretionary public expenditure that has the single largest medium and long-term financial and economic implications. A PIP is not an alternative to an MTEF: it is its largest building block and the only way to progress toward a comprehensive framework at some future time. (Except for the social sectors and general administration, public investment in developing countries accounts for the bulk of the MTEF. Moreover, in most African countries the PIP includes large sums for maintenance.)

Elements of a second-generation PIP

In addition to appropriate budgetary provisions for investment projects, the ingredients of a second-generation PIP can be listed as follows:

» The first priority is to design ironclad procedures to prevent the birth of “white elephant” projects. Once a project of very large size is on the drawing board, the bureaucratic dynamics from both donor and recipient sides make it very difficult to stop the project. Political gatekeeping through the involvement of high-level policymakers (and, for very large projects, the Cabinet) must be built in at a very early stage.

» No project should be included in the PIP, even for the out-years, unless it has sufficient profitability in national economic terms, as demonstrated through sound economic appraisal.

» No project should be included in the current year PIP unless financing is certain, or in the out-years unless financing is reasonably assured.

» A prompt and skillful procurement process is needed to enable managerial efficiency in project implementation while minimizing the opportunities for corruption.

» Financial and physical monitoring of project implementation and completion should be frequent and reliable—and obtaining systematic feedback from local entities can be extremely useful for this purpose.

» A realistic procedure and a minimum capacity for reliable estimation of the total cost of investment projects and their recurrent costs are a must for improving the integration of capital and current expenditure over time. This is always preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process.
Estimating the recurrent cost of investment projects
The objective is to quantify the overall implications of public investment on future years’ budgets, to assess fiscal sustainability and future fiscal policy options, and reduce the risk of wastage of valuable assets for lack of sufficient operations and maintenance expenditure. This is an eminently practical challenge. A simple and workable sequence include as main steps:

» Collecting standard costs from national and international experience and technical manuals. Although the requisite information is generally available, this is a substantial exercise, which requires structuring the information clearly, and arranging at least annual updates;
» Deciding on the time period over which the recurrent costs are to be estimated (a minimum of five years after project completion);
» Deciding on the cost elements to be considered—primarily for labor (especially the higher-level skills required, e.g., surgeons in hospitals), durable goods (especially expensive equipment, e.g., x-ray machines) and materials, fuel, other supplies, and maintenance of buildings and other physical facilities;
» Deciding on a standard simple format for preparing the estimates, and aggregating them by sector and nationally;
» Including in the terms of references for the feasibility studies of projects the requirement to estimate future recurrent costs, on a standard format;
» Limiting detailed recurrent cost estimation to large projects, approximate calculations should be sufficient for smaller projects;
» For large projects, examining alternative variants of project design that have different combinations of initial investment and future recurrent costs.

In the context of medium-term expenditure forecasts, the estimates of future recurrent costs of investment projects would also be rolled annually and adjusted according to changes in projections of inflation, interest rates, import prices, etc.

It must be emphasized that such estimation affects only the expenditure side. Public investment also adds to the economy’s productive capacity and thus to the tax base and government revenue. If the choice of projects is appropriate and their design, execution and financing are sound, the resulting indirect increase in government revenue should more than compensate for the associated debt service, depreciation, and operations and maintenance needs—which is of course the basic test that public investment must meet.

The problem of project overloading
When confronted with excessive investment proposals from line ministries, the ministry of planning or of finance is tempted to avoid the hard decision to reject the weak proposals by including them in the out-years of the PIP, without any real intention of eventually financing them. The temptation is understandable; but as happens with all evasion and postponement of hard choices, the eventual outcome is unfavorable. In a year or two the out-years of the program are cluttered with projects that everyone knows to be unrealistic—destroying the credibility of the medium-term PIP itself (and making a meaningful MTEF impossible).

Overloading the PIP is sometimes justified as an instrument for negotiating additional project aid. In practice, however, donors quickly realize that the program is deliberately overloaded, and the practice will result only in distorting the pattern of aid rather than increasing its amount.

To avoid overloading, it is necessary to frame the preparation of the PIP for each year of the period, with a binding ceiling for the coming fiscal year and indicative ceilings derived from the macroeconomic and fiscal framework for the out-years. The most important requirement, however, is to put in place and enforce rigorous procedures for appraising project proposals and selecting the projects to be retained in the PIP.
Screening and selecting public investment projects

A good PIP is more than a collection of good projects, but good projects remain the bedrock of a good PIP. Typically, the aggregate of “good” projects requires financing in excess of available funds, and difficult choices must be made. The basic operational principle is to place the burden of proof on those who advocate including a project in the PIP, and not on those who believe it should be excluded.

The major selection criteria

Proposed public investment projects should be screened according to four major criteria:

- **Consistency with national policy** (particularly the national poverty reduction strategy and the strategy for the sector concerned);
- **Acceptable rate of return**, in national economic terms. Techniques of cost-benefit analysis of project proposals are well-established and need not be discussed here. (For a practical and still current description, see Kohli, 1993.)
- **Implementability** of the project, in light of its requirements compared with actual capacity for project execution and for investment monitoring.
- “Fit” of the project within a sound overall PIP.

The uses, abuses and decline of cost-benefit analysis

Cost-benefit analysis is intended to assess the net benefits to the economy, measuring both the costs and the expected benefits in terms of “opportunity cost”, i.e., the alternative uses of the resources. For development projects, the economic rate of return of projects is what matters, not the internal financial profit. Therefore, the analysis must include appropriate consideration of the “external” effects of the project on other projects, the sector, or the economy as a whole. External effects may be positive (e.g., draining a malarial swamp in the process of building a rural road) or negative (e.g., pollution). Not all costs and benefits can be measured, but all must be considered in the appraisal of the project. Similarly, especially in fragile states, future risks should be taken into account—normally through simulation exercises designed mainly to make the project design more robust and resistant to the risk of failure. (See Squire and van der Tak, 1975, for a still-current description of economic analysis of projects.)

The use of economic analysis in aid-assisted projects has been declining in multilateral institutions. The reasons are twofold: a decline in the quality of the analysis, and an increased recognition of the non-measurable and external costs and benefits of projects. A vicious circle has been at work: the recognition that standard cost-benefit analysis is insufficient to fully appraise the development impact of public investment projects has also produced an excuse not to conduct the analysis at all as well as neglect the quality of the analysis actually conducted. This neglect in turn diminishes further the credibility of the methodology itself. The decline has been nothing short of dramatic. During the four decades from 1970, in World Bank projects the proportion with cost-benefit analysis dropped from 70 percent to 25 percent—partly but not entirely caused by a shift toward projects in social sectors, less amenable to such analysis (World Bank 2010d). In African low-income countries, while it is appropriate to keep in mind the limitations of economic analysis of public investment projects; it is risky and unnecessary to neglect the use of the methodology where it is applicable. Indeed, doing so can generate a lax attitude toward project appraisal. This is antithetical to the imperative of raising the efficiency of public investment in an environment of scarce resources. At the same time, it is critical to assure transparency in the methodology, because the assumptions behind the calculation of the economic rate of return can too easily be manipulated to yield a pre-ordained result.
Given the need to economize on scarce capacity (and minimize reliance on expatriate expertise), full application of cost-benefit analysis in developing countries should be limited to large projects. This is because large projects are particularly likely to generate the positive or negative externalities that are important for development. Only projects of significant size should be analyzed in detail, with small projects “bundled” and evaluated only for their general correspondence with sector policies and on the basis of economic common sense. Moreover, within the full panoply of cost-benefit methodologies, the simpler appraisal methods are preferable.

Concerning the larger projects, even low-income African countries can benefit from the creative experience of Korea, which has instituted a system of “pre-feasibility studies” of project proposals, conducted by the Ministry of Finance independently of the sector ministries concerned. The system has resulted in reducing sharply the proportion of “feasible” projects down to those truly deserving of public resources. (In effect, this has turned the subsequent “feasibility study” by the line ministry into an “implementation modalities study”.) Simple variants of such a system could protect African countries from the risks and costs of allowing “white elephant” projects into the project pipeline, which are extremely difficult to remove.

Equally important, but particularly innovative, has been the “Analytical Hierarchy Process”, by which the decision-making process on projects reflects the “votes” of experts from different disciplines, rather than only a mechanistic application of formulas. (The formulaic approach is easy to manipulate by those in possession of the numbers and able to tweak the assumptions.) And the willingness in the Korean system to actually cancel a project if the mid-course reassessment of its feasibility so recommends is remarkable, in light of the notorious reluctance of most administrative systems to stop pouring good money after bad (Park 2008).

Finally, it is well to remember that—however high the ex-ante economic rate of return of a project may be, neglecting the implementation requirements or failing to provide the resources necessary for project execution will inevitably cause the ex-post rate of return to be far below what had been anticipated. (We will return to this subject later in the book.)

**Priority ranking?**

In the heyday of economic planning in the 1970s, it was thought possible to rank projects in order of their economic rate of return, with the highest-ranked then selected in turn until the financial envelope was filled. This approach has been attempted in a few countries unsuccessfully. As noted in Chapter 4, comparing the social worth of activities in different sectors according to quantitative criteria is hazardous—as it is impossible to decide technically whether one or another group of intended beneficiaries should be preferred.

The idea of ranking projects by relative priority has recently re-emerged in some African countries—in part as a way to rationalize political pressures to finance a powerful minister’s “pet project”. It is therefore useful to recall the old but still valid principle set out by Squire and Van der Tak in 1975: “For a given investment budget... projects are either acceptable and should be included in the investment program or are not acceptable and should be excluded...There is no single ranking of projects that are added or deleted from the program in accordance with variations in its size. Changes in the investment budget tend to affect its general composition and not simply marginal projects.” It is not unusual, of course, that a particular project is launched for purely political reasons—good or otherwise. But if this is so, there is no reason to waste time and resources in artificial “ranking”, the sole purpose of which is to cloak the political decision in “technical” terms.

**Rules of thumb for screening, budgeting and improving investment proposals**

The next chapter on budget preparation discusses the screening of requests for current expenditure. For investment projects, subject to the four criteria listed above, one may extract from actual experience in developing countries certain practical rules to use for screening project proposals,
and for budgeting and monitoring the projects that have been retained in the PIP:

» Use the “double sense” principle: common sense and economic sense. If an economic appraisal of the project reaches a conclusion that the project makes economic sense, but the project idea still doesn’t meet the test of common sense among those with practical experience in the sector, it is worth seeking a “second opinion” through another economic study.

» Don’t rob Peter to pay Paul. Except in the poorest fragile states, most aid-assisted projects require local contributions from the budget. (These contributions are often called “counterpart funds”. Confusingly, the term is also used to refer to the local currency proceeds from selling goods or services provided by an aid donor). Even if all requisite local contributions are accurately estimated and included in the annual capital budget, problems during budget execution are likely to arise—from shortcomings in revenue, or delays in aid disbursements or other reasons. However, implementation problems are inevitable if the total amount of counterpart funds in the budget is lower than required to cover all aid-assisted projects. Either some projects will have to be halted in order to shift sufficient counterpart funds to other projects, or they will all be delayed in implementation. And because the local currency contribution is usually a fraction of the foreign aid, having to cut it causes a much greater reduction in aid. Insufficiency in aggregate counterpart funds in the budget guarantees bad execution of the capital budget and reduces the inflow of aid.

» Beware of “free” money. As explained earlier, the focus should be on project quality. If the project is selected, then it will be time to look for the best financing terms. It is understandably difficult to turn away a grant or a loan on soft terms, but if the project is not economically viable in the first place it may not justify the burden on future budgets from the necessity to operate and maintain it. (And if the donor agency is genuinely interested in assisting the country’s development it should be willing to rechannel its soft loan or grant to finance a more viable project.)

» A good no is better than a bad yes. It is possible to recoup a missed opportunity but it is difficult to undo a major mistake or to halt an unviable project once implementation has begun.

» External feedback. Assure appropriate external feedback, both on the project itself (particularly its design variant) and on its implementation. The farmer who still gets wet crossing the river is the best source of information that the bridge has not yet been completed. The form of civil society involvement will depend on the country and the type of project, but a mechanism to obtain external reality checks is essential everywhere.

» Improve quality at entry. The objective of investment screening is not only to reject bad proposals, but also to foster lasting improvements in investment proposals. Hence, some positive incentive is needed for improvement in quality at entry. A “ladder approach” has proven effective in customs clearance and regulatory enforcement and may be useful for investment as well. Ministries that submit consistently improved project proposals and demonstrate positive impact of investments undertaken could be given more favorable consideration in the next budget and/or be subject to progressively less stringent tests.

A zoological taxonomy of public investment projects

Aside from all the economic, financial and technical criteria, during the preparation of a public investment program it may help to ask: “What sort of investment animal is this?” Without any pretense at analytical substance, I suggest that most public investment projects fall into one or another of five zoological categories.

» Black cows. Black cow projects are large, well-bred, well-financed projects with a high and lasting impact on productivity: the mainstay of good public investment. The appropriate policy vis-à-vis black cows is to make sure they are conceived properly, born in a safe environment, raised attentively, and fed ev-
erything they require. Short-changing the gestation or the care and feeding of black cow projects will cost much more in terms of lost productivity than any savings that can possibly be achieved.

» Brown donkeys. Brown donkey projects are mid-size investments—the majority of projects in most sectors—with moderate costs and benefits and thus limited risk. The appropriate policy vis-à-vis brown donkeys is to delegate responsibility for design, implementation and monitoring to the line ministry concerned, confining the central tests to assuring that they are consistent with the sector strategy and have been adequately prepared.

» Pink pigs. Pink pigs are investment projects undertaken mainly for reasons of political patronage or regional balance. Pink pigs can be important for system maintenance, and in a fragile state may be essential for the politics of reconstruction. One cannot apply cost-benefit methodology to them, because the political and/or security benefits are intangible. The appropriate policy vis-à-vis pink pigs is to set up clear criteria for “fair distribution” and surveillance that the money does go to the intended beneficiaries.

» Gray rabbits. Gray rabbit projects are small geographically-dispersed investments for social and humanitarian objectives, usually subcontracted to NGOs or local communities. Gray rabbits can make worthwhile contributions and produce visible “quick wins”. Again, they may be especially important in a post-conflict environment. They are too small and heterogeneous to justify application of cost-benefit methodology, but do require explicit government clearance based on common sense and avoidance of duplica-

tion. Also, like their namesake, these projects can reproduce very fast and can cause unexpected accountability problems and reputational risks. The appropriate policy vis-à-vis gray rabbits is to limit total expenditure on the group, require basic but regular reporting and monitor implementation.

» White elephants. White elephant projects are very costly “prestige” projects with imaginary or unclear benefits and large future expenditure requirements. One or two white elephants can destroy the public finances of a small developing economy. Africa has fewer white elephants today than a generation ago because most of them have expired of their own obesity after having gobbled up large amounts of African taxpayers’ money. But Africa still suffers indirectly from their burdensome inheritance. It is very difficult to stop the gestation of a white elephant project once it is in the pipeline, and next to impossible to terminate the project after it is born—owing to the vested interests it has created and to the political embarrassment it would cause to admit such a big mistake. The only workable policy vis-à-vis white elephants is to prevent their conception. It is critical to set up “gatekeeping” mechanisms to prevent potential white elephant projects from even entering the project pipeline. Such gatekeeping should include a political as well as a technical mechanism. The political gate should involve the highest levels of government. The technical gate may take any form suitable to the specific country, but must have political support and full operational autonomy. (An example of such a mechanism is described in Box 8-1.)
Box 8.1
Providing Technical Contestability for Large Public Investment Proposals

To help address weaknesses in project preparation, a technical contestability office (TCO) could be established to provide: (a) technical oversight of the preparation and execution of major projects; and (b) guidance and facilitation of capacity building in the line ministries. Such an office would be autonomous, under a board chaired by the minister of finance or planning and including other key ministers as appropriate.

For major projects, the TCO would be responsible for the following, in sequence:
- General advice on viability of project ideas before launching feasibility studies (especially important to prevent conception of potential white elephant projects);
- Confirm that the project preparation and appraisal procedures were respected, before a project can be included in the investment budget;
- Follow up on project execution;
- Lead the preparation of relevant project preparation manuals for the ministries;
- Initiate the post-completion evaluation of projects.

In its review of project preparation, the TCO would be expected to ascertain, among other things, the consistency of the proposed project with the sector strategy. It may comment on the strategy, but only to the extent that weaknesses impede the preparation of sound projects, and without any authority to review the sector strategies themselves.

The TCO would be lightly structured, with short lines of command and a small but highly competent staff. It would operate mainly by commissioning studies by external consultants, and its overhead costs would be covered by a regular budget allocation—with additional amounts allocated as needed to cover the costs of studies and other approved activities. This would permit the TCO activities to expand and contract as required. An external auditor would provide accountability, as for any other public entity. However, in this case, a special substantive audit of the technical quality of TCO activities would also be conducted periodically by an external entity.

The TCO could be active for a number of years, but it would be inherently temporary, to transition from a system without effective quality controls to a system in which such controls exist and are exercised primarily in the line ministries themselves. The TCO capacity-building role would be intended for this purpose, as part of its work program.

Source: Adapted from a proposal for the Government of Algeria.
NOTES

1 In the U.S., for example, if the structural rate of economic growth is to accelerate, the budget process needs to focus on long-term decision-making. A recommendation advanced long ago by the General Accountability Office is even more relevant today in the aftermath of the Great Recession of 2008-2011. The GAO recommended to set up an explicit investment component in the budget to help Congress and the President make better-informed decisions on consumption versus investment spending for the future—provided that such component is set within a fiscal framework that strives to cut the deficit to a sustainable level over an appropriate period. Setting investment targets in the congressional budget resolution could be a feasible way to do so.

2 In earlier years, the share of current expenditures included in development budgets has been as high as one third in some countries (e.g., Bangladesh).

3 The precedent led to a post-independence distinction made between “plan” and “nonplan” expenditures—a holdover from the central planning approach of the 1950s and 1960s that continues to this date. The political and bureaucratic incentives at making “the plan” look as large as possible lead to a fiction whereby a huge sum of money is in theory allocated to “plan expenditure” on a large number of projects, while everyone involved knows that only a fraction of that money will in reality be available. The fiction is anything but harmless, however. The inclusion in the plan of a number of projects in excess of what can conceivably be financed leads to starving all projects of the funds necessary for their implementation. The result is that even the best projects cannot produce the intended results because of the delays in implementation from being short-changed of resources. This is one of the problems that a sound public investment program would address and avoid.

4 The popular revolution of January 2011 has revealed to everyone what Tunisians well knew as a highly repressive police state, with increasing corruption especially in the last decade. The administrative apparatus, however, was and remains competent and well organized, and public financial management was prudent and comparatively efficient—which will considerably help the transition to full democracy in the times to come.

5 Pages 248-249. The fungibility of aid was first pointed out by Barend de Vries, 1967.
Chapter 9:
The Process of Annual Budget Preparation and Approval
What to Expect

This chapter discusses the most important requirements of a good budget preparation process, as well as the most frequent bad practices in budgeting. The various stages of a sound budgeting process are then described, including: the “top down” phase of setting the expenditure limits and giving instructions to government ministries and agencies (consistent with the overall macro-economic framework); the “bottom up” phase during which the agencies make their decisions and prepare their budgets (consistent with the priorities established for their respective sectors); and the reconciliation/negotiation phase, when major differences are discussed and resolved prior to submitting the draft budget to the political leadership. Practical rules of thumb are suggested for screening different types of expenditure requests. The chapter goes on to discuss the appropriate presentation of the budget documentation, and concludes by outlining the division of labor within the executive in the budget preparation process, and the procedures for debate and approval of the draft budget by the legislature.

Politics and the budget

Like democracy, budgeting is not an event but a process, and, like democracy, it requires compliance with clear, efficient and transparent rules, uniformly enforced. Within the basic principle, the process of budget preparation described in this chapter is aimed primarily at fulfilling the first two objectives of public financial management: aggregate expenditure control and strategic allocation of resources. The third objective—operational and service efficiency—underpins part IV on implementing the budget, as well as Chapter 15 on monitoring, evaluation and encouragement of performance.

Beware of technocratic illusions: Budgeting is inherently political

This book focuses on the economic and technical aspects of budget preparation. However, it must never be forgotten that all budgeting is inherently political, since it requires making choices among different activities that benefit different people. No “objective” technical rules can determine, for example, whether three additional rural health centers in one district are “better” than one additional primary school in a city. One hears sometimes the wistful wish by civil servants or public accountants to “get the politics out of the budget”. This wish is not only impossible but is wrong, because the legitimate authority of expenditure managers does not include making decisions about expenditure policy. Those decisions must be made by the political leadership of the country. An apolitical budget process is an oxymoron.

Thus, the characteristic of good budget preparation is not to take politics out of the budget, but to confine the politics to the start of the process when the key policy decisions are made, and to the end when the coherent technical proposals consistent with those decisions are submitted to the political leadership for its consideration and disposition. In between, no micromanagement or partisan political interference should occur, precisely to allow the administration to prepare a budget that is consistent with the policy choices. Paradoxically, such interference by politicians in the midst of the budget preparation process would weaken the political relevance of the budget, not improve it, because it would distort budget preparation away from the original policy choices.
Fiscal problems versus budgeting problems
In parallel with the essential difference between policy and management, a clear distinction must be made between a fiscal problem and a budgeting problem. Fiscal problems emerge from low revenues in relation to high expenditure, and call for changes in policy: either mobilization of greater revenue or reduction of expenditure, or most often, a judicious combination of both. (See “Mr. Micawber’s Principle” in Charles Dickens’ *David Copperfield*: “Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.”)

Instead, budgeting problems emerge from badly estimated revenue and expenditure, and call for changes in management and methodology. The plain but important implication of the distinction is that rich countries can and often do have weak and inefficient budgeting processes, whereas a poor country can manage its budget process well. (In the first few years after independence before the large-scale discovery of diamonds, Botswana was very poor but was also a careful and realistic budget manager.) Indeed, the unfortunate reality is that the poorer the country the less it can afford to mismanage its public finances.

Three requirements of good budget preparation
To be an effective instrument of public financial management, the government budget must in the first place be credible, and to be credible the expenditure program must be known to be affordable. Therefore, budget preparation must take as its starting point a good estimate of revenue (although the revenue estimate usually will change before the budget is finalized). Thus, fiscal marksmanship—that is, the accuracy of revenue forecasts as shown by the close correspondence of actual revenues to the revenue estimates—is the lynchpin of the budget preparation system. (While overestimating revenue is the more frequent problem, underestimation of revenue can also lead to difficulties, albeit of a different sort.)

When revenues are overestimated, sharp expenditure cuts must be made later when executing the budget. On the revenue side, overestimation can come not only from technical factors, such as an incorrect appraisal of the impact of a change in tax policy (see Chapter 3), but also often from the desire of politicians or ministries to keep an excessive number of activities in the budget with the intention of requesting increased appropriations later.

Assuming reasonably accurate revenue forecasts at the start of the process, three major conditions are needed to prepare a budget that is both technically sound and faithful to political directions: a medium-term perspective, taking early decisions, and the associated need to set expenditure limits within which each ministry and spending agency should prepare the budget proposals.

The need for a medium-term perspective
Chapter 7 explained that because the budgeting system should provide a link between government policies and the allocation of resources and most policies cannot be implemented in the short term, the process of preparing the annual budget should take place within a medium-term expenditure perspective. In Africa, given the fluid situation of most countries and repercussions of global events, a forecast covering two years beyond the coming budget year is probably as long as can reasonably be expected for framing the preparation of the coming budget.
The need for early decisions
By definition, budgeting entails making choices. These choices can be made, at a cost, or avoided, at far greater cost. The ostrich that hides its head in the sand usually pays a heavy price. Political interference, administrative weakness, and lack of needed information often lead to postponing these hard choices until budget execution. This postponement makes the choices harder, and leads to an inefficient budget process.

On the expenditure side, underestimation can come from unrealistic assessments of the cost of activities, but can also be a deliberate tactic to launch new programs. Unfortunately, governments are naturally reluctant to abandon an expenditure program after it has been started, despite the general rule of economics that one should never throw good money after bad. When combined with bureaucratic and political momentum as well as vested interests, this natural reluctance leads to continuing an expenditure program even when a broad consensus exists that it is ineffective and wasteful. No technical or methodological improvement can resolve institutional and political problems of this nature by itself. Robust gatekeeping to prevent bad projects and programs from getting started in the first place is therefore much more important. By the time they are in the budget pipeline, it is usually too late to stop them.

None of the five possible ways to correct the effects of an unrealistic budget is efficient when applied during the last step, budget execution:

» Across-the-board cuts lead to implementation problems in all activities, including the priority activities.
» Selective cuts help, by protecting spending on priority activities—but ministries and agencies still lack predictability and have no time to adjust their commitments.
» Excessive commitments lead to payment arrears, which create their own inefficiencies and destroy government credibility.
» The cash available can be rationed, but doing so politicizes budget execution and enables corruption. This approach has recently come to be known as cash budgeting. This term is highly misleading, because it has nothing to do with the basic budgeting system, which is on a cash basis almost everywhere. Cash rationing is simply rationing, not “budgeting”—indeed, it reflects the absence of budgeting.
» Isolating core programs within the budget and giving them higher priority during budget implementation can be viewed as a second-best response to a temporary situation of high uncertainty of resources (as in a period of very high inflation or in a post-conflict situation). As general practice, however, it has nothing to commend it, compared to the obvious alternative of preparing a realistic budget to begin with. Indeed, depending on the political interests involved, once non-core programs are included in the budget they may in practice chase out more deserving programs. (As discussed in Chapter 8, the core-noncore approach is not efficient when applied to investment.)

Accordingly, a higher but more realistic fiscal deficit target is far preferable to an optimistic fiscal target based on overestimated revenues or underestimated expenditure. Clear signals on the amount of expenditure that is compatible with the overall financial resources available should therefore be given to each spending agency at the start of the budget preparation process, as discussed next.

The need for initial spending ceilings
The objective is to move the budgeting process and its actors away from a “needs” mentality to an “availability” mentality and to face the necessary choices early in the budget preparation process. A needs-based budget preparation process starts by eliciting requests from spending agencies without any indications of financial constraints, which inevitably results in total demands exceeding the available resources, whereas a resource-based process begins with making choices of how to allocate the available resources among worthwhile activities. As discussed in detail later, annual budget preparation should include a top-down stage, a bottom-up stage, and an iteration and negotiations stage. At the top-down stage, the start of the budget preparation process, expenditure indications or ceilings should be communicated by the ministry of finance to all spending agencies.
Bad Practices in Budget Preparation

Violation of one or more of the above three basic requirements of good budget preparation leads to one or more of a number of dysfunctional budgeting practices.

"Incremental" budgeting

The problem is not that budgeting is incremental, as such. Life itself is incremental: we do not revisit each morning every aspects of our life, profession, and prior commitments. The budget process must necessarily take as its starting point the current situation, continuing policies and ongoing programs. The problem arises when budgeting is augmented (or reduced) in a mechanical way, when the “budget” for the next year is put together as a mechanical set of changes to the previous year’s line-items.

With mechanical incremental budgeting, the dialogue between the ministry of finance and line ministries is confined to bargaining on cuts or increases, item by item. Negotiations between a ministry of finance typically uninformed about sector realities and a sector ministry in a purely defensive mode focus solely on inputs, without any reference to results. The negotiation is seen as a zero-sum game and is usually not approached by either party in good faith, as each party understandably assumes that the other is interested only in compressing or expanding expenditure. Moreover, incremental budgeting of this sort is not even a good tool for expenditure control—as it generally focuses on goods and services expenditure, whereas the “budget busters” are normally entitlements, subsidies, hiring, wage policy, or—in many low-income countries—expenditure financed with counterpart funds from foreign aid.

Needs-based processes

As noted, a needs-based budget preparation process starts by eliciting requests from spending agencies without any indications of financial constraints. Because these requests express needs, in the aggregate they invariably exceed the available resources. Spending agencies have no incentive to propose savings, because they have no guarantee that any such savings will come back to them to undertake new activities, and include new programs as bargaining chips. Lacking information on the relative merits of the proposed expenditures, the ministry of finance is led into making arbitrary cuts across the board among sector budget proposals. At best, a few days before the deadline for presenting the draft budget to the cabinet, the ministry of finance gives firm directives to line ministries, which then redraft their requests hastily—making cuts across the board themselves in the budgets of their subordinate agencies. Of course, these cuts are also arbitrary, because the ministries have not had enough time to reconsider their previous budget requests.

Policy volatility

Because credibility is a critical feature of a good budget, even the most mechanical and inefficient forms of incremental budgeting are not as damaging as large and capricious swings in budget allocations in response to purely political whims or power shifts.

Excessive bargaining and conflict avoidance

An element of bargaining is inherent in budget preparation, because choices must be made among conflicting interests. But the bargaining should be confined to the important issues and at the appropriate level. When bargaining instead
drives the process at every single stage and covers the most minute issues, the only predictable result is inefficient resource allocation. Choices are based on the political power of the different actors rather than on policies, facts, or results. Bureaucratic actors all have incentives to hide information rather than share it. Compromises are reached through increased tax expenditures, creation of earmarked funds, loan guarantees, or a shift of key activities outside the budget altogether—all of which reduce fiscal transparency and facilitate confusion and corruption.

These conflict-avoiding compromises are frequent in countries with weak cohesion within the government. Consequently, improving the processes of policy formulation can benefit budget preparation as well, through the greater cohesion generated in the government.

Conflict avoidance characterizes not only the relationships between the ministry of finance and the line ministries, but also between each line ministry and its subordinate agencies. Indeed, poor cohesion within line ministries is often used by the ministry of finance as a justification for its leading role in determining the composition of sectoral expenditure. Perversely, therefore, the all-around bad habits generated by needs-based budget preparation processes may reduce the incentive of the ministry of finance itself to push for real improvements in the system.

**Dual budgeting**

This issue was discussed at length in the previous chapter and only a brief recapitulation is needed here. Since a separate presentation of current and investment expenditure is always needed, the problem of dual budgeting refers to dual and separate processes of budget preparation, whereby the responsibility for preparing the investment budget is assigned to an entity different from the entity that prepares the current budget, and no coordination exists between the two entities. The solution cannot be found in reshuffling organizational boxes or in covering up the problem by setting up inter-ministerial groups or other purely formal coordination mechanisms. Genuine progress towards the integration of current and capital budgeting can only come from analyzing the real incentives for cooperation (or competition) between the top managers and technical staff responsible—and then making the political, institutional, and personnel adjustments required to reward cooperation and penalize the lack of it. Persistent leadership from the very top is required.

**Earmarking “high-priority” development expenditures**

A peculiar form of dual budgeting has emerged with the requirement of the Heavily Indebted Poor Countries (HIPC) initiative’s process to track pro-poor spending and raise the budgetary allocation of poverty-reducing expenditure. In its general form, the question is whether “high-priority” development expenditure should receive special consideration in the budget preparation process. The issue is politically and socially difficult, as it calls for balancing the fundamental objective of unity of the budget with the legitimate goal of channeling the debt relief granted to low-income African countries to reducing poverty instead of financing low-priority expenditure. Is it compatible with good PFM practice to try and identify high-priority development activities and protect their funding through the budget process? As always, the answer depends on the specific country, but five criteria can be suggested:

- Ineffective expenditure management is neither pro-poor nor pro-growth. Only by strengthening public expenditure management can countries improve the pro-poor and pro-growth quality of expenditure in a lasting way. Particularly through a multi-year perspective, a pro-poor strategy can be articulated into a restructuring of expenditure over a number of years. Establishing and monitoring medium-term targets for broad categories of expenditure has a valuable role to play in indicating the longer-term direction.
- Because strengthening public expenditure management is a medium and long-term institutional challenge, in special cases a need may exist for transitional targeting and monitoring of expenditure priorities within the budget. Such “virtual budgets”, however, should not lead to enclaving the
expenditures or separating them out of the regular budgeting process.

- Micromanagement must be avoided. The ministry of finance (and the donors) must resist the temptation of negotiating individual expenditures on specific budget line items. Doing so would further reduce the already very limited flexibility afforded to operational budget managers in African developing countries and prevent them from moving gradually in the direction of greater results orientation and thus greater effectiveness of expenditure in the interest of poverty reduction and growth.

- Moreover, because money is fungible, such transitional targeting must be done on the basis of broad expenditure categories and avoid creating a “budget within a budget”.

To create an expenditure enclave within the budget would:

- Undermine the budget as an instrument of government policy;
- Neglect possible cuts in “bad” expenditure even though identifying the most wasteful activities is often as important as increasing spending on the good ones;
- Make economic comparisons impossible, obscure the true distribution of resources, and create coordination problems for spending departments and local service providers;
- Generate an incentive to spend up to the target, regardless of whether the activities are well designed, and perhaps even serve to create new corruption opportunities.

The “white elephant” projects discussed in Chapter 8 are not necessarily confined to physical infrastructure, and can emerge in the social sectors generally associated with pro-poor activities. (Large and underutilized urban hospitals are a case in point.) Especially counterproductive is the donor practice to set increased percentages of spending on specific categories as conditions for eligibility for debt relief or other special favorable treatment, thereby turning an expenditure target into a floor. It is not difficult for any government to spend more by wasting more; the objective is to improve access to and quality of public services. Thus, if such specific targets are to be used, robust and monitorable indicators of the quality of expenditure must accompany them to make sure they do not inadvertently serve to encourage inefficiency or corruption;

- Most appropriate, instead, is the requirement to conduct expenditure tracking to ascertain that the budgeted expenditure actually reaches the intended beneficiaries. Indeed, donors should insist on and governments should perform more robust tracking of expenditure on a rotating basis for all sectors.

Alternative approaches to pro-poor targeting within the HIPC process were identified in a comparative study of five African heavily indebted poor countries commissioned by the European Commission, as described later in Chapter 11.

The budget preparation process

In both logical and chronological sequence, the main stages in the budget preparation process proceed from the elaboration of the macroeconomic and fiscal framework to the issue of budget instructions, preparation of budget proposals, negotiations on those proposals, endorsement by the political leadership, and finally, presentation to and approval by the legislature. The macroeconomic and fiscal frameworks have been described in Chapter 2 and public investment programming in Chapter 8. Below we focus on the process of preparation of the annual budget.
Chapter 9: The Process of Annual Budget Preparation and Approval

Stages of budget preparation: Top down, bottom up, negotiations

In the budget formulation process, close cooperation between the ministry of finance and the top leadership (president’s or prime minister’s office) is required. The role of the leadership is to oversee that the budget is prepared along the policies defined, to arbitrate major issues, and to ensure that the relevant stakeholders are appropriately involved in the budget process. An interministerial committee may be needed to review cross-cutting issues and especially sensitive ones. That being said, a sharp distinction exists between the three stages of budget preparation: the top-down, bottom-up, and negotiation stages.

The top-down stage

As previewed earlier, the starting points for budget preparation are a clear definition of fiscal targets and a strategic framework consisting of a comprehensive set of objectives and priorities. The aggregate expenditure consistent with the macroeconomic framework must then be disaggregated into allocations to each ministry and spending agency. These can be “hard” ceilings or indications of available resources, depending on the state of advancement of the country’s PFM systems and the political landscape.

It has become customary in every country to prescribe to each line ministry a “hard ceiling” at the start of budget preparation, in order to shift from a “needs” mentality to an “availability” mentality. A hard ceiling should in principle entail sending back unread to the originating ministry a budget request that exceeds the ceiling by even the slightest amount—and requesting re-submission. This is indeed the desired end-point of reform in budget preparation. In the situation of uncertainty and limited capacity typical of many African countries to jump from a loose needs-based budgeting approach to a genuinely hard ceiling in just one or two years is, however, simply not feasible, will fail, and will accomplish only a loss of the credibility of the ministry of finance. Such major shifts in attitudes and practices cannot be accomplished overnight. As explained in Chapter 1, there is no such thing as an institutional revolution.

The logic of the argument is unassailable, however. The budgeting approach does indeed have to shift away from a mere listing of “needs”. The total of budget requests should not be allowed to exceed significantly the available revenues. Ministries do require an early and clear indication of available resources in order to put together their proposals. Such indications increase the de facto authority and autonomy of the line ministries to determine the composition of their budgets—and thus their accountability for the use of the resources, and when appropriate, the results achieved.

The question is how to get there. A realistic approach would start by including in the budget circular that sets off the budget preparation a numerical indication of the resources on the basis of which each ministry should prepare its budget request. That a numerical indication is included is more important than its initial “hardness” and accuracy of estimation. Progressively, such soft indications could be made more and more binding every year and grounded on better and better estimates, until such time as the data, capacity and attitudes have improved sufficiently to permit setting a truly “hard ceiling” at the start of the process—and then enforcing it strictly.

The evolution from a needs-based to an availability approach could be encouraged and accelerated by giving favorable consideration to the budget requests of ministries which come closer to the initial indicative ceiling, or comprise better quality proposals, or achieve savings in certain activities to finance expansion of others. Inserting in the process an early indication of the resource envelope is important, even if the number is less than fully reliable and not expected to be enforced to the letter. This approach can only succeed, however, if there is a consistent determination by the ministry of finance—with support from the highest political levels—to continuously “harden” the ceilings and provide appropriate rewards for ministries’ cooperation through the budget process.

This gradual approach should not be confused with the two-step practice of some countries, to first allow the line ministries to translate the
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general guidelines into their initial budget proposals and then—after brief review of the preliminary requests—to notify them of binding ceilings. In most African developing countries, this two-step approach is likely to simply default to an open-ended process. By the time the initial budget requests have been formulated on a totally unconstrained basis, the chance of a disciplined budget process has disappeared. It is much better to have one soft ceiling at the start of the budget preparation process than no ceiling at all at the beginning followed by a pretend-hard ceiling some weeks or months later.

The ministerial ceilings—whether indicative or prescriptive—must be consistent not only with the aggregate expenditure envelope but also with the sector policies, and must be credible throughout government. They should therefore be proposed by the ministry of finance but must be approved by higher political authority—whether the full cabinet, the head of government, or an appropriate interministerial group.

Preparing the initial ceilings is largely an incremental exercise. As noted, budgets are never prepared from scratch. Debt servicing, multiyear investment commitments, pensions and other entitlements; rigidities in personnel management; and the simple reality that government cannot stop all funding for its schools, health centers or the army—these factors limit the possible annual shifts to perhaps 5 to 10 percent of total expenditures. In theory, this percentage could be higher in developing countries than in industrial countries (where the share of entitlements is higher). But in practice, because of earlier over-commitments, the fiscal room to maneuver is often even lower in developing countries.

The bottom-up stage

During this stage, the ministries and spending agencies are responsible for preparing their requests within the spending limits or indications provided. If possible, line ministries’ budget requests should distinguish (a) the amount necessary to continue current activities and programs, and (b) proposals and approximate costing for new programs, including some estimate of future impact on the budget. This step is particularly important for investment projects (as discussed in the previous chapter) and new entitlements, which may increase future expenditures. This assessment is required whether or not a formal MTEF exercise is carried out. Estimates of future costs related to multiyear commitments could be annexed to the overall budget document. (They would already be included in the public investment program annexed to the budget.) These estimates would facilitate the preparation of the initial ceilings for the next budget.

In a similar manner, line ministries must coordinate the preparation of the budgets of their subordinate agencies and give them appropriate directives. The submission of budget requests from subordinate agencies should meet the same criteria as the line ministries’ requests.

The review, negotiation, and iteration stage

During this third stage, the ministry of finance reviews the conformity of ministries’ budget requests with overall government policy and compliance with the spending limits or indications. The ministry then reviews performance issues related to the previous year’s budget execution and takes into account changes, if any, in the macroeconomic environment that occurred since the start of budget preparation. Almost always, these reviews lead the ministry of finance to suggest modifications in the line ministries’ budget requests, and negotiation follows.

The basic objective of negotiations (often called budgetary conferences) is to resolve as many issues as possible directly, and escalate to higher levels of government only the major problems that warrant their attention and decision. Staff from the ministry of finance and line ministries should also be in contact and hold informal meetings to avoid later misunderstandings and minimize conflicts. It is a disservice to the government and political leadership to “pass the buck” on minor issues instead of making every effort to resolve them directly between the ministry of finance and the line ministry. Naturally, the outcome of negotiations and referral to higher authority depend largely on the relative balance of administrative and political power between
the minister of finance and the line minister concerned.

**A suitable budget preparation calendar**

None of the stages of budget preparation can be completed satisfactorily without providing the necessary time. A pragmatic budget preparation calendar must be decided that fits the realities of the country and the requirements of good budgeting. If the timetable is not long enough, one or another phase of budget preparation will be unduly constrained, the legislature would not be given sufficient time to debate and approve the budget, or both. If the timetable is too long, changes are likely to intervene after the issuance of the budget circular that may invalidate some of the initial assumptions and targets and require revision of the draft budget proposals.

The most important stages that should not be too short are the bottom up stage and the time afforded to the legislature to debate and approve the budget. If the bottom up stage is too short, ministries will formulate their budget requests in mechanical fashion and the link to government policy will be weakened. If the time for debate and approval at the legislature is too short, it may lead to a failure to approve the budget before the beginning of the fiscal year. In many ways, this is the worst outcome, for even a realistic and sound budget’s execution will be compromised unless cash plans can be prepared in good time and resources released predictably.

There is no hard and fast rule in regard to the length of the budget preparation process. In general, in African developing countries, seven or eight months would be an appropriate budget preparation period, from the date of issue of the budget circular to the formal legislative approval of the budget. Recall that the macroeconomic and fiscal framework has to be prepared, and the sector ceilings proposed and approved, before the issue of the budget circular. In effect, this means that the activities to prepare the budget should begin shortly after the end of the previous fiscal year. Indeed, in a real sense, good budgeting is virtually a continuous process. See the illustrative budget preparation timetable in Box 9.1.

**Other relevant budget preparation issues**

**Reaching out: The importance of listening**

Consultations can strengthen the legislative scrutiny of government strategy and the budget. Legislative hearings through committees and subcommittees, particularly outside the high-pressure environment of the annual budget, can provide an effective mechanism for consulting widely on the appropriateness of policies.

But the executive branch, too, should try at all appropriate stages during the budget to gather and process feedback from civil society on its policies and the budget. Consultative boards, grouping representatives from various sectors in society, could discuss government expenditure policy. On crucial policy issues, the government could set up ad hoc groups. Preparing evaluation studies, disseminating them, conducting surveys, and so forth provide information to stakeholders and the civil society and help the government receive reliable feedback. User surveys and meetings with stakeholders and customers when preparing agencies’ strategic plans or preparing programs can enhance their effectiveness. Finally, and most concretely, in countries with weak budget execution and monitoring, only mechanisms for feedback from local citizens and service users can reveal malpractices such as “ghost schools”, shoddy infrastructure, incomplete projects, theft and waste. They are generally resented by the executive branch, but governments (and donors) should really see them as cost-effective monitoring and encourage and support them as such.

These consultations must not be formalistic in the sense of influence on budget decisions; a direct and mechanical link to the budget should be avoided. As noted repeatedly, the budget preparation process needs to be organized along clear rules so that the budget can be prepared in a timely manner while avoiding excessive pressure from particular interests and lobbies. Participation, like accountability, is a relative concept.
<table>
<thead>
<tr>
<th>Scheduled dates</th>
<th>Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1</td>
<td>Fiscal year begins.</td>
</tr>
<tr>
<td>Jan—March</td>
<td>The Ministry of Finance (MoF) prepares the macroeconomic and fiscal framework. If a “rolling” medium-term framework is prepared, as it is appropriate, the framework is advanced by updating the coming year and adding a future year. The Minister of Planning (or other responsible entity) prepares the public investment program. If a “rolling” PIP is prepared, as it is appropriate, the program is advanced by updating the coming year and adding a future year, covering the same period as the MTEF. Frequent and regular consultations are necessary between the two entities to assure consistency between current and capital plans.</td>
</tr>
<tr>
<td>April 15</td>
<td>The MoF presents to the Government for approval the parameters for the draft budget of the following year, including the overall expenditure ceiling and the proposed ceilings or indications on the expenditure of each line ministry and agency.</td>
</tr>
<tr>
<td>May 1</td>
<td>Budget circular is issued to all line ministries and government agencies, including policy guidelines, the fiscal program (deficit, revenue, debt); terms and format on which ministries must prepare their budget proposals; and the expenditure ceilings within which to prepare the proposals.</td>
</tr>
<tr>
<td>May—July</td>
<td>Ministries/agencies prepare their budget proposals.</td>
</tr>
<tr>
<td>August 1</td>
<td>Budget proposals submitted to the MoF.</td>
</tr>
<tr>
<td>August—September</td>
<td>Budget negotiations take place between the MoF and line ministries/agencies.</td>
</tr>
<tr>
<td>October</td>
<td>Major disagreements are presented to the cabinet for resolution, following which the MoF finalizes draft budget.</td>
</tr>
<tr>
<td>November 1</td>
<td>The draft budget and related documentation is presented to the legislature.</td>
</tr>
<tr>
<td>Nov 1-Dec 15</td>
<td>Public hearings, testimony by government officials; legislative debate.</td>
</tr>
<tr>
<td>Before Dec 31</td>
<td>Vote on and promulgate the budget law. Should the budget law not be approved by December 31, the government issues a decree authorizing appropriations to cover public service activities as based on the draft budget law, or preferably, authorizing expenditure at the monthly rate of 1/12 of the previous year’s budget.</td>
</tr>
<tr>
<td>December 31</td>
<td>Fiscal year ends.</td>
</tr>
</tbody>
</table>
Efficiency dividends
In the 1980s, Australia began to demand from each spending unit efficiency dividends. It required savings in their ongoing activities (about 1.5 percent annually). On the surface, this practice may look like the typical (and undesirable) across-the-board cuts made by the MoF when finalizing the budget. However, two major differences exist:

» Efficiency dividends are noted early in the process and within a coherent multiyear expenditure framework;
» The allocation of savings among activities and expenditure items is entirely the responsibility of the spending agencies; this alleviates an arbitrary approach.

Naturally, savings measures are much more likely to be implemented when the ministry concerned is proposing them than when they are set by the ministry of finance.

This approach appears to have achieved effective results in Australia from the mid-1980s and in Sweden since the turn of the century. In other industrial countries, the potential for fiscal savings and efficiency improvements also exists—although the evidence is that savings are limited to the initial years, and common sense suggests that one cannot raise efficiency forever within the same production function.

In African developing countries, efficiency dividends are normally not relevant or appropriate. Demanding efficiency dividends is better than making arbitrary across-the-board cuts, but only in a medium-term context and if adequate technical capacities are available in line ministries and the line ministries are willing to make their own hard choices. In countries where the current budget is too inadequate to allow departments even to function normally (and the capital budget is determined largely by donor funding), the real question is not how to tinker at the margin to generate a gradual increase in efficiency, but how to restructure public expenditure by eliminating questionable activities altogether. Moreover, where evaluation capacity is weak, there is a real risk that the “efficiency dividends” are achieved by diminishing service or program quality. However, this practice may help introduce greater results orientation in a complacent administrative system and trigger more structural improvements.

A subceiling for capital expenditure?
As discussed in Chapter 8, a separate and uncoordinated budget preparation process for capital and current expenditure (dual budgeting) presents problems, but a separate presentation is necessary. That aside, should separate subceilings for capital and current expenditures be set at the start of the budget preparation process and included in the budget circular? The answer depends on the sector concerned.

Obviously, if only an overall spending ceiling is set, line ministries would be able to make tradeoffs between their current and capital spending, whereas separate subceilings fix the distribution between current and capital spending. (Despite its decision to introduce program budgeting, the West Africa Economic and Monetary Union prohibits transfers between capital and current expenditures.) In certain sectors, such as primary education, leaving the choice between current and capital spending partly to the line ministry may be preferable, and line ministries presumably know better than the ministry of finance what would be the most efficient allocation of resources within their sectors. In some cases, however, the sector budget depends largely on the decision to launch a large investment project. (For example, the budget of a ministry of higher education would largely depend on the decision whether to construct a new university.) Because such large investment projects are a government policy issue, not only a sectoral policy issue, separate subceilings on capital would be appropriate in these cases. In general, a reasonably good public investment programming process will produce a coherent capital budget (the coming year “slice” of the multiyear investment program), thus permitting a subceiling on capital expenditure in each ministry. Depending on country circumstances and policy priorities, separate subceilings may also be needed for other expenditure categories, e.g. personnel expenditures and subsidies.
Screening expenditure requests

The issues of reviewing requests for investment projects were addressed in Chapter 8. Current expenditure requests also call for careful review, including that of their possible medium-term implications. Rules of thumb for such review are suggested below.

**Screening sector expenditure programs**

The criterion of “allocative efficiency” is to distribute financial resources across different sectors in such a way as to maximize the aggregate efficiency of national resources. This theoretical criterion is in practice a chimera. As noted earlier, the strategic allocation objective is the most political and least technical of the three key objectives of public expenditure management, and one cannot decide on a purely technical basis whether one more primary school in district A is “more efficient” than three additional rural health clinics in district B. However, the decision does not have to be entirely “political” and discretionary. Certain pragmatic tests exist, and can be applied in the following sequence:

1. Is the overall expenditure request reasonably consistent with the expenditure ceiling? If No, return for downward adjustment; if Yes →
2. Is the proposed expenditure profile consistent with government policy for the sector? If No, return with comment; if Yes →
3. Is the amount consistent with reasonably well-designed activities and costs? If No, return with suggestions for redesign and/or re-estimate of costs; if Yes →
4. Are implementation capacity and complementary resources adequate?

If No, recommend adjustments in the pace of implementation; if Yes, approve the expenditure request in principle, assist capacity, and monitor implementation.

**Screening the various types of current expenditure requests**

Different criteria apply to different current expenditure categories, as follows.

**Screening requests for wages/salaries/pensions**

The general criterion is that the expenditure request must be fully consistent with the government wage/employment/pensions policy. Basic checks include the following:

- Is the number of employees consistent with authorized posts?
- Are ministry procedures and records sufficient to prevent “ghosts”, illicit payments, double employment, or other major irregularities?
- Have large wage items been “mis-classified” in the budget? (But note that a certain labor cost component in investment projects is normal.)

General advice includes the following:

- Encourage ministries to monitor labor supply and demand in their sector;
- “Undershoot” on employment, i.e., try to limit the number of employees, by not authorizing filling all vacant posts or in other ways;
- “Shoot straight” on wages, i.e., try and assure adequate compensation for the (smaller) number of employees, as consistent with government compensation policy and with compensation for comparable skills in the local private sector (including the value of benefits and adjusting for the greater security of government employment);
- Demand from each ministry adequate proof of needs for new staff, i.e., an indication of their likely functions, a satisfactory explanation of why these functions cannot be filled by internal redeployment, etc.;
- Discourage non-monetary allowances except in case of obvious need (e.g., safe housing in insecure areas in post-conflict situations); they usually tend to proliferate and distort the budget;
- Legally prohibit “topping up” of salaries by donors and discourage (not prohibit) “moonlighting” (second jobs);
» Reward special job risks with a transparent and temporary salary supplement, not with promotion or a higher base salary. This is particularly important in post-conflict situations, where lack of security engenders safety concerns for personnel in particular occupations or districts. These risks must be recognized and adequately compensated—but only for the employees directly involved and during the period when they are being incurred.

The payroll in developing countries, including in Africa, is frequently problematic, with “ghost” employees, individuals in duplicate or triplicate jobs, incorrect compensation and other problems. When the system has deteriorated for years, for whatever reason, the scrutiny of personnel expenditure requests during the annual budget preparation process is insufficient, and a thorough “clean-up” and audit may become necessary.

**Screening requests for expenditure on services**

Requests for budgeting interest payments do not need to be “screened” because interest payments are a legal obligation, but careful verification of the amounts, creditors, terms, and schedules is required. (In any case, normally only the Ministry of Finance itself is responsible for debt service, through a debt department set up for this purpose, as discussed in Chapter 11.)

Concerning technical services, the cost of project-related technical assistance is included in each project and should be reviewed as part of project review. Free-standing technical assistance by expatriate or national experts—normally for institutional development, capacity building, etc.—is a source of potential benefit but also of potential long-term problems, and should be scrutinized especially carefully, as discussed in Chapter 11 on aid management.

**Screening subsidies and other transfers**

Ordinary subsidies and social benefits are based on political and social criteria as well as affordability in light of the overall fiscal situation, but five questions can be asked during the budget preparation process, in sequence:

» Is the subsidy or benefit clearly grounded on law, regulation, or explicit policy?
» Is the expenditure request for the particular subsidy likely to achieve the stated objective?
» Are there ways other than budgetary subsidies to achieve the same objective?
» Is the administration of the subsidy cost-effective (e.g., could targeting be improved, etc.)?
» Are there sufficiently robust systems to assure that the subsidy reaches the intended beneficiaries and to provide them with complaint or appeal opportunities?

**In regard to other transfers in post-conflict situations**—for resettlement of internally displaced persons (IDPs), reintegration of former combatants, etc.—the criteria are specific to each situation and the only general rules are to:

» Require bottom-up cost estimates (even if approximate) based on the intended programs of activities and using the cost information of similar programs in other countries. (In Africa, regrettably, there is abundant information on “special” post-conflict expenditures.)

» Consider carefully the variety of ways to provide compensation or transitional assistance. The long-term economic and social implications of certain modalities of assistance can be negative. Tap the substantial experience on record.

» View these transfers as either compensation for past merit suffering, and/or as means to facilitate the transition. The compensation should be as generous as circumstances require, but should not consist of giving a permanent government job as compensation. (Preferences for veterans or other meritorious persons in the hiring process are legitimate, however, so long as the person’s qualifications are suitable for the job.)

» Include the cost of these special post-conflict transition programs as a separate major item in the budget—with sufficient detail but without attempting to disaggregate by economic or functional categories.

**Screening operations and maintenance expenditure**

The budget request for purchase of goods and services needed for operations and maintenance
(O&M) is one of the easiest requests to reduce during budget preparation or cut during budget execution because O&M expenditure is not buttressed by legal obligations or entitlements and carries comparatively limited opportunities for personal enrichment or misuse (with the major and notorious exceptions of passenger motor vehicles and military supplies). However, unwarranted cuts in O&M have a heavily negative impact on government efficiency. Delayed maintenance, in particular, leads invariably to deterioration of equipment and physical assets, at a far greater future cost than whatever savings may be obtained during the fiscal year.

As a general rule, therefore, line ministries should make sure not to underfund O&M, and the ministry of finance should give O&M expenditure requests the benefit of the doubt. Of course, this does not at all imply unquestioned acceptance of such requests. In addition to common sense questioning (e.g., why are additional computers requested when computers previously purchased are known to still sit in their packing boxes?) the following may be suggested:

» The request should be consistent with technical and cost norms. (If such norms are not available, assembling the information from suppliers’ data and neighboring countries and disseminating it should be an urgent priority.
» For durable goods, track the earlier purchases, and ask for explanation of their use.
» Require each government unit to start a register of physical assets, limited to assets that are both valuable and “at risk”.
» Most importantly, do not assume that just because a physical asset still exists it automatically deserves to be maintained.

Division of roles and responsibilities among finance and planning

In Chapter 8 it was suggested that owing to scarcity of skills and administrative capacity, African countries might do well to have a single ministry of finance, planning and economy instead of two or three separate ministries. This is simply a general presumption because such important organizational decisions must be made mainly on the basis of the country’s specific characteristics, including the political landscape. In any event, stability and development are complementary. It is necessary to manage the public finances as well as look out for the long run and assist in formulating a vision for the country’s equitable development.

Whatever specific organizational architecture is chosen, therefore, must ensure that neither long-run prospects nor short-term needs are neglected. Whether with one or two or three ministries, it is critical to have a dedicated entity to handle financial issues, a separate one responsible for public investment, and a third to assist formulating long-term prospects. Because the short run and the long run are part of the same time continuum, the core institutional requirement is for close cooperation between these entities, whether they are located in different ministries or under the same roof—and cooperation requires positive incentives for all involved. Financial stability is very different from stagnation, and sound investment programming and development strategy are much more than a set of targets and wishes.

The finance function

The main roles of the entity responsible for finance are as follows:

» Advise the government on all domestic and international aspects of public finance.
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» Propose a revenue, expenditure, and budgetary policy, consistent with the government’s objectives, and manage the implementation of such a policy.

» Devise and manage an efficient system for government payments.

» Mobilize internal and external financial resources (in collaboration with the planning entity).

» Ensure an efficient financial regulatory framework to promote financial integrity and combat fraud and manipulation.

» Supervise all activities that entail an actual or contingent financial commitment for the state.

» Supervise the corporate governance of public enterprises and other nongovernmental public sector entities, and monitor their financial performance.

» Take all measures to protect major state assets, and encourage their best use.

In pursuit of these roles, the entity responsible for finance must do the following:

» Prepare the medium-term macroeconomic framework in consultation with the planning entity, consistent with broad government objectives, for government consideration and approval.

» Prepare the medium-term fiscal framework, consistent with the macroeconomic framework and sectoral government policies, for government consideration and approval.

» Prepare the government budget, consistent with the medium-term fiscal framework, in consultation with the other government entities, but not diluting their responsibility for preparing their own budget.

» Ensure consistency between capital and current expenditures (in consultation with the planning/economy entity).

» Monitor the financial execution of the budget (in consultation with the planning entity).

» Guide and coordinate activities in internal audit throughout the government.

» Interact with the legislature and other concerned stakeholders on all these matters.

The planning/economy function

The main roles of the entity responsible for planning (and economy) are as follows:

» Prepare a medium- and long-term development strategy, for government approval.

» Prepare a poverty reduction strategy, consistent with the development strategy, for government approval.

» Coordinate and facilitate sector strategies, consistent with the above.

» Monitor implementation of these strategies, and recommend adjustments.

» Facilitate formation of a national policy on population and environment.

» Coordinate foreign aid (in collaboration with the ministry of finance).

» Prepare the public investment program.

» Monitor the physical execution of these programs (in collaboration with the ministry of finance).

A standard organizational structure

On the assumption of a single ministry of finance and planning, the appropriate organizational structure is shown in Box 9-2. If the country chooses separate ministries, the only changes necessary are to split the right side from the left side and elevate each deputy minister to the rank of minister. In any case, the two ministers or the two deputy ministers need to have equal rank—even if one may carry seniority or greater political weight of one sort or another.
Budget presentation and the role of the legislature

The enactment of the budget should not merely be a formal exercise carried out to comply with the letter of the constitution. The legislature is the locus of overall political and financial accountability, and its role should go much beyond rubber-stamping decisions already taken.

Presentation of the budget

The budget and the budget documentation are sometimes confused. The budget is the fundamental legal instrument by which the legislature authorizes the executive to collect revenues and make expenditures. Other information should be presented at the same time as the budget (e.g., on extra budgetary funds or loan guarantees), in order to provide the legislature with a full picture of the state of the public finances and their implications for the economy and for the future years, but is not subject to legislative approval. The budget itself and this additional information constitute the budget documentation.

Box 9-2

Structure of a Ministry of Finance, Planning and Economy

Legal counsel — MINISTER — Secretariat

/                        \
/                        /
Deputy minister (finance)       Deputy minister (planning and economy)

Macroeconomics
Policy analysis
Medium-term framework
Aid management
Budget
Budget systems
Budget preparation
Budget execution
Treasury
Debt management
Asset register
Payments and cash management
Revenue
Customs
Administration
Investigation/inspections
Taxes and other domestic revenue
Policy, planning, statistics
Operations (returns, processing, collection, etc.)
Audit and taxpayer services

Financial regulation
Public enterprise monitoring
Accounting and financial reporting
Financial inspectorate
Internal audit, standards and oversight
Procurement: standards, oversight, appeals
Long-range planning
Growth and trade
Poverty reduction strategy
Sector and other cross-cutting policies
Public investment
Large projects evaluation
Sector coordination
Public investment program
National economic databases
(jointly with statistics bureau, which, however, must be totally autonomous)
Non-financial regulation and facilitation
Guidelines and manuals
Technical assistance
The budget submitted to the legislature should include all elements needed to assess budgetary and fiscal policy and present the appropriations according to the needs for legislative control. Revenues, expenditures, and the fiscal outturn should be presented together. Concerning the expenditure side, one may distinguish the main presentation, on the basis of which appropriations are voted; and the budget annexes that give additional information.

**Main presentation of the budget**

Some countries present thousands of line items in the budget while others group appropriations into just a few—twenty or even fewer (although in these cases detailed annual expenditure plans are also presented in the budget documentation—as in China.) There is no “optimal” number of line items, and the degree of aggregation in the budget presentation should be appropriate to country-specific factors and preferences, and to the organizational structure of the government.

In general, however, an excessive number of line items makes the budget difficult to read and requires summaries to make the budget presentation understandable. On the other hand, too few line items may not provide sufficient detail for informed legislative approval and oversight. Much depends on the rules governing transfers among the line items (“virement”) during budget execution. Virement rules are discussed in Chapter 10. Detailed budget appropriations and flexibility of virement go hand in hand. At one extreme, if virement rules are very restrictive, a budget with a very large number of line items can turn into a straitjacket and make efficient service provision very difficult. At the other extreme, if the rules are very permissive, a budget with a very small number of line items can turn into a blank check for the executive. In any case, the main budget presentation should clearly identify responsibilities in budget management, presenting the appropriations by line ministry and agency, and by their major subdivisions.

**Budget annexes and other documentation**

As noted, annexes to the budget are needed to give a fuller picture of the fiscal stance and facilitate analysis of the budget itself. These annexes could include, separately: the medium-term macroeconomic and fiscal framework; the functional classification of the line-item appropriations; the medium-term public investment program; comparisons of the proposed appropriations with those of previous years; and/or other annexes, depending among other things on the legislature interests, capacity of the system, and the government objectives.

**The need for timely presentation of the budget**

To permit informed debate and approval, the draft budget should be presented to the legislature in a timely manner—that is, at least two months before the start of the fiscal year. The time allocated for the legislative budget process is important for a sound scrutiny of the budget and informed debate. The budget debate lasts up to 75 days in India; in the German Bundestag, it may last up to four months; in the U.S. Congress, it sometimes lasts even longer; in Africa, it tends to be much shorter than would be necessary.

In some cases, delays in presenting the draft budget are caused by special circumstances, such as political changes, pending financial negotiations with international financial institutions or other events. In several African countries, however, delays are institutionalized, and the budget is systematically presented to the legislature just days before the beginning of the fiscal year. This puts the legislature in the impossible position of either preventing the government from operating or giving formal approval to a budget of which it knows virtually nothing. In extreme cases, the legislature does not meet to consider the budget until after the beginning of the fiscal year and is thus asked to give retroactive approval to a budget that is already being implemented. (Low-income African countries do not have a monopoly on such abnormal situations, however. In the U.S. for example, as of April 2011, the budget for 2011 had not yet been approved, and the government was functioning on the basis of successive two or three week congressional authorizations.)

Systematic delays in presenting the proposed budget to the legislature are a symptom of grave
governance problems, and cause equally grave difficulties to the execution of the budget, since ministries and spending agencies have no certainty on the amount of resources they will get and when—and thus cannot plan. (They also enjoy an easy alibi for underperforming). They also cause problems for the private sector and government suppliers. All things considered, it is better to present an imperfect budget on time than to present a better budget too late. Imperfect budgets can be improved, and incentives will usually go in the direction of improving them. Delays in budget presentation tend to become expected, and incentives will usually go in the direction of continued delays. First and foremost, fiscal discipline requires compliance with the basic budget preparation rules.

When delays are justified by special circumstances, the organic public finance law (see Chapter 5) should include a provision authorizing the executive to commit expenditures before the budget is approved, under explicit criteria. This authorization should be based on the budget of the previous year, rather than on the new budget that has not yet been reviewed by the legislature. In the U.S., for example, when the budget is not approved before the start of the fiscal year in October, the Congress can vote a ”continuing resolution” authorizing the executive to commit each month up to one-twelfth of the appropriations of the previous fiscal year. However, in developing and industrial countries alike, care must be taken lest these special provisions be abused and become a systematic way to sidestep the normal budget process.

The legislative debate
Individual members of the legislature have different preferences regarding how resources are allocated, and they are subject to a variety of pressures from their constituents. The sum of these various preferences and related claims can generate a systematic tendency to increase expenditure during budget debates (a phenomenon known as logrolling). Much worse is the practice of ”pork,” whereby certain expenditures are introduced in the budget by influential members of the legislature at the last minute, without any scrutiny of their economic and social viability and even without the knowledge of members of the legislature who vote on the final package. (In the United States, this practice has grown dramatically since 2000, reaching more than 13,000 different projects in 2005 accounting for a total cost of more than US$60 billion.) In developing countries, a sound process of public investment programming would preclude such practice.

Accordingly, many countries have adopted procedural rules to regulate and limit logrolling, pork and other practices inimical to budget integrity and public finance efficiency. These rules cover the sequence of voting on the budget and the legislature’s powers to amend the budget. In parliamentary systems with a clear majority of one party, the budget prepared by the executive is routinely approved by the legislature; in most parliamentary systems, legislative refusal to approve the budget is equivalent to a vote of no confidence and normally results in the resignation of the government.

Approving and amending the budget
The role and procedures of the legislature in amending and approving the budget vary from country to country. In some countries (e.g., France) the budget is voted in two stages: the overall amount of the budget and the appropriations of resources among ministries. This procedure is aimed at protecting the overall fiscal target and the aggregate expenditure limit. In most countries, including African countries, the budget is debated and voted on one single occasion and aggregate expenditures and revenues are reviewed together—which allows the legislature to discuss macroeconomic policy. (Recall, however, that the macroeconomic and fiscal framework should be communicated to the legislature before the start of the budget preparation process to allow for a general debate on policy priorities.)

The legal powers of the legislature to amend the budget fall into three categories:

» Unrestricted power gives the legislature power to change both expenditure and revenue up or down, without the consent of the executive. Some presidential systems (for example, in
the United States and the Philippines) fit this model—although the “power of the purse” granted to the legislature is counterbalanced by a presidential veto. This situation implies substantial and direct legislative influence on the first two objectives of public expenditure management (fiscal discipline and expenditure allocation) as well as some indirect influence on the third (operational management).

» **Restricted power** is the power to amend the budget but within set limits, often relating to a maximum increase in expenditures or decrease in revenues. The extent of these restricted powers varies from country to country. In France, the United Kingdom, and the British Commonwealth countries, parliaments are not allowed to propose amendments that increase expenditure and have very restricted powers to propose any other amendment. By contrast, Germany allows such amendments, but only with the consent of the executive. This situation implies very limited legislative influence on resource allocation and (indirectly) on operational management.

» **Balanced power** is the ability to raise or lower expenditures or revenues as long as a counterbalancing measure maintains the budget balance. This intermediate arrangement concentrates legislative influence on resource allocation.

It is important to keep in mind that the formal power of the legislature to amend and approve the budget may be in practice inoperative if the real political weight of the legislature is limited, and/or its competence and capacity are weak. (Recall the distinction between formal and informal rules explained in Chapter 1.) Once again, the fundamental issues of governance and capacity come to the fore in the PFM agenda. Accordingly, major improvements in budgetary outcomes can result from sustained efforts to improve the capacity of members of the legislature to understand and debate the budget, strengthen both the number and the skills of the staff of key legislative committees, and enable the participation of key civil society stakeholders in the budget process. This will be discussed next.

**Supporting the legislative process**

Legislators are not elected to become instant experts in public financial management, but to represent their constituents and contribute to making national policies. Technical support for the legislature is essential to permit it to fulfill its constitutional responsibilities. Strong and capable committees enable the legislature to develop its understanding of public financial management and play a greater role in budget decision making and oversight. Generally, different committees should deal with different facets of public expenditure management. For example: the finance or budget committee reviews revenues and expenditures; a public accounts committee ensures legislative oversight (and the supreme audit institution normally reports to the public accounts committee); and sector or standing committees deal with sector policy and may review sector budgets. In countries where the role of the legislature in amending the budget is significant, amendments are usually drafted by committees rather than proposed on the floor by individual members.

The legislature and its committees should have access to independent expertise for proper budget scrutiny. In India, for example, parliamentary committees are supported with secretarial functions, and legislators have access to the parliament library and associated research and reference services; the U.S. Congress benefits from the competent staff of the appropriations committees and the services of the large and well-equipped Congressional Budget Office, as well as assistance from the Government Accountability Office with audits and information on program compliance and performance.

Legislative committees should also have easy access to administrative information. In Germany, the budget committee interacts quasi-permanently with government departments through regular departmental briefings and expenditure reports. In India, the Public Accounts Committee receives reports and departmental accounts and revenue receipts from the Comptroller and Auditor General (although this interaction concerns the oversight function of the parliament, rather than budget preparation and approval). Regular
consultations between the administration and the legislative committees on budget policies and their implementation strengthen the capacity of the legislature to review the budget, and after approval, increase the legitimacy of the budget and thus the authority of the executive to implement it rigorously.

Unfortunately, the record in these respects is mixed in Africa. Although in countries such as South Africa, Botswana, Ghana, Senegal, Kenya, Tanzania and others the appropriate legislative committees are functioning well and technical support for parliaments has been provided, much remains to be done in most African countries to provide the legislatures with the material, technical and skill support needed to perform effectively their constitutional roles in the budgeting system. Financing such support and providing practical advice should be a high priority for donors and governments alike.

**Budget amendments and reallocations**

**Budget amendments**
Concerning budget amendments, the general principle is that any amendment during the fiscal year should receive legislative approval in the same way as the budget is originally approved. At one extreme, too many amendments during the year weaken the credibility of the budget. At the other extreme, precluding any amendment during the fiscal year would be quite impractical—especially in the fluid conditions of most African developing countries. Thus, budget amendments are necessary, but should be limited to once or twice a year. Accordingly, amendments should be brought to the legislature as a package of proposed changes instead of the highly inefficient practice of requesting approval of each individual change.

**Budget reallocations**
Transfers between budget items are discussed next in Chapter 10 on budget execution; but aspects that relate to the executive-legislative division of powers are also briefly addressed here. Procedures differ between presidential systems and parliamentary systems, where the executive is a creature of the legislature. In general, any reallocation between ministries should be in the form of a formal budget amendment and require approval by the legislature—because the individual ministers are theoretically accountable for the use of the resources and their budgets are supposedly in support of sector strategies approved by the legislature. (However, it is possible to specify in the organic budget law or at the time of budget debate, that legislative approval is not required if a reallocation between ministries does not exceed a certain specified percentage of the budgeted amount.)

Within a budgetary appropriation to a ministry, the executive branch generally should be free to reallocate as it judges best—within certain limits. Pragmatic rules should define the level of authority required for different types of reallocations—called virements. Such rules, normally promulgated by executive decree or administrative instruction, should specify that minor reallocations required for operational reasons (for example, between different types of current supplies) can be effected on the sole authority of the department head concerned; more significant changes (for example, between current supplies and durable goods) can be effected by the line minister; and still more important ones (for example, from durable goods to fuel) would require ministry of finance approval in the event that they exceed a specified percentage of authorized expenditure.

Reallocations between major budget categories (for example, from operations and maintenance to salaries) may or may not require prior legislative approval, depending on the country, but the legislature should always be notified on a timely basis and have the opportunity to raise questions or objections. Simple disclosure after the fact is not sufficient. However, in African developing countries, where the appropriate composition of public expenditure is critical for fiscal sustainability and development, reallocations between major budget categories are highly undesirable without express approval by the legislature, and if appropriate, consultation with international partners.

The situation is different for investment projects, because their multiannual nature and
uncertainties of implementation and funding necessarily require giving the executive branch more flexibility in the timing of commitments and payments. And for an entire program (a collection of complementary activities aimed at the same objective but with different individual allocations), the line ministry must have the authority to shift resources between activities—again with ministry of finance approval if the reallocation goes beyond a certain percentage of authorized expenditure. (See Chapter 4 on program budgeting.) Instead, reallocations between large projects or between major programs would normally call for some meaningful consultation with the legislature, rather than formal approval.

In actual practice, much depends on the quality of overall governance. Aside from the procedures for approving and amending the budget and the rules for reallocations during the year, which must be defined in law, in a healthy governance system consultations between the executive and the legislature are substantive and continuous, and are not limited to one-off events such as the budget debate or the presentation of a budget amendment. When this healthy situation of continuous and constructive interaction prevails, and external participation by civil society is provided for as well, a broad understanding of the reasons for budgetary decisions is generated; conflict and dissension are minimized; and a good budget is much more likely to be executed.

NOTES

1 I am indebted to Ed Mountfield for helping to summarize these criteria.

2 In January 2007, the U.S. Congress approved new rules to require, among other things, identification of the members of Congress sponsoring each “earmark”. If these rules go through and are enforced, they will make a major contribution to restraining this fiscally and economically wasteful practice.

3 The U.S. Congress attempts to restrict its own power through the annual budget resolution, which contains an overall spending cap as well as spending targets for congressional committees. Among other things, the pay-as-you-go (or PAYGO) rule prescribed that new expenditures or tax reductions could be made only to the extent that expenditures were cut or revenues raised elsewhere. (This budget rule should not be confused with the pay-as-you-go system of funding pensions or health funds, as contrasted to a fully funded system, whereby funds are set aside in advance to meet 100 percent of all foreseeable obligations.) These restrictions, however, are self-imposed and can be lifted at any time by legislative action; they are thus different from a restriction imposed from outside the legislature. Indeed, the PAYGO rule was not applied in the United States after 2001, a fact that was partly responsible for the historic levels of fiscal deficit in the country (see also the discussion of fiscal responsibility in Chapter 5).
Part IV: Managing Budget Implementation and Assuring Accountability
Chapter 10:

Budget Execution and Monitoring
What to Expect

After the budget is approved by the legislature, the responsibility to implement it falls to the executive branch of government. In this “downstream” phase of public financial management, various systems and protections are needed to ensure that the budget is executed in conformity with the approved budget; to adapt to intervening changes; and to enable efficient management of the funds. This chapter reviews these systems and the arrangements for controlling the budget execution, preventing the accumulation of payments arrears, and assuring the financial and physical monitoring of the major expenditure categories: personnel, investment, and goods and services. Concerning the latter, the basic principles and good practices in public procurement—an essential component of public financial management—are summarized briefly. The challenge of how to balance central control with management flexibility is addressed next, including procedures for release of funds, budget implementation planning, the pros and cons of carrying some funds past the fiscal year and the appropriate provisions to regulate transfer of funds between line items. The chapter concludes with an explanation of the principles of cash management, the need for centralizing government cash, and the treasury function—including the workings of a “treasury single account”.

The framework of budget execution

To understand the objectives and modalities of budget execution it is necessary to go back to the fundamental principle of public financial governance. No revenue can be mobilized from the people nor any moneys spent on behalf of the people without the explicit approval of the elected legislature as representative of the people. Once the budget—properly prepared, as explained in the previous chapters—is approved by the legislature, the executive branch of government has the authority and the obligation to execute it faithfully.

Fiduciary risk

The general definition of risk is the exposure to the probability of damage or loss. But the “damage or loss” relevant for public financial management is different from that of risk in private activity. For a private enterprise, the risk of lending is non-repayment and the risk of major commercial reverses is the disappearance of the entity. In official concessional aid, instead the risk of non-repayment is inapplicable to grants and remote for soft loans. And in budgeting, the risk is the exposure to the probability of breaching the implicit contract between the government and the citizens—it is fiduciary risk.

A fiduciary is a person or an entity entrusted with acting in the interest of another person or entity. In public financial management, who are these entities, and what is the “interest” being protected? It is the executive branch of government that is the fiduciary for acting in the interest of the population as a whole, and the “interest” in question is the execution of the government budget—as the financial mirror of the economic and social choices of the population.

The first requirements of a functioning budget execution system are to (i) protect the money and (ii) assure that it goes for the approved purposes. These requirements are related to the first two objectives of PFM—expenditure control and strategic resource allocation—discussed in Chapter 4. Therefore, the first immediate definition of fiduciary risk in PFM is the exposure to the probability that the execution of the government...
budget will not be consistent with the budget approved by the legislature. If budget execution systems do not prevent theft or misallocation of the money obviously it will be impossible for the approved budget to be implemented.

There is a broader definition of fiduciary risk, however, which is sometimes referred to as “development risk”. Executing the expenditures in conformity with the approved budget is necessary but not sufficient to ensure that the public resources are not wasted as a result of inefficient institutions and organizational practices. For this, budget execution systems ought also to enable and promote efficient and effective use of the resources and do so in a manner that is viewed as respectful of the rule of law and meeting basic standards of equity. Indeed, efficient management and equitable processes are the other two fundamental objectives of PFM.

The objectives of budget execution
The objectives of budget execution flow directly from the basic objectives of PFM and the concepts of fiduciary risk in public finance. Budget execution is the phase where resources are used to implement policies incorporated in the budget. However, budget execution processes do not come down simply to mechanisms for ensuring compliance with the approved budget. Even with good forecasts of revenues and expenditure, unexpected changes in the macroeconomic environment will occur during the year, and need to be accommodated. Of course, adjustments should be made in a way that is consistent with the initial policy objectives to avoid disrupting the activities of ministries and projects. Successful budget execution depends on numerous other factors as well, such as the ability to deal with changes in the implementation capacities of agencies and enabling the efficient management of the purchase and use of resources. Budget execution involves a greater number of players than budget preparation: it calls both for assuring that the policies incorporated in the budget are implemented and for taking into account feedback from actual experience in implementing the budget. Hence, the objectives of budget execution are:

» compliance, by ensuring that the budget is implemented in conformity with the authorizations granted in the law, both in the financial and policy aspects;
» adaptability, of the execution of the budget to respond to significant changes in the economic and social environment and to resolve problems that arise during implementation;
» sound management of the purchasing process and utilization of the resources.

Compliance is the heart of traditional budget execution systems, through input controls that ensure against overruns and preclude unauthorized changes in the composition of the budget during its execution. This approach is aimed at assuring fiscal discipline and strategic resource allocation, but poses two types of problems if the input controls are excessively detailed or intrusive. Excessively detailed controls are time-consuming and make the budget very rigid. Worse, traditional detailed controls are not even sufficient to assure fiscal discipline, because they focus on payments while deviations from fiscal discipline are just as likely to occur elsewhere (uncontrolled hiring, arrears on utilities services, etc.). To assure compliance, internal management controls, ex-post audits and sanctions are often more important than detailed input controls (as discussed in Chapter 12).

To accomplish the two other objectives of budget execution—adapting to intervening changes, as well as enabling implementation of government activities in an efficient and cost-effective way—the line ministries and agencies should be given limited but adequate flexibility to manage their resources within the policy framework of the budget. This flexibility concerns mainly the composition of the inputs needed to carry out a given activity and the allocation of resources among activities that meet the same set of objectives. We will return again and again to this core issue of balancing control with flexibility.

The main cause of budget execution problems: An unrealistic budget
The principal reason for problems in budget execution is an unrealistic budget in the first place. Good budget preparation comes first, logically as well as chronologically. It is possible to imple-
ment badly a well-formulated budget; it is not possible to implement well a badly formulated budget. In most cases, problems “downstream” are related to deficiencies “upstream” in the budget preparation process. For example, “technical advice about compiling and controlling commitments [is] not likely to be successful” if the root cause of unrealistic budget preparation is not addressed (Diamond et al 2006: 12). Both budget overruns and under-spending are related to inadequacies in budget preparation, which lead to the necessity to keep changing the budget during the fiscal year itself—a problem that has been called “repetitive budgeting”. When identifying problems in budget execution, it is always necessary to ask whether these are corollaries of weak budget preparation or can be addressed by strengthening budget execution mechanisms themselves.

When revenues are overestimated and expenditures underestimated, obviously at some point during the year the resources available will not be sufficient to finance the expenditures required, and ad hoc cuts will have to be made, with various disruptions and costs, or spending overruns will be experienced. The ministry of finance is empowered and required to control budget execution and, if the approved budget is unrealistic, it must take its own decisions on how much of the funding in the official budget can actually be released. In effect, alongside the formal budget, there is an informal “core” budget known only to the ministry of finance from which funds are released. Expenditure control and cash management are thus achieved at the cost of disruptions in implementation of government activities and delivery of public services.

But underspending, too, is a source of problems, although of a different kind. Underspending is mainly found in the investment component of the budget, and is often caused by overly optimistic programming that doesn’t take into account the time needed for procurement or for mobilization of external funds. Adequate flexibility to reallocate funds from projects that are delayed to projects that are proceeding well can help; but the optimal approach is a realistic public investment program in the first place, combined with the practice of launching projects only when the financing is assured and implementation requirements have been met (as explained in Chapter 8). Implementation capacity is key for good project execution: no investment project should ever be launched without a favorable economic appraisal and assured funding; but to include projects in the capital budget only based on a good appraisal and availability of donor funds almost invariably leads to underspending.

The expenditure cycle:
The stages of expenditure

Following adoption of the budget by the legislature, the expenditure cycle consists of the following stages:

> Allocation of appropriations/release of funds to spending units. Funds may be released through notification of cash limits, issue of warrant, funds transfers to imprest accounts, etc. In some countries, the release of funds includes two steps: (i) apportionment by the central budget office, which consists of defining which part of the appropriation the line ministries and spending decision units can use; and (ii) allotment by the line ministries and main spending decision units, which consists of allocating apportioned appropriations to subordinate spending units.\(^1\)

> Commitment. In the commitment stage a future obligation to pay is incurred. A commit-
ment consists of placing an order, awarding a contract, etc., for goods or services to be received or works to be completed. It entails an obligation to pay only if the third party has complied with the provisions of the contract. The term “commitment” is used in different ways for different categories of expenditure and in different countries—to apply variously to the reservation of funds or the order placed, contract awarded, or verification completed. For a multiyear contract, in the budgetary sense a commitment may correspond to the entire contract or to an annual tranche of the contract. In this book, the term “forward commitment” is used to refer to a multiyear commitment and the term “annual commitment” to the annual tranche. In a legal sense, the term commitment applies to the contract as a whole, not to the annual tranche of the contract.

**Acquisition/verification (or certification).** At this stage, goods are delivered and/or services are rendered and their conformity with the contract or order is verified. Government assets and liabilities are increased and recorded in the books, if the country has an accrual accounting system. Expenditures at the verification stage are called accrued expenditures in some countries (e.g. in the U.S.). Accrued expenditures should not be confused with full costs or other expenses for which certain appropriations within an accrual budgeting system are used. Expenditure at the verification stage entails a liability, and arrears are the difference between expenditures at the verification stage and payments.

**Payment.** Payments can be made through various instruments: checks, cash disbursed, electronic transfers, debt instruments, barter agreements, deduction from taxes, cash vouchers, etc. Payments through barter agreements, deduction from taxes and cash vouchers are questionable. Payments through deduction from taxes are frequent in some FSU countries, but have negative consequences in both tax collection and competition among suppliers. Barter agreements impede competition among suppliers. Cash vouchers should generally be seen as an administrative stage in the expenditure cycle, rather than payment, especially when they are not paid immediately. Payments through checks are recorded when checks are issued in a majority of countries. Comparisons with bank statements should be systematic. When the float of unpaid checks is significant, payments must be reported on the basis of checks paid.

**Controlling the execution of the budget**

**Types of budgetary controls: Financial, physical, accounting, audit controls**

After the stage of allocation of funds, by the ministry of finance, four different types of budgetary execution controls are applicable to each stage of the expenditure cycle described above: financial, physical, accounting, and audit controls.

**Financial control**

Financial control applies at the commitment stage, to ascertain that (i) the funds have been included in the budget for the purpose specified; (ii) the proposed contract is for expenditure under the approved category; (iii) sufficient funds remain available in the appropriate expenditure category; and (iv) the proposed contract has been formally approved by a duly authorized person. Verification of the first three items is necessary for compliance with the approved budget; verification of the last item is clearly essential for the validity of the contract itself and hence to protect against mistakes or corruption.

**Physical control**
At the verification stage, when the goods or services have been delivered, procedures are needed and specific individuals must be designated to attest that the goods or services have been delivered in accordance with the contract provisions, including quantity, quality specifications and timeliness. Authorized and accountable persons in each ministry and department must review and certify the documentary evidence that the goods have been received and that the services were actually performed.

**Accounting control**

Accounting control is needed at the payment stage, to confirm before the payment is made that: (i) a valid contract exists; (ii) a competent person has certified that the goods have been received or services performed as per the contract; (iii) the invoice and other documents requesting payment are correct and in a form suitable for payment; and (iv) the beneficiary and his location are correctly identified. Some countries tend to rely on accounting controls to prevent fraud and assure compliance. However, it should be clear from the foregoing discussion that accounting control alone, while necessary, is quite insufficient to ensure compliance with the approved budget. Accounting controls can prevent neither payments arrears that permit but do not compel the actual payment nor the commitment of expenditures that are not authorized in the budget.

**Audit control**

Audit takes place after the expenditure cycle is completed, to examine and scrutinize the transactions and report any fraud, irregularity or error. (Issues related to audit are discussed in Chapter 12.)

**Organizational arrangements for budgetary control:**

**Centralized or delegated?**

In any organization, there must be a separation of duties for: authorizing expenditures, approving contracts and placing orders, certifying that goods have been received and that services have been provided as specified, and authorizing payments. In very small organizations, some of the above tasks may be performed by the same persons but if so, they cannot be associated with any of the individual stages of expenditure. In almost all cases, however, it is necessary and prudent to designate different individuals accountable to different offices for each level of control.

In governments, this separation of duties is often associated with the distribution of responsibilities between the ministry of finance and the line ministries and spending agencies. Depending on the country, controls may be performed within and under the responsibility of the relevant line ministry or by an external entity (ministry of finance, financial comptroller, etc.).

Arrangements for accounting control and payment processing vary from one country to another. In many countries, a paymaster office is responsible for accounting controls and effecting payments. This office is also generally responsible for cash management and the treasury function (described at the end of this chapter), but there are exceptions. In other countries, payments are processed by line ministries, but cash and bank accounts are controlled by the Treasury Department, which is responsible for cash management. The issue of whether accounting and payment controls should be centralized, reviewed below, is different from issues related to cash management, discussed at the end of this chapter. It is important not to confuse centralizing government cash (which is essential in almost all countries) with centralizing government payments (which may or may not be desirable depending on country circumstances).

Centralizing budgetary controls ensures that they are performed by qualified persons, and allows the central ministry to monitor that all expenditures fit the purposes stated in the budget and all payments are correct and appropriately documented. It is easy to understand why centralized controls are sometimes seen as the cornerstone of fiscal discipline. Recall, however, that good public financial management has two other and equally important objectives—strategic resource allocation and operational effectiveness. None should be sacrificed to gain some isolated advantage in terms of one objective. Centralized budgetary control interferes with the ownership of line ministries and agencies in the execution
of their programs and activities and reduces the opportunities for efficient management. As Premchand (1995, p. 41) puts it:

[O]bservance of discipline, which is an essential part of effective government financial management, must be secured through tighter controls, periodic oversight, strengthened accountability, greater citizen participation and, above all, greater transparency.”

When payments are processed centrally under the ministry of finance, locating the accounting offices within the line ministries is preferable to locating them centrally, as it reduces delays in processing invoices and requests for payment, as well as the risk of distortions in budget execution.4

If the government’s organizational arrangements are fragmented and capacity is extremely weak, a centralized system of budgetary control is the obvious cost-effective solution. However, there should be a gradual move toward decentralizing financial and accounting controls as line ministries’ capacity improves. There is little logic and substantial cost in a system where every invoice and request for payment has to be submitted to a central office. If the concern is with preventing corruption or accumulation of arrears, it is doubtful that centralizing controls and payments would be effective. It is equally likely that doing so would merely centralize corruption opportunities rather than reduce corruption in the system as a whole. Central control does not necessarily prevent over-commitment either, but may simply provide an excuse to develop the “exceptional procedures” that are so frequent in the African countries that follow the highly centralized control system of the former French model.

However, removing ex-ante financial controls without prior or at least concomitant strengthening of accountability mechanisms can seriously compromise the integrity of the system.

Concerning payments, however, decentralizing payment systems in developing countries that currently use a centralized control system would be problematic. Skilled accountants are not plentiful; decentralized payments could increase difficulties in budget monitoring and cash management because of lack of modern technologies; and decentralizing without the corresponding institutional and incentive changes could create significant disorders and loosen financial discipline.

The main problem with ex-ante external controls is ineffectiveness. Controlling commitments for personnel and investment needs specific provisions—discussed below—and commitments related to entitlements, transfers, and subsidies are directly related to policy decisions. Even for goods and services, ex-ante budgetary controls are insufficient. For example, to reduce consumption of services from utilities, which absorb a significant part of recurrent budgets, there is a need to improve management, not to tighten up budgetary controls. In most situations, achieving compliance with the approved budget requires much more than budgetary controls—however effective they may be.

In some countries, the officials responsible for financial or accounting controls report to both the ministry of finance and the head of the relevant spending agency. This dual responsibility dilutes accountability and submits the officials to contradictory requirements. (Moreover, their functions and responsibilities are rarely specified, and it is difficult to ascertain whether in the final analysis they are responsible to the minister concerned or to the ministry of finance.) However, in the rare cases where this dual responsibility has been managed well, and depending largely on the personal qualities of the officials involved, the system has served as a vehicle for capacity building in the line ministries and as mechanism of cooperation between the ministry of finance and the spending agencies, as well as for proper reporting on budget execution.
Managing payables and preventing payments arrears

Managing payables
Careful management of invoices is essential, by whatever system appropriate to the country. Computerization can help track invoices, but not fully, since invoices can accumulate both upstream and downstream. If payments are issued by the Treasury, invoices could accumulate at the level of the spending agency managers, where they do not send in the invoices either because they know the Treasury does not have cash or for less acceptable reasons (e.g., it is possible to extract a bribe from a supplier in order to send the invoice to the Treasury). Whether the system is manual or computerized, three rules must be followed:

» Expenditures must be verified as soon as the goods or the services have been acquired;
» Verified expenditures must be entered immediately into the accounts;
» Payments must be recorded as soon as they are made.

Each contract, or at least those contracts concerning civil works and projects of a significant size, needs to be monitored accurately. Payments that will be made over the fiscal year must be noted to prepare the cash plan. In the day-to-day management of payables, it is necessary to take into account the date on which the payments are due. To avoid penalties for late payments, invoices should be paid on the due date, but to reduce borrowing needs they should not be paid in advance.

Overt and covert non-compliance
There are two ways of violating the requirement of compliance with the approved budget. Overt non-compliance stems from lack of control over commitments, since the controls are on actual payments and commitments can be made without the resources to pay for them during the fiscal year. The conformity of the budget execution with the approved budget is only apparent, because sweeping certain payments due under the rug only pushes the problem to the next fiscal years. The violation of the compliance objective is no different under covert noncompliance, but in addition fiscal transparency is reduced, government credibility is harmed and a variety of costs and problems emerge. In a cash budget, a separate and systematic procedure for monitor and control commitments is therefore necessary if payment arrears are to be prevented and genuine compliance to be achieved.

Covert non-compliance: The issue of payments arrears
Failure to manage payables and to make payments on time leads to “payments arrears”. An arrear is incurred when an invoice is not paid on the contractual due date. Arrears are thus different from “float”, which is the normal time delay between delivery and payment that is needed to process outstanding invoices. If allowed to accumulate, payment arrears are the quickest and most efficient way to damage the credibility of the government, raise government costs, and distort the fiscal accounts.

Most obviously, delaying payments poses problems to the suppliers, but also disrupts public financial management. When the government accumulates arrears the private suppliers face financial difficulties but quickly develop defensive strategies—demanding payment before delivery, overbilling, or bribing line ministry and/or treasury officials responsible for the management of the waiting list of payment arrears.

Arrears have many causes, such as insufficient commitment control or the perverse effects of
a cash rationing system that does not take into account commitments already made. Improved commitment monitoring is generally required. However, in many cases, the decision or the event that generates an obligation to pay is upstream to the commitment in the budgetary sense. Arrears in payments to public utilities for consumption of their services are frequent. Generally, state-owned utilities cannot afford politically to stop providing services to government agencies even when they are not paid, and cope with the situation by demanding larger and larger government subsidies to cover their operating losses. (Payment arrears are also a convenient excuse for public utilities not to improve their performance.) Limiting the generation of arrears to public utilities requires both realistic estimates of annual consumption and management measures (such as installing meters). All such measures should be identified during the budget preparation, as it is normally too late to introduce them during budget execution.

In general, limiting generation of arrears requires a combination of measures such as realistic budget estimates, internal management controls, good personnel management, and control and monitoring of commitments.

In cases of extreme fiscal stress, it may simply be impossible for the government to face its payment obligation on time. As soon as the problem is recognized, however, arrangements should be made for a negotiated understanding with suppliers (or with government employees, pensioners or recipients of budgetary transfers) instead of simply burying one’s head in the sand and allow the problem to grow in uncontrolled, inefficient, and inequitable fashion.

The process of settlement of payments arrears can be as problematic as the initial accumulation of arrears. It is a major source of corruption opportunities. In principle, arrears payments should be prioritized on the basis of the date on which invoices were due, and if full payment is financially impossible, an equitable system of pro-rated payments should be implemented. But invoices can be paid sooner, or later; the interest accrued since the due date can be calculated conservatively or “generously”; payment can be authorized although the goods were defective or procurement rules were violated; collusion can modify or manufacture the invoices, etc.—all depending on the “price” received by the person in charge of settling the overdue payment obligations. It is critical therefore to have a program of arrears settlement that is comprehensive, governed by strict rules without exception, monitored by an independent external entity, and subject to a special audit by the external audit office.

Monitoring the execution of the budget

Monitoring: Clear need, light hand
Budget implementation must be reviewed periodically to ensure that programs are implemented effectively and to identify any financial or policy slip-ups. The monitoring of budget execution should cover financial, physical and other performance indicators. Cost increases due to inflation, unexpected difficulties, insufficient initial study of projects, and budget overruns must be identified so that adequate countermeasures can be taken. A comprehensive midterm review of the implementation of the budget is needed, while the financial execution of the budget should be reported to the ministry of finance and reviewed monthly.

In monitoring the budget, the legitimate information needs of the overall PFM system have to be weighed against the reporting costs imposed on the line ministries and agencies. This is an application of the general requirement to balance control and flexibility. Resolution in practice
depends on the country and its circumstances. Often, however, there is a tendency by the ministry of finance to impose excessively detailed or frequent reporting requirements on the spending agencies, without a real need for the information and thus without substantive follow-up. This tendency must be resisted, as excessive reporting is destructive all around. Knowing that the ministry of finance has neither the interest nor the capacity to analyze the reports and take corrective action, the spending agencies will send in formalistic and sloppy reports. Then the ministry of finance is pushed to tighten up its standards for reporting, causing even greater waste of time and effort in the spending agencies. In one African country, for example, each ministry is required to submit a quarterly report on the physical execution of every single program, leading to nonsensical reports produced at substantial transaction costs. As an official said: “We are required to report so much on our work that we have no time to do the work.” Selectivity is essential for enforcement and efficiency, in budget execution reporting as much as in all other areas of public administration.

Monitoring of transfers and subsidies is largely focused on assuring that the right beneficiaries receive the transfers in the right amount and on a timely basis. The main protection of accuracy and integrity in this area is the provision of easy channels for complaints and feedback by the intended beneficiaries and assurance of adequate follow-up action. Monitoring of interest payments is handled by a dedicated debt management entity, as explained next in Chapter 11. The execution of the remaining major expenditure categories—personnel expenditure, investment, and goods and services—calls for careful monitoring tailored to the characteristics of each expenditure category.

**Monitoring personnel expenditure**

In a few countries (e.g. Australia and New Zealand), personnel expenditure is grouped together with goods and services expenditure, to encourage efficiency in delivering services by giving agencies an incentive to use saving in personnel costs for other expenditures. Using budgetary procedures to spur efficiency is not necessarily the right approach, however, as compensation changes, efficiency dividends, market-testing etc., can do so more effectively. Moreover, some measures to improve performance, such as contracting out some activities to private entities, may increase efficiency in the short term at much greater cost down the line. In developing countries, block appropriations as an incentive to reduce employment are likely to be counterproductive, as both the politicians and the civil servants prefer to reallocate money to wage payments from nonwage expenditure, at probably higher cost in the medium term. In most developing countries, personnel expenditure must be budgeted separately and both the expenditure and the number of employees need to be carefully monitored.

In most developing countries, personnel expenditures are budgeted under a separate line item and transfers between personnel and nonpersonnel expenditure are not allowed. In countries where the size of the civil service is not excessive, personnel management is effective, and compensation is adequate, this may be sufficient to keep personnel expenditure under control; information on staffing can be included as a budget annex and lightly monitored during the year. In other countries, separate budgeting of personnel expenditure and limits on transfers may not be sufficient for compliance, and must be complemented by limiting the number of employees or of posts. These limits should be carefully monitored throughout the year, with penalties for violating the limits.

A payroll system is necessary to monitor staff limits and ensure integrity and transparency in personnel expenditures. In general, the payroll system needs to be centralized in the Ministry of Finance. In several countries, government employees are placed under the responsibility of a civil service board or commission. Good coordination between this office and the Ministry of Finance must be established. If the civil service board manages personnel positions, they should be fully compatible with the staff ceilings and the appropriations for personnel expenditures. Personnel management systems maintained independently from the payroll system are a source
of inevitable confusion. If a central personnel management system exists, it must be integrated with the payroll system. Close links must be established between the payroll system and management, which keeps personnel information files. When the budget system has fallen into serious disrepair, rebuilding the payroll and its linkages to the personnel management system is one of the first priorities, as in the case of Zimbabwe, shown in Box 10-1.

**Monitoring public investment**

Monitoring the financial and physical execution of the investment budget follows schedules specific to each project. General requirements also apply for monitoring of expenditure by the min-

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**Box 10-1**

**The Payroll and Skills Audit in Zimbabwe**

The public service in Zimbabwe has been gravely affected by macroeconomic decline and hyperinflation, with large numbers of public servants leaving and others demoralized, and uncertain fiscal implications of the wage and pension bill. Before considering structural reforms to revitalise the civil service, the Government requested World Bank support for the Ministry of Public Service to conduct a comprehensive audit that would: (i) update and validate the authenticity and correctness of a comprehensive repository of government personnel data (the payroll audit) and (ii) take stock of the existing skills base in the civil service based on correct and validated personnel data (the skills audit).

The audit, carried out by an international firm, has four stages. Stage 1 built a comprehensive HR repository of current and past government personnel, by gathering the data maintained by various agencies and ministries, normalizing them as needed and storing them in standardized format. In Stage 2 the employees were enumerated and personnel records verified (physical audit) from the HR repository. (The lessons learned through a pilot audit strengthened the physical audit.)

In Stage 3 the data collected and verified will be analyzed, and a skills audit conducted to identify skills gaps as well as understaffed and overstaffed units. In the final Stage 4, a complete audit of the payroll and HRMIS systems will be undertaken to identify capacity building needs as well as the infrastructure and equipment required to operate and maintain robust systems—including the integrity of the records management system and a set of controls to synchronize transactions of the HR Lifecycle Management System, the HRMIS and the Compensation System (including payroll.)

Political factors have intervened to delay and complicate the process. If the audit continues without further interference and is completed, Zimbabwe will have a comprehensive and fully updated database of civil service employees, as well as a clear assessment of the weaknesses in the system—allowing for the formulation of sound reforms. The budgetary outcomes will also include significant savings through the identification and removal of a large number of ghosts and double dippers, as well as the elimination of systemic opportunities for graft and mismanagement.

*Source:* Zimbabwe Ministry of Finance.
The execution of investment budgets is often beset by problems because of insufficient implementation capacities and other factors such as delays in mobilizing external financing, overoptimistic construction schedules, labor disputes, climatic hazards, or difficulties in importing supplies. Mechanisms for regular review of the progress of the largest and the most problematic projects are needed—preferably a regular monthly or quarterly review of projects within the line ministry concerned and a midyear review involving the line ministry and the ministries of finance and planning.

The monitoring of multiyear commitments is especially necessary when the public investment budget is comparatively large. For countries that finance their investments mainly from domestic resources, overruns often are caused by badly estimated multiyear commitments in the budget. A “second-generation” public investment program, such as described in Chapter 8, would provide the framework for monitoring the multiyear commitments, provided that it is detailed enough to identify the activities that will be carried out through multiyear contracts.

To monitor and control multiyear commitments appropriately, a ceiling for forward commitments should be established. This could take the form of a commitment authorization included in the budget, a multiyear appropriation, or authorizations derived from a PIP. The commitments would be authorized up to these ceilings and should be reported in the same way as the annual appropriations.

Generally, in aid-dependent countries, the problems met in executing multiyear projects are due more to deficiencies in financial programming than to poor administration of forward commitments, since a significant share of the contracts is financed by external sources.

As in budget execution in general, problems in implementing investment projects are inevitable if the public investment program is weak or overambitious, or insufficient local resources are included in the budget to complement foreign aid.

Public Procurement

Overview

Government acquisition of goods and services and works is referred to as public procurement. Its central importance as a critical aspect of public financial management is rarely recognized. The subject is complex and only the basic elements are presented here. (Interested readers are referred to Schiavo-Campo and McFerson, 2008.)

Historically, the role of public procurement was to obtain supplies and equipment for the military. Samuel Pepys was appointed in 1660 to find out why the quality of ships and supplies for the British Navy was so unreliable and prices so high. His diary gives a striking description of the procurement function in 17th-century England and the uncontrolled scope for self-enrichment by government officials in those times. Pepys did manage somewhat to clean up the navy procurement process and to require reports on procurement to an increasingly assertive parliament. However, he concluded resignedly that “[I]t is impossible for the King to have things done as cheap as other men.” (See Latham, 1978.) The activities gradually expanded until procurement became a core function of public administration, accounting today for about one fifth of expenditure in high-income countries and as much as one half in African developing countries.
There are essential differences between the procurement process in government and in private companies. Managers in private companies have built-in incentives to purchase goods that provide high value for money, and to hire contractors who will do quality work at competitive prices. Their accountability is related to results, not process, and private procurement inefficiencies will show up in their impact on overall company profit. In contrast, the public manager must follow procedures that give a major weight to fairness and equity, and public procurement is subject to oversight by the legislature and public audit (in addition to internal administrative accountability mechanisms). Also, public procurement is often used as a tool for public policy goals, and mistakes or malfeasance in public procurement can have vast political repercussions. Finally, private entities prefer stable relationships with specific suppliers, for certainty and easier business planning; but several factors (including fear of collusion with contractors and integrity rules) preclude public agencies from developing such long-term relationships.

Contracting for public works and construction (roads, bridges, ports, etc.) and purchase of goods and services are subject to different rules, for a number of reasons. Unlike goods and services for consumption or as intermediate inputs, public works represent long-lasting final outputs. The standards and specifications for bids and contracts are also different, and the contracting process for works lends itself to unbundling into separate contracts for each component (e.g., design, technical services, actual construction). The process of contracting therefore stretches over a much longer period than the acquisition of goods and services, and calls for closer supervision. (The African Development Bank recommends using a separate set of documents for construction contracts.)

Consulting services are also subject to special procurement criteria, because advice is intangible and its value is difficult to assess in advance. Also, unlike equipment, a consultancy cannot be realistically tested prior to contracting: the buyer does not have the same specialized competence as the consultants and thus has difficulties in selecting them. However, with judicious research and scrutiny, individual consultants can often be more cost-effective than contracting large consulting firms. In any case, the overriding consideration in consultants’ procurement is the quality of the advice, rather than the price, since in most cases the consulting fees are a very small fraction of the total project cost, while good advice is key to project success.

Procurement is governed by three key requirements: competition, transparency, and uniformity of treatment. The procurement cycle includes three main stages: (i) identification of user needs and bid preparation; (ii) determination of the procurement procedure, e.g., restricted list of vendors, local competitive bidding, international competitive bidding (for aid-financed expenditures procedures must conform to the donor guidelines); and (iii) bidding process. (To avoid a distortion toward low-priced bids, it is often desirable to review the bids in two steps, first on technical grounds, and then on the basis of cost.)

Choosing the winning bid and awarding the contract is not the end of procurement, however. The goods and services still need to be delivered as ordered, and the works must begin and be completed as per the contractual agreement. As in the budget process, while it is difficult to execute well a badly formulated contract, it is entirely possible and quite common to execute badly even the best contract. In the first place, therefore, problems in contract management are often caused by ambiguities or deficiencies in the contracting process and the contract itself. However, even when the contract is clear, realistic and comprehensive to begin with, it is unlikely to be executed well without appropriate supervision. Contract management and monitoring is a critical but often-neglected area in many developing countries, reflecting either weak capacity or inattention by senior management, usually both.

Objectives of public procurement
The main objective of procurement is economy: to acquire goods and services and works at the lowest price and on a timely basis, without sacrificing quality. In public procurement, the objective of economy is complemented by other objectives:
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» **Fostering competition.** Competition in procurement is defined as equality of opportunity for qualified suppliers to compete for public contracts. Because the number of qualified suppliers is directly related to the degree of competition, information and technical assistance should be given to potential bidders to better understand the rules of procurement and thus become qualified to compete.

» **Domestic preference.** Domestic preference practices are generally suspect. In developing countries, however, giving some preference in public procurement to domestic firms has traditionally been accepted by the African Development Bank and other development agencies to stimulate the growth of domestic competitors to large multinational suppliers. Similarly, although the World Trade Organization (WTO) prescribes uniform treatment of domestic and foreign suppliers, it provides for special treatment of developing countries.

» **Protecting public services.** Governments retain the basic responsibility to ensure that the services paid for by the taxpayers reach the citizens. In procurement, this entails setting up recourse mechanisms, monitoring contract execution by private suppliers, giving information to citizens, and opening avenues of complaint.

» **Fostering equity and remedying the effects of past discrimination.** Especially important in ethnically diverse African countries, preferences can be given to ethnic or regional groups previously discriminated against. Such preferences can be circumvented by putting up “front companies” to take advantage of the procurement preference. This risk, however, can be addressed and mitigated. South Africa offers a major illustration of how to move from an extremely discriminatory system to one with an explicit equity component—Box 10.2.

**Organizational arrangements**

The central organizational question is whether procurement should be entrusted to one central agency, or decentralized to the spending ministries and agencies concerned. The main advantages of centralized procurement are staff familiarity with the policies and procedures, and lower cost through bulk purchasing. The main advantage of decentralized procurement is greater appropriateness of the goods and services and timeliness of acquisition. However, instead of inquiring whether all procurement should be central or decentralized, it is more constructive to ask which of the several procurement functions are best performed by a central agency. The general answer is that a central entity is essential to set uniform procurement rules and standards, exercise oversight and handle appeals, while the actual purchasing and contracting should generally be left to the spending ministry and agency directly concerned. As far as local governments are concerned, subnational units should have the autonomy and flexibility to procure their own goods and services, within the overall rules and standards.

Senior managers generally tend to leave procurement to the “specialists”. This is not a healthy state of affairs. In the first place, procurement is much too important to be neglected by senior management—particularly for large civil works and informatics contracts. Also, rank and file procurement staff members have an understandable aversion to risk because of the lack of rewards for good decisions and the special external scrutiny to which procurement is exposed. Especially when anticorruption efforts are intensified, this risk aversion can paralyse the procurement function altogether. Senior public managers must become more involved in procurement and provide greater support for and control of the actions of the procurement specialists.

**Managing risk and combating corruption in procurement**

The degree of procurement risk differs in different sectors and countries, and is determined by three variables: specificity; market structure; and size and complexity of the transaction. Specificity is inversely related to risk: the more specific the product or contract, the fewer the opportunities for manipulating the procurement process. A less competitive market structure is associated with greater risk. Finally, a large transaction
Box 10-2

**Procurement in the New South Africa**

Procurement reform in South Africa has been part of the difficult challenge of balancing short-term efficiency with the imperative of dismantling the racist structure of the apartheid regime. The old procurement system was not only racially discriminatory, but also fragmented, hard to use, and biased toward large, established businesses. The onerous procedures often caused delays in delivery and prevented the government from taking advantage of its size in negotiating procurement contracts. All contracts had to be approved by ten Tender Boards (one national and nine provincial), and there were separate boards or committees for parastatal and local authorities. Each of these boards was autonomous, with its own procedures, requirements, and policy interpretations.

South Africa is among the countries whose constitution contains a special provision on government procurement (section 187 of the 1994 constitution):

- the procurement of goods and services for any level of government is to be regulated by an act of parliament and by provincial laws, providing for the appointment of independent and impartial tender boards;
- the tendering system must be “fair, equitable, transparent, competitive and cost-effective”, and the tender boards shall have to justify their decisions at the request of interested parties;
- no organ of the state or any public official or any other person may improperly interfere with the decisions and operations of the tender boards; and all decisions of the tender boards shall be recorded.

The procurement system of the apartheid regime, with its extreme form of built-in racial discrimination, obviously did not meet the above constitutional requirements. Public procurement reform in South Africa was therefore aimed at three main objectives: good governance, uniformity, and the achievement of socioeconomic goals — balancing the objective of economy with the encouragement of broader participation and the overcoming of discrimination. The Preferential Procurement Policy Framework Act 2000 is a key piece of legislation in this delicate process, and applies to all levels of government (although the minister of finance may approve exemptions). The act specifies a two-tier preference system.

For contracts below a certain value threshold, 80 points are given for low price and 20 points for empowerment and development objectives. For projects above the value threshold, the split is 90/10. The aim is to enable smaller contractors to bid for lower-value contracts, and to allow some redress for past discrimination. A penalty clause is included to discourage established firms from establishing “front” companies in order to qualify for preference.

The South African legislation is well worth considering by other multi-ethnic countries that must reconcile short-term cost-effectiveness with long-term sustainability and equity.

*Source:* Laura Walker, personal communication, 2001
is normally more complex technically, thus offering greater openings for manipulation and making oversight more difficult. To illustrate, information and communication technology is an especially sensitive area in terms of risk: it entails bulk purchase of expensive equipment; requires a level of buyer expertise not normally found in government; competition among the few suppliers is limited; and information technology is frequently driven by suppliers, donors or both—irrespective of the real needs of the users in the company or the government. The best single measure to protect against procurement risk is to set up a mechanism to obtain independent technical advice, as well as to assure much greater participation by the final users of the equipment or the software, from the very beginning of the process.

Balancing control and flexibility in budget execution

As repeatedly emphasized throughout this book, none of the three interrelated objectives of PFM—fiscal discipline, strategic resource allocation, and operational efficiency—should be pursued in isolation. The PFM system must therefore provide both for central control and for enabling the spending agencies to manage their activities. Central control alone may assure fiscal discipline but cannot facilitate the appropriate resource allocation, let alone the efficient use of the financial resources. At the other extreme, giving excessive flexibility to the spending agencies would, in most countries, lead to uncontrolled expenditure, fiscal risk and possible corruption. The appropriate balance between control and flexibility must be struck differently in different countries, but the challenge of balancing the two is a perennial feature of public financial management debate and reform. The control/flexibility balance revolves mainly around the issues of when and how funds are released to the line ministries and spending agencies, and of the extent to which the line ministries are empowered to shift funds from one item to another during budget execution.

Release of funds
To ensure effective budget implementation, the authority to spend must be given to line ministries and spending agencies in useful time. Although the funds should always be released in conformity with budget authorizations, the timing of their release differs and primarily is based on the need for sound cash management.

Cash rationing
In some countries, funds are released to line ministries through cash rationing because of emerging fiscal problems or an overestimated budget. Where a centralized Treasury system exists, this mechanism consists of an ad hoc selection of agencies to which cash will be transferred or a selection of the invoices to be paid. In some countries, this selection is made by a high-level committee.

Under cash rationing, funds are often released on pressure and political grounds, discarding the priorities defined in the budget. The de facto budget resulting from these day-to-day decisions is quite different from the budget approved by the legislature. Moreover, cash rationing cannot even solve the problems it is meant to address, since the spending agencies can continue to make commitments according to the formal budget, and accumulate arrears that add to the government liabilities and burden future budgets. Such situations were common in transition economies but have lessened substantially as budget preparation improved and the economic situation stabilized. In Africa, cash rationing is limited largely to some fragile states.
Budget implementation plan
Assuming the budget is realistic, release of the funds can occur in four quarterly installments, or as one-twelfth of the budgeted amount every month, or in accordance with a detailed budget implementation plan. Whatever practice is adopted, the system for releasing funds should ensure effective and efficient implementation of the budget and avoid generating arrears. Hence, the following elements need to be taken into account:

» To plan their activities effectively, spending agencies should know in advance the amount of funds that will be allocated to them, and when.
» Funds must be released in time and without any delay. In case of emerging cash problems, the schedule for releasing funds will need to be revised, but the revised schedule should be communicated to the line ministries instead of adapting to the cash shortage by simply delaying the release of funds compared with the agreed schedule.
» Particular attention must be given to government agencies located in remote areas. Good coordination is needed within the Ministry of Finance and the line ministry concerned, and between the line ministry and its regional offices.5
» Regulating cash flows without monitoring commitments tends to generate arrears. In many cases when monthly cash limits are established, it is unclear whether spending units are allowed to enter into commitments up to the entire amount in the budget or only up to the monthly cash limits.
» The financial implications of ongoing commitments must be taken into account.
» Adjusting commitments needs time. Imposing monthly limits is generally more of a regulation of cash through float than a regulation of commitments, since a month may be too short a time to adjust commitments, even for goods and services. In a fiscal emergency situation or when the budget itself was unrealistic, monthly cash limits are preferable to day-to-day cash rationing.

In some countries, “warrants” are issued at the start of budget execution to authorize the government to implement the budget. These warrants are submitted to ex-ante clearance of the national auditor.7 This procedure is a historical remnant and is mainly ceremonial, since these warrants do not affect expenditure or cash release decisions, but only the allocation of funds already decided. However, although such a purely formal step does no harm, it causes unnecessary delay.

Cash plan
A cash plan, consistent with the budget implementation plan, must be prepared at the start of the fiscal year and adjusted subsequently as needed. The preparation of a cash plan is discussed in the last section at the end of this chapter, as part of the broader issue of cash management.

End-of-year spending rush and carryover provisions
The annuality rule of the budget can create a rush to spending at the close of the fiscal year. (This end-of-year spending spree was common in centrally-planned economies and in the old Soviet Union was called shturmovschina, “the storming”. ) The reasons vary. The worst reason to waste money is to make sure that the following year’s budget allocation will be made on a higher base. But a spending bulge at the end of the year may only reflect commendable prudence on the part of a ministry that keeps its expenditures down throughout most of the year, as protection against unexpected cuts in appropriations. Still, rushing expenditures almost invariably requires some avoidance or bending of the procurement rules—not a practice to be encouraged.

Here again, the importance of a sound and realistic budget is brought into sharp focus: with a serious and well-considered budget preparation process, allocations would not be decided merely on the basis of the previous year’s expenditure, and the ministries’ incentive to waste money at the end of the year would be much weaker. Also, with a realistic budget, ministries could count on receiving the funds on the established release schedule and would thus not need to compress their expenditures in the first half of the year to protect against cuts in the latter half. The optimal
response to end-of-year spending sprees would be to tighten up and improve budget preparation.

Nevertheless, budget preparation cannot be improved overnight. Also, unfavorable changes do happen during the year, and especially in developing countries, it may indeed be wise for a line ministry to be particularly prudent with spending its budget in the first eight or nine months of the year—which will lead to a slight spending bulge in the last few months, other things being equal. In this case, a provision authorizing a proportion of budgeted expenditures to be “carried over” to the following fiscal year may be desirable and serve as a second-best mechanism to remove the temptation to “get rid” of leftover funds before the spending authority comes to an end. The additional flexibility would entail a negligible cost in terms of the integrity of budget execution or in terms of fiscal discipline—because expenditures carried over from the previous year would be offset by expenditures carried over from the current year to the following year. (Appropriate procedures are also needed for paying bills and invoices that were regularly committed over the previous fiscal year, but have not yet been paid because, for example, of delays in deliveries.)

However, a carryover provision can easily be abused, and if justified by country circumstances, the provision should be expressly included in an amendment to the organic budget law (see Box 5-1), and not authorized yearly on an “as needed” basis. Also, any carry-over should be quite small—probably only about five percent of total expenditure in developing countries, and no more than 10 percent in high-income countries (e.g., in Australia). Owing to its medium-term nature, capital expenditure should be subject to much more flexible rules for carry over, which may require only approval by the ministry of finance rather than legislative action.

Adapting to changes

Contingency reserves
As noted, adaptability is a major objective of good budget execution systems. Changes during the year are only to be expected, especially in the fluid situation of developing countries. It is difficult to make accurate forecasts of implementation of certain types of activities and even harder to foresee changes in economic parameters such as inflation, interest rate or exchange rates. Other intervening changes, too, may need to be accommodated during budget execution:

- Laws enacted after the start of the fiscal year may increase benefits or cause revenue losses;
- Special events may give rise to additional spending, for example, to pay for an adverse court judgment, etc.;
- Unforeseen expenditures related to major policy actions, e.g., a privatization program;
- Exceptional expenditures not included in the budget or impossible to estimate, such as for natural catastrophes.

Some provision for unforeseen needs can be made through the introduction of a contingency reserve in the budget. (A contingency reserve in the budget is a financial cushion and must not be confused with a contingent liability, discussed in Chapter 5.) However, such contingency reserve should be quite small—perhaps two or three percent of the budget. If it is higher, the credibility of the budget will be weakened; and since everyone knows of the large pot of money held in reserve, budget execution will involve bargaining on the use of the contingency reserve, which will thus quickly disappear and not be available if the unforeseen change occurs. The main approach to dealing with changes during the fiscal year consists either of formally amending the budget or providing a measure of flexibility to the line ministries and spending agencies.

Budget revisions
Provisions to formally amend the budget depend on the country, but should be explicit in the organic law or other budget legislation. The broad principles are clear. Since the budget has been approved by the legislature, revisions should be made by law. Generally, changes in appropriation above a certain percentage of the initial appropriation, or changes that affect the total amount of expenditures, must be submitted to the legislature for formal approval. To allow the
government to address urgent problems on a timely basis, provisions should be made authorizing exceptional expenditures before legislative approval. However, such provisions should be clear and limited, and the executive must report as soon as possible to the legislature concerning these exceptional expenditures and request ex-post approval or, if the expenditures are substantial deviations from the budget, present a revised budget to the legislature showing, among other things, the adjustments needed to maintain the original macroeconomic and fiscal program or how it is expected to be modified.

Budget amendments are discussed in Chapter 9. To recapitulate briefly, amendments should be presented only at fixed times, preferably once or at most twice during the year and requests for changes from line ministries should be reviewed together, not on a case-by-case basis.

Virements
Rules for transfers between line items—virements—must be established in the organic budget law or the financial regulations. The rules must distinguish virements that may be made freely by the individual budget managers within their own authority; virements that require approval by the minister or head of agency; virements that require approval by the ministry of finance, and virements that are prohibited except by legislative authorization in the context of a budget amendment. The amount of expenditure is the major dividing line, with virements progressively more and more difficult as their size increases.

Controlling and keeping track of virements is one of the major activities of the budget offices during budget execution. Because administration of virements is time consuming and absorbs administrative resources, investing attention and effort during the preparation of the budget to estimate accurately the costs of activities and input requirements can save a lot of time and frustration during budget execution. But even with a perfect budget, line ministries and spending agencies need flexibility in implementing it, for any number of reasons—including accountability for results.

Depending on the internal capacities of line ministries to control their activities and the nature of problems met in budget implementation, it may be necessary either to protect or cap some line-items of expenditure. In developing countries, virement between personnel expenditures and other categories of expenditure should be prohibited or very tightly restricted. Reallocating expenditure from other categories to personnel may be prohibited when the objective is to limit the wage bill; and reallocating expenditure from personnel to other categories may be prohibited when the objective is to protect personnel. Most often, virement is prohibited either from or into personnel expenditure.

In some countries, it may be desirable to have rules either to protect some nonwage items for which arrears are frequently generated (such as electricity consumption) or to cap categories of expenditures that have dubious value or are vulnerable to public criticism (e.g., foreign travel by government officials). However, these rules should be reviewed regularly, as a problem of compliance in a given year will not necessarily be a problem in the subsequent years.

For investment expenditure, flexibility is essential to reallocate funds from projects delayed for one reason or another to projects that are going well. However, such virements should not be so large as to alter the investment program and policy framework adopted by the legislature. For instance, the ministry of education should not be permitted to reallocate budget funds from primary to higher education.

Micro virements, within projects or specific programs, should be left to the authority (and responsibility) of the project manager and not micromanaged by the ministry of finance or planning. At the other extreme, macro virements between major programs or between ministries would require at least cabinet authorization, if not legislative approval.
Cash management and the treasury function

The treasury function
The treasury functions mainly to provide spending agencies the funds needed to implement their activities in a timely manner; to manage government cash to minimize the cost of government borrowing; to manage public debt; and to manage the financial assets and liabilities of the government. In order to perform these functions, the treasury also handles all government bank accounts.

Control of cash is a key element in macroeconomic and fiscal management, whether in a cash-based or an accrual-based budget. (As emphasized earlier, control of cash payments must be complemented by an adequate system for managing commitments, to avoid payment arrears and assess fiscal risk.) Among other things, control of government cash is necessary to ensure that claims are paid according to the contract terms and due date (but not in advance); that revenues are collected on time; and that government borrows at the lowest interest rate and maximizes returns by investing in liquid interest-yielding instruments.

In developing countries, governments often do not pay sufficient attention to cash management issues. Budget execution procedures focus on compliance issues, while daily cash needs are met at low cost by the country’s Central Bank. Spending units are not concerned with government borrowing costs; large idle balances can be kept in agency accounts. However, experience has shown that very large savings or profits can be made by improving the management of government cash to minimize borrowing costs and maximize short-term investment returns.

Managing cash flows
Concerning cash inflows, it is necessary to minimize the delay between the time when cash is received and the time when it becomes available for financing expenditure. Therefore collected tax revenues need to be processed promptly and made available for use. For this purpose, the organization of tax administration offices may have to be reviewed and equipment modernized. Commercial banks can often receive revenues more efficiently than tax offices, which should focus on enforcing tax obligations. In this case, however, arrangements are needed to foster competition among banks and to ensure prompt transfer of the collected revenues to government accounts. The banks need to be remunerated, of course, but it is not advisable to do so indirectly by allowing them to keep the money for a longer time than strictly necessary. Remunerating the banks through explicit fees is more transparent and promotes competition.

The control of cash outflows poses more difficulties. The major purpose is to ensure that there will be enough cash at the due date of payments while keeping cash outflows compatible with the cash inflows and the overall fiscal targets. As noted, the precondition for ensuring that cash outflows fit the fiscal targets is good budget preparation; but during budget implementation cash outflows must be expressly regulated through cash plans.

Minimizing transaction costs is always a major concern, particularly in low-income countries with limited administrative capacity. The transaction costs of cash outflows are affected primarily by the payment methods. Depending on the banking infrastructure and the nature of expenditures, payments can be made in a variety of ways (cash, check, electronic transfer, debit card, etc.). At one extreme, making all payments through electronic transfers allows the government to plan its cash flow more accurately, expedite payments, simplify administration and accounting, and keep down transaction costs. Of course, these advantages can only be realized when the banking and broadband infrastructure is well developed. At the other ex-
treme, payments may have to be made in cash, for example when there are no banking services in certain areas of the country. This happens quite frequently in post-conflict situations and very large low-income countries.

Cash payments are cumbersome, and amount to an open invitation to theft and discrimination in places where oversight and accountability mechanisms are weak. This is especially the case for payment of government employee salaries and other monetary allowances. Major and rapid reductions in corruption have been achieved by the simple device of requiring all employees to have a bank account and depositing their salaries directly into the account. Cash payments should be avoided if at all possible, and the promotion of even rudimentary banking facilities in outlying areas of the country can serve important social objectives as well as PFM efficiency.

Centralization of cash and treasury single accounts

To minimize borrowing costs and maximize interest-bearing deposits, operating cash balances should be kept to a minimum. When spending agencies have their own bank accounts, idle cash balances accumulate, causing the government to borrow in order to finance payments of other agencies, even though the necessary cash is available somewhere in the system. Only the centralization of cash balances can avoid unnecessary borrowing and interest charges.

Cash balances are efficiently centralized through a Treasury Single Account, which is an account, or set of linked accounts, through which the government transacts all payments. A standard Treasury Single Account is organized along the following lines:

- ministries and agencies hold accounts either at the Central Bank or, for banking convenience, with commercial banks, but in both cases the accounts must be authorized by the Treasury and are subsidiary accounts of the Treasury’s account;
- the ministries and agencies’ accounts are “zero-balance” accounts, with money being transferred by the Treasury to these accounts as and when specific approved payments are made;
- the accounts are automatically “swept” (cleared) at the end of each day (where the banking infrastructure allows daily clearing) and the balances transferred automatically to the Treasury;
- the Central Bank consolidates the government cash position at the end of each day including the balances in all the government accounts.

Whatever the institutional arrangements, the centralization of cash balances should cover all the government accounts used for payment transactions. In practice, under the general notion of a “Treasury Single Account”, there are a variety of methods of centralizing transactions and cash flows, which can be grouped in two broad categories:

- **Active Treasury Single Account with centralized accounting controls.** Requests for payment are sent to the Treasury, which controls them and plans their payment. The Treasury manages the float of outstanding invoices. This solution appears to be more efficient both for cash management and for expenditure control. However, as discussed earlier, the centralization of accounting controls and the central management of float lead to inefficiencies, and even corruption in countries where the Treasury department selects which suppliers are to be paid.
» **Passive Treasury Single Account.** Payments are made directly by spending agencies, but through a Treasury Single Account. The Treasury sets cash limits for the total amount of transactions, but does not control individual transactions. In practice, the Treasury Single Account consists of several bank accounts. As noted, these accounts may be held at the Central Bank or also in several other financial institutions (e.g., Agriculture Bank, postal service). The accounts are swept every day and their balance automatically transferred to the central account of the Treasury. This system allows but does not require diversified banking arrangements. Payments can be made through banks selected on a competitive basis. The banks accept the payment orders sent by spending units up to a certain limit defined by the Treasury. Settlement is made at the end of each business day with the Central Bank, where the Treasury Central Account is held. From a cash management point of view, either of these arrangements produces the same result. The passive variant of Treasury Single Account has the added advantage of making the spending agency responsible for internal management, while keeping the all-important centralization of cash. The feasibility of their implementation depends on the level of technological development of the banking sector and of the government. Modern technology allows electronic links between spending agencies, the Central Bank (or the commercial banks), and the offices of the Treasury.¹⁰

Poor banking and technological infrastructure in some developing countries is an obstacle to combining centralization of cash balances with decentralization of payment processing. But most countries use most of their cash either for transactions at the central level (e.g., debt payment and expenditures managed by the central departments of line ministries) or for payments that are due on a fixed date (e.g., wage payments). Therefore, a first step in streamlining cash management consists of: (i) daily centralization of transactions made at the central level; and (ii) establishing procedures for transferring cash to line ministries and agencies in a manner consistent with the within-month distribution of their expenditures.

In developing countries without a fully developed banking or broadband infrastructure, daily clearing of accounts with various banks can be more difficult than daily settlement within a set of accounts at the Central Bank. Maintaining a large number of accounts could also hinder the implementation of appropriate clearing and consolidation procedures. However, in many countries, the treasury fails to perform daily clearing of the balances of the line ministries’ accounts with the central bank and despite a positive balance with the central bank the government still has to borrow. Daily consolidation of cash balances cannot be assumed only because the line ministries’ accounts are held with the Central Bank, and must be prescribed explicitly.

In several countries, arrangements for cash management have been aimed implicitly at supporting ailing banks—either by allowing them to keep revenues for a period of time or by holding government accounts in the banks. Banking reform should be addressed directly, and not through the backdoor of the subsidy implicit in holding government cash. In these cases, however, before improving the cash management practices, the effect on the banking system should be taken into account. Risk can flow in the opposite direction as well. Entrusting to commercial banks the management of the government’s accounts could burden the banks with the government’s own cash problems, if the Treasury is not able to meet its obligations.

Whatever the organization of tax collection or expenditure payment, the Treasury must be responsible for supervising all central government bank accounts, including any extra-budgetary funds. When commercial banks are involved in revenue collection or expenditure payments, the banking arrangements must be negotiated and contracted by the Treasury, to enable the government to negotiate favorable arrangements and ensure that requirements for cash and budget management are appropriately taken into account.
**Cash planning**

Annual cash plans must be prepared in advance, and should set out projected monthly cash inflows, cash outflows and the resulting borrowing requirements. The cash plan shows forecasts of financial flows before new borrowing, including reimbursements of loans or bills due from the government, repayment of arrears, and drawings on loans already contracted. The plan should be rolled over every three months, and the projections systematically updated every month. The preparation and updating of the cash plan requires close coordination between the treasury department, the budget department, and the tax administration office.

Concerning inflows, forecasts of the monthly distribution of revenues should be prepared, including forecasts of nontax revenues to be prepared by the Treasury in close coordination with the agencies responsible for their management. These forecasts should be updated regularly, preferably every month, since changes in the macroeconomic environment or in the tax administration system may affect revenue collection.

The preparation of monthly revenue forecasts requires economic as well as management expertise, to factor in changes in the tax administration system. This exercise should be carried out by the Tax and Customs Administration Departments, in close co-operation with the Treasury and the departments responsible for macroeconomic analysis. In several developing countries, monthly forecasts prepared by the tax administration departments are more administrative than economic. They show the distribution of budgeted revenues over the fiscal year but do not take into account fiscal and economic developments after the budget preparation. The Treasury may therefore have to strengthen the forecasting capacities of tax administration departments.

A good monitoring system is a prerequisite for forecasting. Thus, revenue collections need to be monitored along the major tax categories and adjusted to reflect changes in the assumptions underlying the forecasts. In-year revenue forecasts must be based on revenue assessment and tax collection reports the results of economic surveys, etc. Short-term forecasting tools, such as short-term macroeconomic models and tax forecasting models, are also helpful.

Concerning cash outflows, monthly forecasts should be derived from the budget implementation plan. Although the budget implementation plan, even in a cash budget system, is not necessarily on a pure cash basis, monthly cash plans should be on a pure-cash basis. The preparation of monthly cash outflow plans requires good monitoring of both payments and obligations. Preparing monthly cash outflow plans is more of a Treasury task than a budgeting task. However, the Treasury should coordinate with the Budget Department, in the event that a departure from the budget implementation plan appears necessary. The monthly cash plans should be updated every month, to take into account, among other things, changes in exchange rates and interest rates, changes in the payment schedule of large investment projects, and outstanding obligations.

Naturally, the government borrowing plans are derived from the monthly forecasts of cash inflows and outflows—underlying the importance of a realistic and timely cash plan consistent with the approved budget.
NOTES


2  See Caiden and Widalsky, op. cit. and dis-
cussion of the “core budget” in chapter 4 of the
present volume.

3  U.S. terminology (Schick, the federal budget
process).

4  A system of revolving accounts where funds
are periodically released after the spending agen-
cies document the payments made in the previ-
ous period could accommodate requirements for
accounting control and reporting. There may be
some inconveniences for cash management, but
in African developing countries that have poor
infrastructure, such revolving-account mecha-
nisms are important for remote areas. Similar
special accounts are normally required by donors
for the management of the aid-assisted projects.

5  In extreme cases, cash may even be rationed
on a daily basis—as in Ukraine in 1996—making
it virtually impossible for government to perform
any normal activity.

6  “In the pre-computer age...there were fre-
quent logistic problems over fund release when
spending agencies had to make repeated visits
to the controller’s office, particularly in the dis-
tricts which claimed that authorization had not
reached them from the Finance Ministry, the
line ministry or the head office of the Controller”
(ESCAP, 1993).

7  E.g. Turkey, New Zealand and some other
Commonwealth countries.

8  As in Palestine in the late 1990s.

9  As in many Francophone African countries.

10 The concept of a General Ledger System,
which is a system into which all transactions
are recorded (see Chapter 12), can fit either de-
centralized or centralized accounting controls
and payment processing systems. Countries
with centralized controls (e.g., Brazil) as well
as countries without central control (e.g. the
U.S.) have set up a General Ledger System into
which not only payment transactions but also
commitments are posted. The GLS can also be
linked with the accounting and management
information systems maintained at the agency
level.
Chapter 11:

Financing the Budget: Debt Aid Management
What To Expect

Fiscal deficits are normal in low-income countries with limited tax potential and dependence on efficient public investment for development and poverty reduction. What matters is not the level of the deficit, in itself, but whether it is sustainable and financed in appropriate ways and at the most favorable terms. The resulting debt must be managed carefully, in accordance with a debt strategy consistent with the development vision and a debt-borrowing plan flowing from the budget implementation and cash plan. In aid-dependent countries, efficient management of external assistance is a major priority for the government and a prime factor of aid effectiveness for the donors. Starting with the key distinction between “autonomous” and “financing” transactions, this chapter reviews first the major criteria and principles of good debt management, including the organizational aspects, and proceeds to review the issues of aid management, foremost among which are the need to include all aid and aid-financed expenditures in the budget and to place the host government in the driver’s seat. The optimal organizational architecture of aid management is suggested, following the basic rule that the aid management entity must be the focal point for relations with donors, but function to facilitate donor relations with line ministries without interfering in their decisions. The chapter concludes with a capsule review of the disappointing results so far of the strategies for improving the effectiveness of aid to Africa.

Financing the budget: The overall view

The “bottom line” of the budget is a fiscal surplus if revenues and ordinary grants add up to more than total expenditures, and a fiscal deficit if expenditures exceed revenue and grants. Recall from Chapter 2 the critical distinction between those fiscal transactions that are undertaken for their own “autonomous” reasons, and “financing” transactions that are undertaken only as a result of the autonomous transactions. A government does not borrow or accept aid as an idle exercise or an end in itself, but because it is necessary to finance certain expenditures which should be undertaken for their own particular reasons. All financing transactions are grouped together and shown below the group of autonomous transactions. Hence, the expressions “above the line” and “below the line” refer to the distinction between the autonomous fiscal transactions and the compensatory financing transactions.

In almost all African countries, an overall fiscal deficit is not only to be expected, but is desirable, provided that the corresponding expenditures are efficient and developmental. In any case, whatever the level of the overall fiscal deficit, it must be financed. Primarily, the deficit can be financed by loans or grants, and from domestic and foreign sources. Loans include government borrowing from the domestic banking system or other domestic sources and government borrowing from foreign sources. While recurrent grants are part of ordinary revenue and thus are shown above the line, grants to be considered as part of financing cannot be counted on to continue. The budget can also be financed by the simple (and destructive) device of not paying for some goods and services; net changes in payment arrears then are included below the line (as “negative financing” if arrears are being reduced on a net basis). Finally, just as new debt is part of positive financing, repayment of loan principal (amortization), which reduces the stock of government debt, is part of negative financing.
Each type and each source of financing of the government budget carries its own advantages, disadvantages, costs and risks—all of which should be carefully assessed. In general, it is obvious that, other things being equal, grants are better than loans and borrowing at concessional terms is better than borrowing at commercial terms (although “other things” are rarely equal, and a government should never engage in an activity only because the aid is available for it and the money is “free”). It is also clear that the implications of borrowing are very different depending on whether the government borrows from domestic sources or foreign sources. Broadly speaking, the two major sources of financing are borrowing (domestic and foreign) and foreign aid. The principles and modalities of debt management and of aid management are thus key components of a sound public financial management system. Sound debt management is critical in countries where debt on commercial terms constitutes the majority of financing, although it is also important in developing countries. Foreign aid, however, constitutes by far the bulk of financing the budgets of developing countries; therefore, aid management is discussed here at greater length.

Debt management

**Principles of debt management**

The basic principles of sound debt management are explained below. Readers interested in an in-depth treatment of the subject are referred primarily to Wheeler 2004 and IMF 2003.

A medium term debt management strategy

Borrowing is a financial corollary of a given set of decisions on government revenue and expenditure, and part and parcel of the overall integrated public financial management cycle. As discussed in previous chapters, a fiscal and expenditure perspective for a medium term period is important for sound budgeting, and public investment, too, ought to be programmed along the same time period. It follows that the government needs a debt management strategy that focuses on the composition of the debt and the risk to the budget, covering the same period of time as the medium term fiscal perspective and public investment, and also updated annually. The absence of such a strategy carries risks and potentially higher borrowing costs than necessary. Once again, the fact that a debt management “strategy” is needed even in low-income countries with limited capacity does not at all mean that it has to be sophisticated or detailed. The content and format of the debt strategy will depend on the circumstances and needs of the specific country.

Centralized control of borrowing

Autonomous expenditure decisions should be formulated by the line ministries and agencies concerned (and approved by the Ministry of Finance). However, under no circumstances should individual ministries or entities of government be allowed to make financing decisions, and particularly to contract debt. Conceptually, the reason is that the borrowing requirements of the government are not associated with one or another specific expenditure category. They flow from the budget as a whole, and must be addressed in an integrated manner to assure that the budget is financed at least cost to the economy and borrowing needs are met for the entire government. Practically, to allow a decentralized authority to borrow would be a source of major fiscal risk, hamper transparency, and open up opportunities for corruption and favoritism. (In one African country in the early 1980s, for example, the officially recorded external debt doubled in a single morning, after the President directed all ministers to provide current information on the loans they had actually contracted.) Accordingly, only one government entity should have the
authority by law to contract debt obligations for the government. (Normally, that entity should be the Ministry of Finance.)

Controlling borrowing by subnational government entities—states in federal systems, provinces, districts, municipalities—is a critical component of managing fiscal risk for the country as a whole. The issues are discussed at length in Chapter 13 as part of the general topic of PFM at subnational government levels.

An annual borrowing plan
As discussed in Chapter 10, as soon as the budget is approved by the legislature, a budget implementation plan and a cash plan should be in place to assure that the resources will be available for the approved expenditures on a timely basis, taking into account the seasonality of both revenue and different types of expenditure. If a fiscal deficit is targeted for the year, there will obviously be financing requirements for the year as a whole, and part of those requirements will be met through borrowing. The annual budget should therefore outline the government borrowing plan, consistent with both the annual fiscal targets and the practical necessity to fill the monthly gap between revenue and expenditure. (A publicly available borrowing plan can be especially useful for the development of an effective market for government securities, particularly in middle-income countries.) Formal approval of the government borrowing plan by the legislature is neither required nor advisable in light of the fluid nature of capital markets and frequently changing loan terms; but the legislature must be informed of the borrowing plan at the same time as the presentation of the draft budget, and is also entitled to know from whom the government expects to contract new loans, and at what terms. (Moreover, in many African developing countries, certain types of external loans must be specifically approved by the legislature.)

Accrual recording and reporting
For accountability and transparency, government loans should not be merged together and recorded in aggregate terms; each loan transaction must be individually recorded. Regular reports on the stock of debt, repayments, and new borrowing need to be produced by the government on a regular basis and in standard format, and adequately publicized. Moreover, even in the cash-based system of accounting that is normal and appropriate in low-income and middle-income countries (see Chapter 12), debt is the only budgetary category that should be accounted on accrual. Among other reasons, government debts must be repaid on the contractual due dates or government credibility will be gravely compromised. The eventual direct and indirect costs to the economy would be far in excess of any “savings” from making late payments. (The analogy is the damage to a person’s credit record and the risk of losing the property to foreclosure by a failure to make mortgage payments.) An up-to-date and comprehensive database of all government loans outstanding and of the exact schedule of repayments is therefore mandatory. In aid-dependent developing countries, preparation and maintenance of such a database requires the active cooperation of the donors.

Organizational arrangements for debt management
A debt department is needed to manage government debt. Normally, the debt management organization is located in the Ministry of Finance, but the Central Bank can also exercise certain debt management functions. The mandate of the debt department, its responsibilities and organizational structure cannot be left to administrative decisions and subject to frequent change, but must be clearly defined in law and the associated implementing regulations. The organizational arrangements for debt management are generally recognized to include three main components: a “front office”, a “middle office” and a “back office”. (See IMF 2003.)

The front office
The core responsibility of the front office is to implement the medium term debt management strategy. The portfolio of loans must be managed and regularly adjusted to keep it within the parameters set by the strategy—including the average maturity of loans, the foreign exchange composition, and the constellation of interest rates. Decisions must be made on when to contract new loans, from which source, and
at what maturity. This necessitates among other things keeping up with the market for foreign currencies and for bonds, and continuous contact with participants in the domestic market. Taking advantage of interest rate differentials by arbitrage—assuming the office has the capacity and competence to do so successfully—can be permissible under certain circumstances. In general, for a government and particularly that of a developing country, the appropriate balance between risks and returns must lean very heavily in favor of safety and risk-minimization.

The back office
The actual transactions decided by the front office are handled and settled in the back office. Accordingly, the back office is responsible for maintaining the public debt database of the government and for the accounting of the debt transactions (on accrual, as noted). In the absence of an ironclad separation between front office, which makes decisions on the loan portfolio, and the back office, which handles the transactions, conflicts of interest and corruption opportunities would be rife. Hence the name of the third office, which must literally be “in the middle” between front and back office.

The middle office
The core responsibility of the middle office is to provide policy analysis and advice on debt management. The middle office is, in a sense, the interface between fiscal policy and the decisions on budget financing through borrowing. As such, it is responsible for formulating the medium-term debt management strategy consistent with the macroeconomic and fiscal parameters, and assessing debt sustainability (in cooperation with the macrofiscal unit that prepares the macroeconomic and fiscal framework (see Chapter 2).

As part of its debt policy advice function, the middle office is responsible for monitoring the activities of the front office to keep the loan portfolio consistent with the public debt strategy, and oversight of the trading limits. The office also interfaces with external entities, such as private and official creditors, the credit rating agencies, and other components of the government’s public financial management apparatus.

A critical role of the middle office is to contribute to monitoring fiscal risk. As such, it interacts with and oversees the borrowing by subnational government, which in some countries has been a major source of fiscal risk. This was especially so in Latin America in the 1990s. (See Chapter 13.) Also, a register of contingent liabilities and other fiscal risks of the government should be compiled and emanate from the middle office. Finally, as noted, the middle office is the watchdog against conflicts of interest and corruption and other operational risks; and a critical requirement in this respect is to assure a “Chinese Wall” between the front and back offices.

Locating the debt management function
In principle, debt policy and management should be located within the Ministry of Finance. Having one debt management entity reduces operational risks and facilitates coordination among the different debt management functions. There are countries where debt management is handled by a department in the Ministry of Finance (e.g., Turkey), and others where the debt management unit is outside the Ministry of Finance (e.g., Nigeria). However, it is common for the Central Bank to undertake some of the debt management function, typically the primary issuance of domestic debt, as well as the back office functions. In these cases the respective roles and responsibilities should be clearly described in a formal memorandum of understanding between the Central Bank and the Ministry of Finance.

The decision on actual location of the front office and middle office depends on the characteristics of the specific country and on government preferences. What must be assured, under any arrangement, is consolidation of the back office functions into a single administrative unit. Fragmenting this function between different offices in the Ministry of Finance or worse, among the Ministry of Finance, Ministry of Planning, and Central Bank leads to incoherent procedures, high transaction costs and unnecessary risks of errors.

Whether the entire responsibility for debt policy and debt management is assigned to the Ministry of Finance or is shared in some fashion with the
Central Bank and the Ministry of Planning, the closest possible cooperation and dialogue must be assured between these key institutions, and preferably formalized through some appropriate arrangement, e.g., a high-level debt management committee.

**The budgetary treatment of debt relief**

Although this is not a permanent aspect of the debt management function, the handling of debt relief through the Highly Indebted Poor Countries facility (HIPC) is of special importance for low-income African countries and merits mention here. The general objective of the HIPC initiative is common and agreed: to assure that the resources released through the debt relief are used for development and poverty reduction, consistent with a Poverty Reduction Strategy formulated by the government with the assistance and agreement of its major development partners, based on certain understandings about the composition of public expenditure, and underpinned by various monitoring mechanisms such as public expenditure tracking surveys (PETS). However, the budgetary treatment of the debt relief and the ensuing understandings can take different forms. (See De Groot, Jennes, and Cas-simon 2003.)

In Burkina Faso and Cameroon, donors’ worries about the use of the HIPC savings led to the establishment of an Institutional Fund Mechanism (IFM), with strict ring-fencing of the savings from the HIPC initiative. The HIPC savings were lodged in special accounts at the Central Bank of West African States (BCEAO) and managed separately from the general budget expenditures, through special HIPC implementation units.

By contrast, Benin, Ghana, and Tanzania spent the savings from the HIPC debt relief through the normal budget procedures, and presented the expenditures in the budget in the same manner as the other expenditures. The government of Benin resisted the initial donor request to lodge the HIPC savings in a special account at the BCEAO on the reasonable argument that doing so would contradict its ongoing budget reforms, aimed at better unifying the different budget components. There was an important distinction, however, Benin and Ghana introduced a virtual fund mechanism (VFM) whereby certain mutually agreed budget items are tagged as HIPC-related expenditures, but only for reporting purposes and without formal earmarking. (In Ghana, the HIPC account was a subaccount of the consolidated fund account at the Central Bank. In Benin, the HIPC account was kept at the Treasury and used for accounting purposes only.)

At the other extreme, Tanzania neither established a separate HIPC account nor implemented a tracking system for HIPC-related expenditures. In agreement with donors, the Tanzanian government has chosen instead to move toward a comprehensive expenditure tracking mechanism, rather than singling out a few budget items.

The Institutional Fund Mechanism implemented in Burkina Faso and Cameroon is said to have diverted attention from the necessary review of overall public spending and impact on poverty reduction. The IFM may also complicate budget execution and put unnecessary strain on an already weak capacity of the Ministry of Finance. Indeed, both Burkina and Cameroon experienced longer execution delays for the expenditures financed from HIPC funds than for other expenditures. Moreover, the IFM cannot even ensure that additional public resources are allocated to poverty reduction, because of the fungibility of money. (As a Cameroonian high official said to the author: “We could not paint the HIPC money a different color.”)

The experiences of Benin and Ghana appear to show that a virtual fund mechanism may succeed in meeting donor concerns about the developmental use of the money without fragmenting the budget. However, even a VFM should be only temporary, because it focuses attention only on a few activities rather than on overall strategic resource allocation for development and poverty reduction. Moreover, the experience of Tanzania demonstrates that comprehensive expenditure monitoring is feasible, at least in the medium term. Although further strengthening of the overall expenditure management system is still needed in Tanzania, the quality of the system
provided donors with sufficient comfort to endorse the use of the country budgeting systems for allocating the HIPC savings.

Once again, one can see how the quality of governance and the trust it engenders in the international community are the determinant factors. A virtuous circle is at work here: budgetary improvements produce greater trust; that allows donors to rely on country systems, thereby strengthening local capacity and in turn facilitating further progress in public financial management.

Aid management

The record of aid management in Africa is mixed. Although government ownership and effectiveness of aid have improved in several African developing countries (particularly those where significant progress has been made in the quality of governance—see Chapter 1), in too many countries the framework for aid management is still weak and the government attitude is passive, with external donors de facto determining expenditure priority.

Principles of aid management

International experience suggests that four basic principles should govern the management of external assistance in developing countries, discussed next in order of priority.

Put the government in the driver’s seat

Foreign aid should be supportive of the recipient country’s development, and thus help finance the priorities, programs and activities decided by the recipient country’s government in the exercise of its sovereignty. Therefore, effective government supervision over the aid process is essential, and aid management is a core government function (as contrasted with the function of coordination among donors). Difficult issues arise when government legitimacy is in doubt and major governance weaknesses exist, for in such a case it can no longer be assumed that the priorities of the government in power are in fact those appropriate for the population and the development of the country.)

Aside from the basic consideration of respect for national sovereignty, the essential reasons why aid management must be driven by the recipient government are the need for policy coherence and integration of external resources within overall resource availability and utilization, in pursuit of national economic policy. Money is money, and it is clearly impossible for a government to implement coherent economic policy if decisions on the allocation of a major portion of the available financial resources are made elsewhere. The primacy of the recipient government in the management of external assistance does not mean that donor participation is unnecessary or avoidable in supervising the use of aid funds and the implementation of aid-financed activities, especially when PFM systems are weak or corruption is a problem. Not only host governments, but donor agencies, too, are accountable to their own constituencies and have a fiduciary responsibility for the resources entrusted to them.

Focus on the activity to be financed, not on the terms of financing

One of the most common temptations of officials in aid-dependent developing countries is to focus first on the terms of aid rather than the project or the activity the aid is expected to finance. It is understandably difficult to refuse an actual grant, which does not add to the government debt. As emphasized, however, the attention should be on the autonomous decision on the expenditure and its contribution to development, and not to the compensatory transaction that finances the expenditure. For example, the grant may serve to build a facility that is not priority for the country but will require domestic funds for its future operations and maintenance. The grant itself is
“free money”, but its economic consequences can be costly. Technically, the advice is to keep a distinction between the nature of the activity and the terms of the financing, and address the former first. Colloquially, the advice is to remember that nothing is really “free”. Contrary to the old proverb, in evaluating foreign aid offers one should look a gift horse in the mouth. The activities to be financed with aid, even as grants, should be assessed for their development impact on the same criteria and in the same way as any other spending.

Show all economic and financial aid in the budget

As Chapter 5 explained, the budget should be as comprehensive as possible and include all types of government expenditures, even if they may be subject to special administrative modalities. The possible exceptions are expenditures financed by humanitarian and emergency assistance. Such assistance responds to special needs and follows criteria that are not necessarily economic or financial in nature. Of course, accountability, transparency and participation are as necessary for humanitarian and emergency aid as they are for financial resources, and the legislature should be regularly informed, but such aid does not need to be integrated into the budget. Moreover, much of humanitarian assistance is in kind; to try and include it in the budget would require questionable valuations and calculations for very little benefit in terms of public financial management. (The IMF Code of Fiscal Transparency calls for aid in kind to be recognized, reported, and incorporated into the budget process. While this is correct in principle, in most African countries it is doubtful that the benefits in terms of budgetary outcomes would justify the substantial estimation and administrative cost. Providing adequate information to the legislature should suffice.)

But all financial aid—whether grants or concessional loans, and whatever the source—must be integrated into the government budget or at least reflected in the budget sufficiently to provide a full picture of the public finances. One of the most significant benefits that aid-dependent developing countries receive from the “second-generation” public investment programs described in Chapter 8 is that the process of PIP preparation itself gives an opportunity to review, and then integrate into the budget, aid-financed expenditures that were previously not budgeted.

Handle counterpart funds transparently

Also shown in the budget should be the so-called “counterpart funds”, i.e., the local currency proceeds from selling aid-financed goods or services—regardless of the requirements or constraints that the donor may pose on their utilization. In the past, counterpart funds have been a source of duplication of expenditure and have compromised fiscal transparency. The responsibility for oversight of counterpart funds should be placed in the Treasury, along with all other government expenditures, and the accounts set up for counterpart funds by agreement with the donors concerned should be monitored and audited in the same way as any other government accounts.

Organizational arrangements for aid management

The high profile of aid and its importance to finance development means that efficient organizational arrangements in this area are particularly visible and are a likely source of positive demonstration effects for other functions of government, as well as the credibility of the government vis-à-vis the international community. The mobilization and effective use of external resources depends crucially on creating the institutions and the organizational capacity to manage the different kinds of aid.

The details of the organizational structure for aid management should be country-specific (including the issue of institutional location). However, international experience in aid-dependent countries points to certain organizational criteria, which are also consistent with the lessons of institutional change, as discussed in Chapter 1. The fact that many of these criteria are obvious and intuitive should not mislead the reader into thinking that they are always applied.

Organizational criteria

One aid management entity At the central government level, there should be one aid management entity as a focal point for all external economic assis-
tance, including technical assistance. (As noted, the exception is emergency aid and some humanitarian aid, even though there is still a need for taking such assistance into account when defining government activities.) In theory, good coordination among different ministries charged with different aid management responsibilities is possible. In practice, such a system has rarely worked. Split aid management responsibilities have proven to be a recipe for confusion, waste and conflict. The frequent two-way split of aid responsibilities between a Ministry of Finance and a ministry of planning is problematic enough. (See Chapter 8 for a discussion of “dual budgeting”.) The occasional three-way split which includes a role for the Ministry of Foreign Affairs is next to impossible to administer. The outcome of split aid management responsibilities is that the government loses control altogether, and aid decisions end up being driven by competing donor agendas. (The Ministry of Foreign Affairs, however, does have the important role of negotiating framework agreements with donors, which govern the diplomatic aspects of the relationship.)

Aid management unit located in a core ministry Because aid management is a key regular function of government, it should in principle be exercised by a regular organ of government—finance or planning. The clear preference is for the Ministry of Finance, owing to its responsibility to develop a coherent budget covering all available financing. As a transitional measure in some countries, especially fragile states, it may be possible to consider an autonomous aid management agency outside the regular structure of government—provided that it is placed high enough to perform its role credibly, and that it reports to a regular structure of government such as the Prime Minister or an interministerial body from which fiscal policy guidance legitimately emanates. However, as soon as time and organizational capacity permit, the aid management function should devolve to the Ministry of Finance.

Function to facilitate The aid management entity must function to facilitate, not to obstruct relations between donors and their counterpart ministries. This prescription has two necessary parts. The entity should function well, but only to facilitate the work of government. It should assure the availability of timely and complete aid information, and regulate the flow of missions and delegations traffic in the interest of all concerned, always in consultation with the line ministries involved. Thus, while the entity must be regularly informed of donor missions and of ministries’ requests, it may but need not be given the authority to clear donor missions.

Complement with sector coordination mechanisms It follows from the above that the existence of a
central aid management entity does not exclude sectoral aid coordination mechanisms. On the contrary, the effectiveness of the central aid management entity depends crucially on good decision making in each sector ministry, which in turn requires an appropriate aid coordination capacity specific to the sector in question. To assure that the central aid management entity acts to facilitate and not to obstruct, clear limits must be placed on its mandate and provisions for accountability and transparency must be specified. On the other hand, it is essential for the government to have provisions that prevent line ministries from making “end-runs” around the central aid management entity, and to ensure that they work cooperatively with it. This is also for the protection of the line ministries themselves, who would otherwise be besieged by donors pushing their particular pet project through the back door when it doesn’t fit the government priorities and investment program.

**Non-interference in the budget process** Similarly, the aid management entity should never be allowed to interfere in budget proposals and project selection. It does have to be regularly informed of such decisions, have authority to approach the “right” donor for financing the various projects, and routinely participate in budget discussions in order to help ensure the adequate provision of local funding complementary to aid resources. (The latter is one major reason for locating an aid management entity in the Ministry of Finance.) But sector budget proposals and project selection decisions are the responsibility of the line ministry concerned, within the programmatic priorities of the country; the overall investment program is the responsibility of the competent core ministry—either finance or planning; and budget formulation, of course, is the responsibility of the Ministry of Finance.

**Act to strengthen intragovernmental linkages** Finally, the aid management entity should act to foster the contacts with other agencies of government and help build complementary aid management capacity in the sector ministries. As for PFM as a whole, without sufficient capacity in the line ministries and agencies, the central unit cannot perform its functions effectively. Moreover, helping to build capacity in the ministries will create goodwill for the aid management entity and defuse suspicions that it will monopolize all aspects of the management of foreign aid.

**Organizational structure**
The architecture of the aid management function, incorporating the organizational criteria listed above, is shown in Figure 11-1. It is worth examining that figure with some attention, as it includes the essential linkages to other agencies of government—shown as information/communication or as guidance/instruction arrows—and by implication the substantive functions of public financial management.

The links to other agencies of government are not part of the organization of the aid management unit, but are essential ingredients of the aid management function, which must be exercised within the context of a coherent economic policy framework and public investment program. Thus, it would not be useful to focus only on the organization of aid management without at the same time defining and enforcing the institutional rules governing the interaction with other agencies of government.

**Aid strategies for African development**

**A plenitude of strategies** Several plans and strategies to underpin aid for the development of Africa have been elaborated over the past 30 years (Box 11-1). Their record of success is hardly encouraging. These plans have been different in their diagnoses of African development, but have been the same in their main weaknesses: lack of selectivity, neglect of the importance of implementation; and a disregard of previous strategies and even of other contemporary plans formulated by other organizations. When a previous plan had no impact because of excessive complexity and ambition, the next one was often even more complex and ambitious. And no matter how ineffective or damaging certain previous ideas and recommendations might have proven to be, they have tended to surface again and again. Quite to the contrary of learning from experience (the successes as well as the mistakes), strategic planning for Africa has been
Figure 11.1
Organizational architecture of an aid management unit
notable for its utter failure to learn from actual experience.

The recent African Development Bank’s *Medium Term Strategy (2008-2012)*, following on its *2003-2007 Multi-year Strategic Plan*, was somewhat more selective, focusing on infrastructure, governance, private sector development and higher education. Also, there are hopeful recent signs of donor recognition of the critical importance of implementation for improving aid effectiveness and producing actual development results. It is to be hoped that the earlier elaborate yet generic plans notable for their obliviousness of priorities, lack of sequencing, and neglect of capacity constraints may perhaps be a thing of the past. Even if this will prove to be true, the fundamental issue remains: is it really meaningful to formulate one strategy of assistance for the entire continent of Africa, with the vast differences that exist between groups of countries, subregions, and the individual countries themselves? (However, sub-regional strategies retain meaning, and could in some cases be the foundation for subregional economic integration—as in East Africa.)

**Focusing on aid effectiveness and capacity development**

Nowithstanding the unsatisfactory record of aid strategies for Africa, at least three genuinely strategic priorities can be identified to apply to the entire continent: ownership, harmonization of aid, and capacity development.

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**Box 11-1. Aid in the context of planning for Africa**

The major continent-wide aid-assisted plans for African development during the last 30 years include:

- More recently, the New Partnership for Africa’s Development (NEPAD, 2001) claimed to embed the “new political will” of African leaders, was endorsed by the international community, and became the springboard for a new crop of plans and strategies for Africa:
  - the African Union/NEPAD African Action Plans, that emphasized regional integration and listed critical investments drawn from the programs of governments and donors.
  - the *Africa Action Plan*, launched by the G-8 in 2002 as a framework for action in support of the NEPAD.
  - the European Union’s *Strategy for Africa* (2005) and *First Action Plan of the Joint Africa-EU Strategy (2008-2010)*, which referred to NEPAD and promoted eight thematic partnerships with the AU.

The critical importance of ownership and the role of foreign aid to complement and support national priorities have always been acknowledged by the donors, although mostly at lip service level. On the other hand, only a government with substantial legitimacy, clarity of vision, realistic programs and credible public management systems has a strong claim to asserting its “ownership” rights fully vis-à-vis the donors and the international community.

Aside from ownership itself, the two international commitments most relevant for aid effectiveness are harmonization of donor practices and donor reliance on country systems (especially PFM). Recognizing the risks and inefficiencies of uncoordinated development assistance, there have been efforts by donors since 2004 to focus on results, avoid duplication, and foster capacity development by greater reliance on national systems of public financial management and control.

After the adoption in 2000 of the Millennium Declaration, which set the goals and targets that came to be known as Millennium Development Goals (MDGs) to be achieved by 2015, a flurry of high-profile international events in 2004-2005 has formalized this agenda. The key milestones in this process have been as follows:

» The Paris Declaration on Aid Effectiveness (March 2005) set indicators and targets to improve the delivery and management of aid based on five principles: ownership (country-led development strategies), donor alignment with country and sector strategies, harmonization (use of common arrangement or procedures by donors), managing for results, and mutual accountability by donors and countries.
» The G-8’s Gleneagles Summit (June 2005) focused on Africa, which was not on track to achieve the MDGs. Leaders committed to doubling aid to Africa by 2010 and to cancelling 100 percent of eligible outstanding debt under the Heavily Indebted Poor Countries (HIPC) initiative. It was “agreed that the World Bank should have a leading role in supporting the partnership between the G-8, other donors and Africa, helping to ensure that additional assistance is effectively coordinated” (Gleneagles summit Chairman’s Summary).
» The UN Millennium Summit (September 2005) also called for significant scaling up of official development assistance and for agreeing on an action agenda to accelerate progress toward achieving the MDGs.

The mixed results so far

These efforts have been only partially successful. Some harmonization has occurred, and the increased “pooling” of technical assistance from different donors has been important to reduce the red tape and transaction costs imposed on African officials. It has also mitigated the risk of providing conflicting advice, which is especially damaging for African PFM systems (although harmonization around unrealistic or wrong advice would not be an advantage).

Some positive results have been achieved in aid organized around sectors. In some African countries, “basket fund” mechanisms have been put in place to support an agreed agenda of public financial management reform (notably in the Tanzania Public Financial Management Reform Programme and the Uganda Financial Management and Accountability Programme). Other similar mechanisms for pooled aid in support of a particular sector or ministry have had mixed results. Even when generally positive, they have experienced a variety of difficulties, ranging from practical problems of disbursement delays to systemic issues of weak integration between aid to the sector and general budget support (as shown in Box 11-2 on the experience of education in Burkina Faso).

However, there has been a disappointing contrast between the goal stated in 2005 by the donor community to foster greater reliance on African PFM systems and the actual lack of progress. A review of all the PEFA assessments conducted in African countries between 2005 and 2009 shows that the indicator of the proportion of aid managed
by national procedures was scored at an average of 2.07 (out of a possible 4) in the 2005/06 and 2006/07 assessments, and at 1.57 in the 2007/08 and 2008/09 assessments. (See Chapter 16 for the detailed assessment results, and www.pefa.org for the actual country reports.) The overall trend of somewhat lower donor reliance on national systems shown by the PEFA assessments is confirmed by the Paris Declaration’s own indicator on the use of country PFM systems. It shows a slight decline between 2005-2007 for the nineteen African countries participating in the survey, from 40 to 39 percent. (Moreover, the average use of PFM country systems in the twelve countries that participated only in the 2007 survey is a much lower 15 percent.) On balance, it does

Box 11-2
Pooling Aid for Sector Support: Education in Burkina Faso

Several donors have pooled their funding in support of primary education in Burkina Faso, grounded on four pillars: a 10-year sector strategy developed in 2000; a budget framework to support it; gradual orientation toward results; and a monitoring mechanism.

The donor partnership is articulated around four main elements: a formal partnership framework; designation of a “lead donor”; a mechanism of coordinated financing; and the associated special treasury account. The pooled fund is complemented by budget support from the EU and projects financed by other donors—including the African Development Bank—consistent with the sector strategy.

Critical to the arrangement is the leadership role of the Ministry of Primary Education in the coordination with donors, using in part a biannual review of progress conducted jointly between the government and the donors—in addition to thematic groups and monthly coordination meetings. Doubts have been raised on whether the transaction costs of coordination with donors have grown to interfere with the need for internal coordination within the Ministry itself—a major issue given the need for government leadership of the effort.

Other emerging issues include weak predictability of financial resources (which usually fall short of the announced amounts); systematic delays in disbursements which interfere with timely implementation of the activities; and insufficient detail in the assessment of progress and recommendations for improvements. The latter, associated with the fixed-tranche disbursement schedule agreed at the start of the year does not allow tailoring disbursements to the actual progress made. (However, doing so would worsen the already serious problem of weak predictability of resources and disbursement delays.)

Finally, three issues typical of sector-assistance and pooled funding are visible in the Burkina education example as well: lack of integration between general budget support and the sector aid; absence of linkage between problems of financial management in the education sector and the conduct of the specific program of support for primary education; and the lack of clarity on whether the pooled funds are in fact additional to the financial resources allocated to primary education.

Source: Adapted from Cafferini and Pierrel, 2008.
not appear that the international community as a whole has yet begun in earnest the transition to a better balance between donors’ fiduciary responsibility and fostering capacity development in the recipient African countries.

This assessment was shared at the High Level Forum on Aid Effectiveness in September 2008, which concluded that progress on implementation of the Paris Declaration was too slow, and then adopted the “Accra Agenda for Action” aimed at addressing three main challenges to accelerate progress on aid effectiveness: strengthening country ownership, building more effective and inclusive partnerships, and delivering and accounting for development results. Only the future will tell whether this latest repetition of the same objectives will put them into operation better than in the past.
Chapter 12:

Assuring Financial Accountability: Accounting, Reporting and Audit
What to Expect

The Russian proverb “trust but verify” exemplifies the extent to which “trust” and “verification” are interdependent. Total lack of trust demands verification of everything. This is not only inefficient but also invites the exercise of guilt-free human ingenuity in hiding facts and evading rules. On the other hand, without the expectation that one’s action might be verified by an independent entity, it is difficult for most persons to resist the temptation to use their position for personal gain. Therefore, assuring financial accountability depends on robust but selective verification of government financial transactions and then demanding from those responsible an account of their action and its results. In turn, the stronger the internal control and internal audit systems are in the executive branch of government, the more effective can be the verification by entities external to the executive branch (external audit). Naturally, without reliable financial information no verification is possible. An obvious prerequisite for public financial accountability is thus the timely availability of reliable data. This has two parts: the production of fiscal and financial data, along an agreed and uniform classification, and the regular reporting of the financial data. Accordingly, this chapter first reviews public accounting and financial reporting, then the principles of good financial control, and finally the norms and practices of internal and external audit—all in light of the realities and specific circumstances of African developing countries.

Accounting

Traditionally, government accounting was aimed at assuring compliance with budget rules and the proper use of public monies. For this purpose, a cash-based accounting system is adequate. Experiments during the 1960s to 1970s led a few countries to develop accrual accounting systems that encompass all liabilities and assets. One such experiment was for the Central Africa Customs and Economic Union (Union Douaniere et Economique de l’Afrique Centrale—UDEAC). However, lack of capacity to implement these systems properly, as well as concerns about loosening expenditure control and jeopardizing macroeconomic stabilization, led developing countries to refocus on cash-based accounting and reporting.

Types of accounting systems

Accounting systems are generally classified into four broad categories: cash, modified cash, modified accrual, and full accrual—depending on the principles that determine when the transactions or events should be “recognized”. Under any basis of accounting, it is necessary to have a system that tracks the execution of the budget: appropriations, supplementary estimates, virements, and the uses of appropriations (release of funds, commitments, expenditures at the verification stage, and payments), as described in Chapter 10.
Cash accounting
Cash-based accounting recognizes transactions and events only when cash is received or paid within the fiscal year. Financial statements produced under cash accounting therefore cover cash receipts, cash payments, and the opening and closing cash balances. Simplicity is the main advantage of cash accounting, requiring limited capacity and enabling greater transparency.

Modified cash accounting
Modified cash accounting recognizes transactions and events that have produced cash receipts or payments within the fiscal year and those expected to result in cash payments within a specified period after the end of the year. The accounting period thus includes a “complementary period” for payments (usually 30 or 60 days) after the close of the fiscal year, during which the books are held open. Payments made during the complementary period that is related to transactions and events of the previous fiscal year are reported as expenditure of the previous fiscal year. (However, there should not be a complementary period for revenues, which must be reported on a pure-cash basis during the fiscal year.)

Modified accrual accounting
Modified accrual accounting recognizes transactions and events as of the time they occur, irrespective of when the payment is made or received, except that physical assets are entirely “written off” during the year when they are acquired. Thus, modified accrual recognizes all liabilities and all financial assets, but does not require depreciating physical assets, which would be a complex and extremely difficult challenge in limited-capacity developing countries. (While there is only one “pure” accrual accounting system, there can be several variants of modified accrual accounting systems, depending on the treatment of pension liabilities, inventories, and other elements.)

Full accrual accounting
Full accrual accounting recognizes all transactions and events as of the time they occur irrespective of when cash is paid or received. Thus, revenues reflect the amounts due during the year, whether collected or not, and expenses reflect the value of goods and services consumed during the year, whether paid or not. Moreover, the costs of durable physical assets are recognized as and when the assets are used, thus requiring calculation of depreciation of each asset. Full accrual accounting is normally used in private enterprises and commercial operations of public entities.

Accrual accounting is clearly superior in principle. In practice, it can only be implemented in governments that possess fully reliable and timely information, including on physical public assets; a plentiful supply of competent public accountants; strong control systems; a culture of rule compliance; and many other advantages. None of these requirements are available in low-income countries, most middle-income countries and many developed countries. Accordingly, accrual accounting will not be discussed in detail in this book. Interested readers are referred to Label (2010), for the basic principles of accounting; to Premchand (1995) and Das (2006) for the policy and practice of accrual accounting in government; and Boothe (2007) for lessons for developing countries.

Table 12-1 illustrates the broad differences between accounting systems. Note in particular the difference between “expenditure” (payment made) and “expense” (value consumed). If in the current fiscal year a ministry pays $20,000 to buy a tractor that is expected to last 20 years, the ministry expenditure for the current year is the $20,000, but its expense is $1,000. The comparison in the table demonstrates the tradeoff between simplicity and comprehensiveness in accounting systems.

Minimum requirements of functioning accounting systems
Whatever the basis of accounting, availability of data and simplicity of accounting practices, any accounting system must have the following features:

» clear and adequate procedures for bookkeeping, systematic recording of transactions, data security, and systematic comparison with banking statements;
all expenditure and revenue transactions recorded according to the same methodology;
» a uniform classification of expenditure;
» regular production of financial statements;
» an appropriate bookkeeping system to record transactions at each of the stages in the expenditure cycle ("budgetary accounting").

Relationship between accounting systems and budget systems
As explained in Chapter 4, budget systems are classified according to the form of the legislative authorization. Except for a few obligation-based budgets, two broad categories exist:

» cash-based budgets, where most appropriations are authorizations to effect payments during the fiscal year;

» accrual-based budgets, where most appropriations are authorizations to enter into commitments, and cover full costs including depreciation and changes in liabilities.

A cash-based budget is in principle consistent with any accounting system (although mixing a cash budget with accrual accounting can cause confusion, as in Thailand), but an accrual-based budget mandates full accrual accounting. Debt, however, must be on accrual under any budgeting system, since all countries must honor debt obligations at the time they are due. In the absence of a negotiated agreement to the contrary (e.g., under the Highly-Indebted Poor Countries initiative—HIPC) government defaults on external or domestic debt carry severe negative financial and economic consequences, both immediate and in the long term.

Chart of accounts and general ledger
A chart of accounts is a classification of transactions and events (payments, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature. The chart of accounts is organized in the way transactions or events are defined (e.g., commitment, liability, payment, depreciation) and by the administrative category (for accounts covering internal operations). The particular budget classification used defines the structure of the subaccounts of the chart of account that are related to budgetary operations.

The set of books or the database where all the transactions are recorded along the chart of accounts (including the budget classification system) is called the general ledger. With a computerized financial management system, each transaction and its attributes can be recorded in the general ledger. These attributes cover both the budget classification categories (function, organization, etc.) and the other chart of account categories (liabilities, increase of assets, etc.). In a manual system, commitments are generally recorded in ancillary books, often badly linked with the main ledger. In a computerized ledger system, there is a single database, or set of interrelated databases, which cover both the main ledger and the ancillary books for tracking the uses of appropriations.

A computerized financial ledger system permits reporting to be tailored to the needs of the different users. It can perform budgetary execution controls, such as control of payments and commitments against appropriations. It fits a system with centralized ex-ante controls (e.g. in Brazil or in France), as well as systems where execution is controlled by each spending agencies (provided that they follow the same classification). In a manual system, instead, accounting should be centralized, as decentralized accounts are inconvenient for the dissemination of information.

Administrative organization of government accounting
In the traditional centralized model, the accounts are prepared at the central level either by the Treasury or a separate central accounting office (such as the Accountant General in anglophone African countries such as in Tanzania—see Box 12-1). This organizational model is cost-effective in countries with a scarcity of public accountants, but is hampered if ministries and other spending agencies report commitments only when they request actual payment. In the centralized accounting model, administrative measures with appropriate sanctions are needed to ensure regular reporting of commitments by ministries and government agencies.
### Table 12-1: Illustrative comparison of accounting systems

**I. Current Expenditure** *(Accounting period January-December)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitment (contract), October 2010: Ordering fuel</td>
<td></td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Delivery/verification of delivery of fuel, November 2010</td>
<td></td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td>Partial payment, December 2010</td>
<td></td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>Fuel used in 2011</td>
<td></td>
<td>700</td>
<td></td>
</tr>
<tr>
<td>Fuel inventory, December 31, 2011</td>
<td></td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Depreciation of assets of the ordering department, 2011:</td>
<td></td>
<td>137</td>
<td></td>
</tr>
</tbody>
</table>

#### Account Debit Credit Date

**Cash**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment</td>
<td></td>
<td>800</td>
<td>2010</td>
</tr>
<tr>
<td>Cash-Bank</td>
<td>800</td>
<td></td>
<td>2010</td>
</tr>
</tbody>
</table>

**Modified Accrual**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Verification</td>
<td></td>
<td>1000</td>
<td>2010</td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td>1000</td>
<td>2010</td>
</tr>
<tr>
<td>Payment</td>
<td></td>
<td>800</td>
<td>2010</td>
</tr>
<tr>
<td>Cash-Bank</td>
<td>800</td>
<td></td>
<td>2010</td>
</tr>
</tbody>
</table>

**Full Accrual**

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Verification</td>
<td></td>
<td>1000</td>
<td>2010</td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td>1000</td>
<td>2010</td>
</tr>
<tr>
<td>Payment</td>
<td></td>
<td>800</td>
<td>2010</td>
</tr>
<tr>
<td>Cash-Bank</td>
<td>800</td>
<td></td>
<td>2010</td>
</tr>
<tr>
<td>Use of fuel</td>
<td></td>
<td>1000</td>
<td>2011</td>
</tr>
<tr>
<td>Expenses</td>
<td>700</td>
<td></td>
<td>2011</td>
</tr>
<tr>
<td>Inventories</td>
<td></td>
<td>300</td>
<td>2011</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td>137</td>
<td>2011</td>
</tr>
<tr>
<td>Expenses</td>
<td>137</td>
<td></td>
<td>2011</td>
</tr>
</tbody>
</table>

**II. Comparison between modified and full accrual for investment expenditure.**

Bridge delivered and fully paid at end of 2010; Cost: one million; Useful life: 50 years

**Modified accrual:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenditure</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>1,000,000</td>
<td></td>
</tr>
</tbody>
</table>

**Full accrual:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Expenses</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td></td>
<td>1,000,000</td>
</tr>
<tr>
<td>2011</td>
<td>20,000 (depreciation)</td>
<td>980,000 (initial value less depreciation)</td>
</tr>
<tr>
<td>2012</td>
<td>20,000 (depreciation)</td>
<td>960,000, etc.</td>
</tr>
</tbody>
</table>
In the decentralized model, ministries and other spending agencies prepare their own accounts, to be consolidated at the central level. In larger countries, this model could be preferable. However, without a functioning computerized financial information system and with accounting still largely on a manual basis, there arises the practical problem of transmitting the accounts to the central level in a timely manner. Consolidation of the accounts is delayed even if one spending agency fails to transmit the accounts on the required schedule.

**Improving government accounting in African countries**

The general direction

All developing countries should avoid over-ambitious reforms in general and accrual accounting in particular, owing to its heavy and demanding requirements. Even in comparatively rich countries, the introduction of accrual accounting in government has absorbed vast amounts of money and taken a decade or more to be completed. In African countries’ governments, the clear priority is to improve cash accounting and reporting, which are often weak and less than reliable. In a few countries where circumstances permit, the progressive development of modified accrual accounting (which recognizes all liabilities and financial assets, but does not require accounting for depreciation of physical assets) might be considered—but only after the cash basis of accounting is already solid. However, all public enterprises, as well as public agencies that deliver commercial services or consume a large quantity of capital goods, should assess their full costs and adopt a full accrual accounting framework, at least initially for internal management purposes.

**Box 12-1**

**Tanzanian Accountant General’s Department**

The Accountant General’s Department is a major department within the Tanzania Ministry of Finance, with a number of key functions that are somewhat broader than those in many other countries. Core functions include: financial management of the exchequer accounts; monitoring the preparation of ministry and agency accounts, and special funds; accounting for development revenue; responsibility for accounting and financial agreements; and lead role in developing the government accounting system as well as accountancy legislation.

In addition, the Accountant General’s Department manages the central payment system; monitors and controls the decentralized sub-treasuries; and manages the payroll system.

Tanzania entrusts to the Accountant General the responsibility of maintaining the database for both domestic and external debt, and to ensure that debt obligations are met when due. Responsibility for borrowing policy and debt strategy, however, is entrusted to the separate Policy Analysis Department. Although, as noted in Chapter 11, it is in principle preferable for all debt management functions to be entrusted to a separate department set up for this purpose, it does not appear that Tanzania’s division of responsibility for policy and transactions has created any difficulty. However, observers view as unclear and ambiguous the arrangement whereby the Accountant General shares with the Treasury the responsibility for internal audit.

**Source:** Based in part on www.mof.go.tz
Common weaknesses
In any case, improving an accounting system requires first analyzing its major weaknesses, and priority should be given to improvements that consolidate the foundations for sound accounting. Various common weaknesses are found in the public accounting systems of many African countries:

» Ministries and other spending units may track uses of appropriations in single entry books, while cash inflows and outflows are matched in double-entry books kept by the treasury department. When spending units record only one kind of operation (payment from a bank account or payment requests sent to the Treasury), single-entry bookkeeping does not pose a major problem. However, better linkages between the different components of the accounting system and the recording of movements between budget accounts require generalized double-entry bookkeeping.

» Uses of “below-the-line accounts” are not transparent and may include off-budget spending. This problem is not directly related to the basis of accounting, but is particularly serious where governance is weak and accounting practices are unsound.

» Whatever the basis of accounting, fiscal transparency is hampered if some payments made during the fiscal year (including payments related to commitments made in a previous period) are not reported in accordance with the unitary expenditure classification system.

» Budget execution is reported on the basis of requests for payment transmitted to the treasury. In theory, these requests correspond to expenditures at the verification stage. In practice, when a government has lost credibility from accumulating payment arrears, private suppliers require payment before delivering services. Payment orders are usually based on pro-forma invoices, and are nevertheless entered into a liability account, where they stay for months or even years. This account mixes true invoices, pro forma invoices, old vouchers for transfers to government entities, and subsidies that were budgeted but never paid—hampering fiscal transparency.

» Budget execution reports show requests for payments along the budget classification. Since accrued vouchers fit budget appropriations well, formal compliance is ensured. But the real budget execution is elsewhere. It consists of the selection of the vouchers to be paid among the vouchers in the liability account. Payments made from the liability account do not follow the budget classification, since they have been classified as “expenditure” months (or years) before. As a result, the “true” budget execution along the formal budget classification is unknown. Moreover, the discretionary power to decide which vouchers will be paid and when creates substantial corruption risks.

» In cash accounting systems and cash-based budgets, the budget and the accounts are closed on the same day at the end of the fiscal year. Under modified cash accounting, the “complementary period” has the advantage of taking into account the time between obligation and payment. However, keeping open the books of the previous year leads to the problematic overlap of executing two budgets at the same time, and requires adjusting budget data to chronological time to allow the comparison of fiscal and monetary statistics. In developing countries, modified cash accounting also presents risks as regards transparency and accountability.

» Sometimes, “internal payments” (i.e., transfers of funds between government agencies) and “true” payments get mixed up, requiring time-consuming line-by-line consolidation of expenditures, autonomous agencies, special accounts and expenditures of the consolidated or budgetary fund. Funds and autonomous agencies may have specific management procedures, but must report according to the common expenditure classifications (see Chapter 6).

» In several developing countries, scarcity of trained accountants in government and lack of clear accounting procedures create difficulties even for accounting for cash payments (let alone for accrual accounting). Comparisons with bank statements are rare-
ly made, forms are coded haphazardly, and different accounts are commingled. These problems, which especially affect small poor countries, must be taken into account when considering changes in the accounting system.

» Management of assets is weak in a majority of African developing countries, with valuable assets deteriorating for lack of maintenance, transport equipment idle for lack of fuel, and other durable goods unaccounted for. Yet, ministries continually include requests for additional purchases in their budget proposals. Asset registers should be progressively set up and regularly updated, but they should focus on major assets and equipment that are both valuable and “at risk”.

Reporting

The principles and types of public financial reporting have been well established for many years and are applicable to all countries, albeit with practical modifications to take into account local needs and capacities. In general, reporting on budget operations should provide the basis for assessing how well the government is managing the public finances. Ideally, therefore, it should answer the following questions:

» **Budgetary integrity**. Have resources been used in conformity with legal authorizations and mandatory requirements?

» **Operating performance**. How much do programs cost? How were they financed? What was achieved? What are the liabilities arising from their execution? How has the government managed its assets?

» **Stewardship**. Did the government’s financial condition improve or deteriorate? What provisions have been made for the future?

» **Systems and control**. Are there systems to ensure effective compliance, proper management of assets and adequate performance?

In practice, in most countries compliance remains the priority challenge and financial reporting should first and foremost be sufficient to assess budgetary integrity and rule compliance.

**Principles of reporting**

Financial reports should meet the following principles:

» **Completeness**. The report should cover all aspects of the reporting entity’s operations.

» **Legitimacy**. Reports should be appropriate for different groups of users (political leadership, ministries and agencies, parliament, private sector and civil society in general), but consistent with accepted standards of form and content.

» **User friendliness**. Reports should be understandable to reasonably informed and interested users, and enable information to be captured quickly and communicated easily. They should include explanations and interpretations for legislators and citizens not familiar with budgetary jargon and methodology. Where possible, charts and illustrations should be used to improve readability. (Of course, reports should not exclude essential information merely because it is difficult to understand or some report users choose not to use it.)

» **Reliability**. The information presented should be verifiable and free of bias. Reliability is different from precision or certainty, however. For certain items, a properly explained estimate is better, even if rough, than no estimate at all (for example, on tax expenditures or contingent liabilities).

» **Relevance**. Information should meet a recognized need. The traditional function of year-end reports is to allow the legislature to verify budget execution. The broader objectives of financial reports require that they take
into account the needs of different users. A frequent criticism of government financial reports is that they are at the same time overloaded and useless.

- **Consistency.** Consistency is required not only internally, but also over time. Once an accounting or reporting method is adopted, it should be used for all similar transactions unless there is good reason to change it, in which case the effect of the change should be shown in the reports.

- **Timeliness.** The passage of time usually diminishes the usefulness of information. A timely estimate may then be more useful than precise information that takes longer to produce.

- **Comparability.** Financial reporting should help users to make relevant comparisons of reporting units, such as comparisons of the costs of specific functions or activities.

- **Usefulness.** To be useful both inside and outside the reporting entity, reports should contribute to an understanding of the current and future activities of the entity, its sources and uses of funds, and the diligence shown in the use of funds.

**Budget reports**

**Budget implementation reporting**

For managing budget execution the following reports are needed:

- Daily flash reports on cash flows. These reports should distinguish inflows and outflows, but it is better for cash flow forecasting to have a breakdown of expenditure and revenue by broad economic categories (at least weekly).

- Monthly reports on budget execution based on the budget classification system, specifying the initial appropriation (and any revision), commitments, expenditures at the verification stage, and payments.

- Quarterly reports on physical progress of large investment projects.

**The annual budget report**

An annual budget report is generally submitted to the external audit office and the legislature, but in many African countries its production and publication takes a year or more, making it useless. In these cases, considering the time that is needed to audit the accounts, preliminary information on budget execution should be compiled and published no later than two months after the end of the fiscal year.

Regardless of the accounting system, the foundation of financial reporting is an annual report on the consolidated financial operations of the government, covering at least two fiscal years to allow for comparisons. This report should be prepared in accordance with GFS standards, complemented with accrual information on debt as well as information on expenditures at the verification stage and payment arrears, and include three tables for central government, local governments and general government. Finally, financial information for “extra-budgetary funds” should be consolidated into the accounts of the relevant level of government. (See Chapter 6.)

Some African countries do not prepare the consolidated accounts of the government on a consistent basis, but gather data from budget monitoring reports, the central bank, extra budgetary funds, etc. Outflows and inflows estimated in such a disparate manner cannot be balanced. As a result, the consolidated accounts show a significant discrepancy, which is often hidden under the catch-all heading of “arrears”.

**Nongovernment public entities**

While the budget itself is limited to the government, financial reporting should encompass a broader scope, including and publishing regular financial reports produced by entities controlled or owned by the government. The information is needed by the public and for policies concerning subsidies, financing of investments of public enterprises, etc. As noted, the accounts of entities carrying out business activities should be on full accrual basis, and their financial statements should be as required under accrual accounting. Rules for identifying the public entities that must produce financial statements are established either via legislation (as in France) or through accounting principles (as in Australia).
Reporting on public investment
In parallel with the requirements for good public investment programming, described in Chapter 8, reports on investment expenditures are usually presented by project, indicating (i) the expenditure during the year; (ii) total project costs; and (iii) the balance required to complete the project.

In addition, accrual-based information on the progress of projects is important, especially in transport, communication, energy and public works, where payment schedules do not necessarily coincide with physical implementation. For large infrastructure projects, the increase in asset value should be presented, along with the indicators of physical progress of the works.

Information on projects financed with external loans should be presented at the verification stage. Information on financing should be based on disbursements, because no matter how efficient the system of data collection is within the country there is invariably a time lag between drawings from loans and verified expenditures, the length of which depends largely on the procedures of the lender.

Reporting on grants
In principle, grants-in-kind should be reported at the time when they are received, and discrepancies in information from donors should be identified and explained. In practice, however, many aid-dependent countries rely on information from donors to estimate expenditures financed by grants-in-kind. This often leads to mixing cash-based information from some donors with commitments or “pledges” from other donors. A better monitoring of grants is needed in most aid-dependent countries. Except when special disbursement procedures have been established, this monitoring should be done at the project level, the only level at which expenditures financed with grants can be reliably estimated. Even then, data from donors must be collected and compared with the data from the projects.

Management controls and internal audit

Much confusion has arisen from a misunderstanding of the word “control” in English and French usage. In English, the term carries prescriptive and enforcement connotation, whereas in French (and other Latin languages) it is much closer to verification and monitoring. In both senses, effective controls by public managers are critical for protecting the public’s resources and achieving operational efficiency (the third major objective of PFM, as explained in Chapter 4), and require a combination of enforcement and monitoring. Many of the key budgetary and other controls were described elsewhere in this book, mainly in Chapter 10 on budget execution and earlier in this chapter. This section recapitulates the basic principles of management control systems, and of the internal audit that serves to advise the responsible officials on the strengths and weaknesses of those systems.

Objectives and types of management controls
Management controls can be defined as the complex of systems and procedures put in place by a public or private entity to pursue the following objectives:

» the efficient and effective achievement of the entity’s objectives;
» production of timely and reliable financial and management information;
» compliance with relevant laws and regulations;
» safeguarding of assets and information; and
» prevention and detection of fraud and error.

In all countries, including in Africa, the first priority in management control must be protection of the organization’s financial resources against
theft or improper use, entailing a variety of types of management controls for this purpose:

- **Physical and cyber controls** include the security procedures intended to restrict access—access to inventories of high-value items that can be easily pilfered, access to particular rooms or buildings, or access to electronic databases and other records.
- **Accounting controls**, discussed earlier, include the procedures by which transactions are recorded in the accounting system, for example, a requirement that all cash receipts be deposited daily in exchange for a written receipt, a copy of which would be filed with the accounting clerk.
- **Process controls** are the procedures designed to assure that actions are taken only with proper authorization and, for large transactions, require approval from higher levels.

**Standards for management controls: Balancing protection with effectiveness**

The ideal standards can be summarized as follows:

- Management control structures should provide reasonable assurance that the objectives of the organization will be accomplished. (This obviously assumes that the objectives are clear—which is not always the case in public organizations.)
- Specific control objectives should be developed for each ministry or agency and should be appropriate, comprehensive, reasonable and integrated into the overall organizational structure.
- Managers should monitor their operations continuously and take prompt action on all findings of irregular, uneconomical, inefficient, or ineffective operations.
- To the extent possible and realistic, at least two persons should be involved in “risky” transactions. For example, in cash collections this “separation of duties” entails that one person collects the cash, a second makes the bank deposit, and a third reconciles the cash receipts and enters the data in the records.

A balance is necessary between the procedures intended to foster the achievement of the entity’s objectives and the “protective” systems designed to assure rule compliance and prevent fraud and abuse. Lack of adequate safeguards entails risks, but excessively protective measures carry costs and hamper efficiency. A system of controls that attempted to guarantee against all wrongdoing or error would paralyze the organization. The objective of the control system should be to provide “reasonable assurance” that improprieties will not occur or will be revealed when they do occur.

Clearly, the effective formulation and implementation of management controls are the responsibility of the top leadership of the organization. Management controls are designed to help managers control the organization, not to control the top managers themselves—who can easily circumvent the systems, bypassing the controls directly or instructing or authorizing others to do so.

The first obvious requirement for effective management controls is therefore the personal integrity and professionalism of the top leadership. Next comes the need for an assessment of the risks facing the organization and an identification of useful risk-mitigating measures. Third, whatever controls systems are put in place must be ones that the management will actually use, and require to be used throughout the organization. Accordingly, the controls must be cost-effective and not so detailed and onerous as to hamper organizational effectiveness. The tendency to introduce redundant or burdensome controls is especially strong in government and public organizations, where even minor misuse or abuse of financial resources is likely to generate a public scandal or a political problem—one of the many important distinctions between public and private management.

**Internal audit**

The balance of risks and costs changes continuously in response to changes in the nature of operations, the external rules, or the economic environment. It is therefore important to periodically examine the systems of management controls, to strengthen some and eliminate or
modify controls that are no longer needed or have become too costly. This is where internal audit comes in.

Internal audit is not to be confused with internal inspection, which is designed to detect specific fraud, abuse and responsibility for major errors, in order to take appropriate disciplinary or other action. Internal audit is intended to keep under review the systems and procedures of management control, and advise the officials responsible on how to plug gaps, strengthen internal accountability, or improve efficiency of operations by lightening unnecessarily burdensome regulations. “Beware the inspector, befriend the internal auditor” is the bureaucrat’s motto. The internal auditor should not only review the soundness of the controls systems, but also conduct such tests as may be necessary to ensure that the systems are operating properly in actual practice.

Internal audit is thus an appraisal activity established within an organization as a service to its top management, a management support function to assess the effectiveness of management controls. Despite the similarity of names, the role of the internal audit entity is very different from that of the external auditor (although good internal audit facilitates the effectiveness of external audit). As discussed in the next section, the external auditor is independent of the organization and reports to an external overseer of the organization, usually the legislature. The internal auditor, on the other hand, is part of the organization, typically accountable to the top management of the organization, to perform a continuing assessment of the control systems and recommend measures to improve the effectiveness of those systems. Thus, internal audit is effective only if its findings and recommendations are followed up by management. Internal auditors can support managers, but cannot substitute for them.

Because internal audit is essentially a management support function, a central office for internal audit (usually in the Ministry of Finance) should not try to dictate to line ministries and agencies of government how to conduct this function, but should aim at guiding and facilitating internal audit development throughout government—as in the example of the Internal Audit Agency of Ghana (Box 12-2).

A final word: in some countries, internal audit is being developed (usually at the urging of aid donors) even where management controls systems are lacking. Evidently, it makes no sense to put in place internal auditors to advise the management of a ministry on the strengths and weaknesses of management control systems that do not exist. The establishment of adequate internal management controls comes first. If guidance and facilitation is needed for this purpose, it should be provided centrally, based on uniform standards but as and when requested by the individual ministries and agencies.

External audit

The centrality of external audit in public financial accountability
A robust review and scrutiny of government financial transactions after the end of the fiscal year is critical to close the PFM loop and provide assurance of financial integrity and compliance with the rules. Recalling that the legitimacy of the initial budget depends crucially on its approval by the legislature as representatives of the citizenry, it follows that the execution of that budget must also be reviewed by the legislature. Owing to the complex nature of financial transactions and the technical issues involved, there is need for a competent and capable auditing entity, independent of the executive branch of government that conducted those transactions—and thus “ex-
ternal” to the executive branch (not external to the country, as it sometimes misunderstood). This book can address only the basic principles of external audit. Readers interested in a thorough contemporary treatment of the subject are referred to Santiso 2009.3

The fundamental requirement of independence of the external audit entity, which should be anchored in legislation, was set out more than thirty years ago by the Lima Declaration of Guidelines on Auditing Precepts, unanimously approved in 1977. The Declaration opens with the following statement:

“The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent—or at least render more difficult—such breaches.”

Effective external auditing can:

« Detect irregularities involving the misuse of public funds and identify related weaknesses in management controls that may imperil the integrity of the organization and the effective implementation of budgetary and other policy decisions;

« Determine the reliability of reports on budget execution and other financial data;

« Identify instances and patterns of waste and inefficiency, which if corrected will permit more economical use of available budget resources;

« Provide reliable data about program results as a basis for future adjustments in budget allocations.

Box 12-2

Ghana’s Internal Audit Agency

A major PFM reform in Ghana has consisted of gradually transferring budgetary authority and responsibility for expenditure control to the line ministries and other government agencies. (Recall from Chapter 4 that the foundations of a sound overall budget and aggregate fiscal discipline are good budget proposals and expenditure control by each spending agency of government.) As part of this transfer of responsibility and control, it became necessary to develop the internal capacity in each agency to review and make recommendations concerning the robustness and efficiency of its control systems. Accordingly, the Internal Audit Agency (IAA) was established by the 2003 Internal Audit Act, and put in place from 2005—governed by a Board of nine members including some from the private sector.

In keeping with the basic vision of the reform, the IAA’s mandate is not to prescribe to the line ministries and agencies, but to set standards and procedures for the conduct of internal audit work in the ministries and agencies; facilitate the creation of internal audit units in each ministry or agency; coordinate their internal audit activities; and evaluate and provide quality assurance—to strengthen the ministries and agencies’ systems for the protection of resources and enhancement of efficiency, accountability and transparency in the management of public financial resources.

Source: Based in part on Internal Audit Agency; www.iia.gov.gh
The organizations responsible for external audit of the government as a whole have different names in different countries but are collectively referred to as Supreme Audit Institutions (SAIs). In most English-speaking countries, including anglophone African countries, the SAI is a national audit office headed by an independent head, the Auditor General. Examples include the General Accountability Office in the U.S.A., the National Audit Office in the U.K., the Office of the Comptroller and Auditor General in India, and the Auditor-General of South Africa (Box 12-3).

In most countries following the “continental” European traditions, the SAIs are judicial or quasi-judicial institutions—Courts of Audit, composed of magistrates and headed by a presiding judge. The Cour des Comptes in France, the Corte dei Conti in Italy, the Tribunal de Cuentas in Spain, and the majority of SAIs in South America are examples.

There are several variations of these two basic models. Thus the external audit entity in Germany, Austria, Holland, and several central and eastern European countries combine characteristics of both the “office” and “judicial” models—the same goes for the SAI of the European Union, the European Court of Auditors.

In francophone Africa, external audit is being developed following the “continental” model of quasi-judicial audit, as for example in the member states of the West Africa Economic and Monetary Union (UEMOA)—see Box 12-4.

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**Box 12-3**

**South Africa’s Auditor General’s Office**

The Auditor-General of South Africa (AGSA) was established under the 1996 Constitution as one of the state institutions supporting constitutional democracy. The importance and independence of the Auditor-General are explicitly recognized and guaranteed, as the Auditor-General must be impartial and exercise its functions “without fear, favor or prejudice”.

The Constitution describes in general terms the functions of AGSA, which are articulated in the subsequent Public Audit Act of 2004. Among other things, it makes a distinction between the mandatory functions, those which the Auditor-General must perform to comply with the mission described in the Constitution, and other audits left to the discretion of the Auditor General.

In keeping with good international practice, the Auditor-General is accountable to the South African legislature, to which it reports concerning the performance of its functions and their results. A standing committee of the legislature oversees the performance of the Auditor General, based on the two main accountability instruments: the budget and strategic plan, and the annual report.

Ex-post audit reports are produced annually on all government departments, public entities, municipalities and public institutions. In addition, reports are also produced on discretionary audits, performance audit, and other special audits, and then used by the national legislature, provincial legislatures and municipal councils, as appropriate, in accordance with their own rules and procedures.

*Source:* AGSA.
Standards of effective external auditing

The International Organization of Supreme Audit Institutions (INTOSAI) has promulgated standards for the audit of government organizations and operations. These standards have been adopted by government audit organizations around the world, including virtually all SAIs. (Readers interested in the auditing function in government can obtain a copy of the standards from the INTOSAI Secretariat in Vienna—www.intosai.org.) The most important of these standards are as follows:

Independence

The independence of the auditing organization is essential to ensure that its work will not be biased by any relationship it might have to the entity being audited. Independence is typically accomplished by creating the SAI as an organization apart from the executive branch of government, and usually responsible only to the national legislature. This is the arrangement in the U.S., U.K., most of the Commonwealth countries, most members of the European Union and a majority of all other countries. An additional way of securing independence is to make the appointment of the auditor general or the members of the court of audit joint between the executive and the legislature or contingent on legislative approval, as in Spain, Germany, and the Netherlands. In other countries, such as Italy, France and Portugal, appointment of the members of the court of audit is made by the executive, but independence of the court is assured by the permanent status of the court members, who cannot be dismissed except for grave cause and with the consent of the legislature.

The constitutional or statutory basis for the external audit organization should be clear. The SAI should have statutory authority to determine the scope of audits, obtain any documents and records relevant to the audit, and exercise its judgment as to the audit results to be reported.

Not only should the SAI be independent, so must be the individual auditors, with respect to the audits for which they are responsible. This is
usually handled through internal regulations promulgated by the SAI, but may also be covered in various laws, including those that are generally applicable to the civil service, which also cover potential conflicts of interest. As an obvious example, an auditor may not be an investor in an entity that might be affected by the results of the audit.

Autonomy and financial resources
The SAI must also have managerial and financial autonomy and sufficient resources to exercise its functions. Statutory independence from the executive branch of government means little if the executive branch can limit at will the budget and other resources of the external audit entity, or interfere in the internal management of the organization.

Professional skills
Integrity and professional credibility are the key assets of any SAI. Among the necessary resources are the technical skills necessary to conduct the types of audits that the SAI conducts. However, while a strong internal core capacity is essential, it is not necessary for the SAI to have a large permanent staff sufficient to meet its entire work program. For specialized audits or for major audits, the SAI can hire specialized consultants or contract a private firm to carry out all or part of an audit for which it lacks the necessary resources or specialized skills—provided that it retains full authority and responsibility for overseeing the work, certifying the findings, and handling the audit.

Types of audits
Most SAIs are required to perform certain audits, and allowed to perform additional ones. (See Box 12-3 on mandatory versus discretionary audits.)

Ex-ante audit
In this type of audit, also called “pre-audit” or “a priori auditing”, individual transactions are examined for propriety before they are completed, e.g. a commitment may not be entered until an auditor has approved. In francophone systems, financial controllers are detached from the Ministry of Finance; they serve in each ministry and agency to exercise this ex-ante audit function. (In France itself, however, the system is being changed in major ways.)

As a general principle of good public financial management, ex-ante audit by entities external to the ministry or agency should be avoided, since the ministry or agency must itself have the responsibility and authority to assure that the transaction is consistent with the approved budget and other applicable rules. (See the discussion of “financial control” in Chapter 10.) However, where accountability systems are in serious disrepair, it would be imprudent to eliminate ex-ante external controls until and unless these systems have been sufficiently reinforced. In a few countries, e.g., Lebanon, the Court of Audit exercises both ex-ante and ex-post audit. While such arrangements might be understandable in light of the particular circumstances of a country, it is risky and inefficient for the entity that will be responsible for a robust ex-post audit of government financial transactions to also have any role in the approval of those transactions before they have occurred. (The SAI can, however, comment and advise on the reliability of the systems in each ministry to avoid improper payments and other financial risks.)

Regularity (compliance) audits
This form of government auditing aims at determining the legal propriety of the transaction, by checking after the fact that government financial transactions have been conducted consistent with the appropriate authorizations and rules applicable to the transaction (including particularly whether the moneys were spent for the purpose for which they were authorized in the budget). Because it is impossible to audit every government transaction, compliance auditing must be very selective. The selectivity should be strategic, in order to allow the SAI to identify the control system weaknesses that permitted the irregularities to occur and demonstrate the consequences of failing to correct those weaknesses. The SAI findings can then help improve controls and strengthen the internal audit units that are an essential element in building and maintaining effective control structures.

One approach to implementing such strategic selectivity is to concentrate the auditing on areas
where frequent irregularities are known to occur. The individual irregularities in such areas may be small but their total amount may be large. Furthermore, they may create a climate of tolerance that, over time, can weaken the integrity of the entire organization. Another approach is to focus on specific areas of government activity, where there is a high risk of large irregularities, e.g., large procurements. The two approaches are of course not mutually exclusive.

The real purpose of a strategic approach to regularity auditing should be to strengthen the systems to prevent irregularities and not just to detect past errors. Experience has shown that, unless regularity audits are part of a broader strategy to deal with the sources of irregularities, detecting errors or malfeasance is unlikely to prevent the same error or malfeasance from arising again and again.

**Financial audit**
Most SAIs are required by the constitution or the law to perform annual audits of the government budget execution and other government financial reports. Their review of the government financial statements focuses on whether those financial statements are accurate, complete, and presented in accordance with the established budget classification and other relevant rules. The findings of the review are presented in a report that is made public (and usually tabled) in the legislature (to which the external auditor normally reports). The executive branch of government is then expected to respond to those findings. However, any action to be taken on the SAI findings depends entirely on the legislature and/or the executive. The function of the external auditor is to audit, not to execute.

**Value-for-money audits**
This type of audit has become increasingly common among SAIs. A value-for-money (VFM) audit examines an entire entity, activity or program to suggest ways of improving the efficiency and effectiveness of those operations. The VFM auditor searches for areas of waste and mismanagement that, if eliminated, would permit the same purposes to be achieved at less expense, and for areas where the same resources, used differently, would produce greater value for the same cost. This type of auditing can make a major contribution to increasing the efficiency of government, provided that the necessary information exists and is reliable and that the government entity enjoys sufficient authority and flexibility in managing its resources (including personnel) to make good use of the recommendations.

Because of the capacity limitations of every SAI, and the institutional constraints existing in many developing countries, it is essential that careful thought be given to relative priorities. The highest priority should usually be assigned to building and maintaining the integrity of the public financial systems, especially where the risk of corruption is high. In countries where PFM systems are weak and management controls have limited reliability, as is typically the case in developing countries, the emphasis must be on compliance and financial audits. Value-for-money audits should generally await the time when the basic systems of public financial management have become strong and the SAI capacity and credibility to carry out compliance and financial VFM audits has become established. Small experiments in VFM, however, can still take place as a way to learn-by-doing and set the bases for more extensive performance audits at some future time when circumstances permit.

**Following up on external audit**

**Reporting the audit results**
Requirements for the distribution of audit reports are often specified in the laws establishing an SAI. In most countries, all audit results are required to be reported to the Parliament. During transitional periods in fragile states, the external auditor may report to the head of state. Usually, reports to the legislature are delivered to a special committee with responsibility for overseeing the work of the SAI, such as a Public Accounts Committee. Typically, most SAIs have considerable discretion to distribute additional copies of their reports as they deem appropriate.

The general rule for distributing audit reports should be to provide copies to those with an interest in the topic and especially to those who...
should act on the findings and recommendations contained in the report. For example, the audited entity should always be informed of the results and the Ministry of Finance should be routinely informed of reports that have implications for the budget. If the audit shows the need for new or revised legislation, the SAI may bring this to the attention of the parliamentary committees that would consider such legislation and the ministry that would be responsible for proposing or implementing it.

The general public has a legitimate interest in the results of the audits of government and public entities, since the expenditures are financed with public money. Thus, all SAI reports should be made available to the public unless restricted for specific and overriding national interests, e.g. for national security. The media should also be appropriately informed, given its critical role in the effective follow-up of audit results, as the public at large is most unlikely to be interested or directly competent to interpret the audits.

**Acting on audit findings**
As noted, for the most part, auditors are authorized only to report what they have found. It is for other authorities to take action to correct the reported problems. However, the auditor bears considerable responsibility for eliciting an appropriate response to audit findings and issuing reminders when necessary. To facilitate corrective action, the audit reports themselves must meet certain requirements:

- **Clear findings.** General observations that “money was wasted in program X” are not helpful. Auditors must state as clearly and specifically as possible the nature of the problems they find and the consequences of those problems.
- **Convincing evidence.** The evidence supporting the findings must be relevant and credible and must be presented in a clear and persuasive fashion.
- **Cost-effective recommendations.** If an auditor identifies a problem, it is incumbent on him to suggest a reasonable and concrete solution for that problem. If changes are needed in laws, regulations, or procedures, these should be described with as much precision as possible. It is also essential that the costs of implementing the recommended solution should not be disproportionate compared to the problem.
- **Effective communications strategy.** The best-written audit report serves no purpose unless its contents are made known to those who can act on its findings and recommendations. A brief, well-written executive summary accompanying the report can help, as can follow-up conversations with the official or with key members of his staff. It is often useful to work with others, such as officials of the Ministry of Finance, who may be in a position to encourage appropriate action. In addition, media attention to an audit report can be a helpful stimulus to corrective action.
- **Open dialogue.** The audited entity must have a full opportunity to respond to draft reports before it is finalized and have its comments and corrections taken into proper consideration. Effective external audit should also be viewed as a critical part of the long-term development of the country’s public financial management capacity. As stressed in the discussion on accountability in Chapter 1, dialogue is often more effective than faultfinding, and is far more constructive for institutional capacity development.
NOTES

1  In this volume, the adjective ‘full’ is added to avoid confusion with modified accrual accounting, which is often confused with accrual accounting proper.


3  Although his illustrations are drawn from Latin American countries, the principles and institutional dimensions of external audit (including its critical linkages to the nature of the country’s system and its political dynamics) are equally applicable to Africa and other regions.
Part V: Fostering Inclusiveness, Effectiveness and Sustained Progress
Chapter 13:

Decentralization and Public Financial Management at Subnational Government Levels
Chapter 13: Decentralization and Public Financial Management at Subnational Government Levels

What to Expect

This chapter discusses the major issues of public financial management at the levels of subnational government (SNG), in both unitary and federal states; how the functioning of SNGs is influenced by the features of the overall PFM system; and the relationship between central and subnational governments—with particular references to the history, circumstances and challenges of African countries. The first section reviews the broad issues of decentralization, the diversity of approaches adopted by African countries, and the potential advantages and disadvantages of decentralization. The chapter then outlines the framework for public financial management at subnational government level and discusses a number of key issues in turn. Although the principles of good PFM are common to both the national and subnational levels of government, the application differs and particular problems arise in respect to the intermediate (provincial) government level and the local (municipal) government level. The last section summarizes the international experience with various methods of controlling SNG borrowing and of mitigating fiscal risk from SNG operations. PFM improvements in SNG should never be seen in isolation and should be approached as part and parcel of the objective of improving public financial management in the country as a whole.

The proper geographic articulation of the role of the state is one of the oldest challenges in political economy. A major aspect of that challenge is the distribution among the regions and localities of the tax burden and of the benefits from public expenditure. This has been a major concern of governments throughout history—in the African empires of Songhai and Great Zimbabwe as much as in the days of Ramses the Great in Egypt or Julius Caesar in Rome. For large states, success in managing the collection of revenues and controlling expenditure in the provinces and localities has been a key to their prosperity and survival. For example, the weakening of the Ottoman Empire after the late 17th century was associated largely with the increasing reliance on “tax farming” companies (subcontracting to private entities the collection of taxes), which caused a drain of central executive power and loss in legitimacy.

The design and content of the public financial management system in any country depends largely on the geographic structuration of the role of the state. In a federal country, the design and functioning of the system are influenced by the explicit recognition of the coordinated and autonomous roles of the subnational governments (SNGs). In a federal system, the constitutional and legal framework is expected to provide an effective machinery to enable the federal government to achieve national policy goals while preserving the autonomous roles assigned to SNGs. In a unitary government, subnational governments are integral parts of the system and their role is more subordinate to the central government.

Key concepts

General government comprises both central and subnational government levels. Three broad levels of government are normally recognized: the “first tier” of central government; the “second tier” of intermediate government—regional, state (in a federal system) or provincial governments; and the “third tier” of local government—county, district and municipal governments. In developing countries, a “fourth tier” is composed of various types of village government in the rural areas, and of sub-municipal organizations such as urban neighborhood groups. In Africa, this fourth tier is in many ways very important for development, as it is directly related to the delivery of the most basic services and to the critical function of informal resolution of disputes. The resources involved, however, are mostly in-kind and the management of village activities calls for very simple arrangements, the effectiveness of which depends mainly on the legitimacy of the leadership and the existence of voice mecha-
nisms for the village people. Although the fourth tier will not be discussed further in this book, its critical importance should be kept in mind, and it is imperative to assure that PFM or other national “reforms” not harm the effectiveness of village and sub-municipal groups. The most important contribution of government to the fourth tier entities is to provide physical protection against external threats, and otherwise leave them to manage their own affairs.

When discussing PFM issues at subnational government levels, it is essential to keep in mind that the levels of government are complementary and the main concern is with the effectiveness of PFM for the country as a whole. This is why the code of fiscal transparency (see Chapter 1) calls for fiscal targets to be defined for “general government”, that is, for the consolidated operations of all levels of government. In many African countries, the requisite data are not available and special efforts at collecting and maintaining them may not be cost-effective. The objective, however, is to move toward a more and more inclusive approach, as realistic and appropriate in each country. In any case, even when it is possible to define and implement fiscal targets for general government, this does not in any way assure that expenditure management systems are efficient at any of the three levels of government.

The major PFM issues in SNGs focus mostly on the second or intermediate tier, i.e., state and provincial governments, rather than municipal government. This is mainly because in most unitary states local governments are the creation and responsibility of the intermediate level, and hence are more of an implementing entity and less likely to be an autonomous agent of institutional change. However efforts are being made in federal countries to empower local governments, and extensive legal arrangements exist for the assignment of tasks to be performed and for the necessary financial devolution arrangements to support them.

Decentralization

The weight of history and the legacy of colonialism

The structure, functions and standing of subnational government are largely determined by a country’s history. In some countries, e.g., Italy with its city-states, the local government units were sovereign for centuries and the local habits of government and administration were well-rooted, long before the country in its present form was constituted in 1860. In general, developed countries have a long historical experience of gradual evolution of internal spatial change along with economic development.

By contrast, the spatial divisions of ex-colonial developing countries were determined largely by the economic interests of the former colonizing powers. Especially in Africa, colonialism imposed artificial boundaries. These were set externally by the scramble for territory among the western powers, and internally by the colonial objectives of resource exploitation and maintaining control. This has generated special difficulties for establishing links among economic activities and ethnic groups in the post-independence period, and has been inimical to nation building. Although at independence most ex-colonial countries had strong central governments, in different regions experiences thereafter diverged.

In many Asian countries, independence led to the emergence of political leadership from the more populated rural areas, and an ensuing shift in the composition of the legislative and executive branches of government. Some political theorists in the 1960s also fueled rural fears about the adverse terms of trade for agricultural products, identified rural life with tradition and
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genuine nationalism, and created the myth of the “parasitic” role of cities. Consequently, while in these Asian countries the intermediate levels of subnational government acquired greater responsibility and authority, economic policies were slanted toward rural interests, and the central cities suffered from neglect. This ideology—which was originally positive—found its extreme perverted expression in the murderous pathology of the Khmer Rouge regime in Cambodia under Pol Pot from 1975 to 1979. The regime viewed the capital of Phnom Penh as “The Great Whore by the Mekong River”, and forcibly emptied it, systematically butchering over a million people, including virtually all educated individuals.

The experience differed in Africa, where the urban elites who had acted as intermediaries for the former colonial power typically tended to dominate the political landscape in the post-colonial era. Even in countries where the original post-independence leaders were replaced by military coups and other means, the urban orientation persisted and economic policies carried a strong pro-industry, pro-city bias. Moreover, the centralization of political and economic power was intensified by the central-planning paradigm prevalent in the 1960s and 1970s, with the consequence that subnational government remained very weak throughout most of the continent.

There are exceptions, of course. There were no local intermediaries in the former Portuguese settler colonies of Angola and Mozambique, where every formal job was filled by a Portuguese colonial. When most of them departed suddenly in 1975, following the revolution in Portugal that deposed the dictatorship of Antonio Salazar, they left behind not a local elite but a total administrative vacuum. (It was a remarkable achievement in both countries to have built a post-colonial local administration in a short time virtually from scratch.) Similarly, at independence in 1960, the former Belgian Congo had a grand total of three Congolese university graduates, since the Belgians fully expected to be able to continue controlling the territory by less direct means. Following the murder of the elected Prime Minister Patrice Lumumba, the result was thirty years of kleptocracy and twenty years of chaos and exceedingly violent civil conflict. (One can only hope for an early end of the great Congolese tragedy, which extends all the way back to the extraordinarily brutal private colonial regime of Belgian King Leopold II in the late 1800s.)

There are positive exceptions, as well. Although Tanzania’s President Julius Nyerere was himself educated first at Makerere University in Uganda (then a first-rate institution, viewed by the Imperial College in London as its equal in quality), and then at the University of Edinburgh where he earned a Master’s degree (only the second African to obtain a university degree outside Africa), his policies were deliberately inclusive of the countryside, with substantial autonomy given to local governments. (It is also plausible that such policies, as well as his insistence on Kiswahili as the national language, were a key factor of Nyerere’s success in turning Tanzania from an assemblage of ethnic groups into a nation, a signal exception in this respect.) Nevertheless, in general, post-independence policies in African countries had a strong anti-rural and centralizing bias.

Aside from the above generalizations, the central message of this discussion is the need to delve into the history of the specific country if one wishes to understand why subnational levels of government have greater or lesser powers and administrative capacity.

The legal framework for subnational government in selected African countries

Notwithstanding the general “pro-urban tilt” in African countries, the constitutional and legal provisions concerning subnational governments differ substantially in Africa. This diversity is illustrated by the examples of Kenya, Mozambique, South Africa, Tanzania, Uganda, Zambia and Zimbabwe, which are briefly summarized below. South Africa, Uganda and Tanzania exemplify a legal framework that empowers local government and encourages and in some cases prescribes civic participation; Zimbabwe exemplifies a centralized system; and Mozambique and Zambia are intermediate cases. However, there has been in this century some movement away from centralization, with increasing legal consideration of local governments and in some
cases recognition of the need for broad participation by the local communities. Kenya is the foremost recent illustration of such a movement.

In Kenya, a major change has taken place with the approval of the new Constitution, by a wide margin, in 2010. The previous heavily-centralized constitution made no mention of the powers and responsibilities of subnational and local government, although the Local Government Act and the Local Authorities Transfer Fund Act set out the requirements for the composition of local authorities and for intergovernmental fiscal transfers. Among other fundamental improvements in political accountability, representativeness and transparency, the 2010 Constitution specifically sets out the fundamental principles of self-governance and public participation in the affairs of state.

In Mozambique, the legal framework for decentralization is defined in the constitution, which also mentions the need for civic participation in local development. Subject to these principles, the Municipal Law encourages (but does not obliges) municipal authorities to establish participation and social accountability mechanisms.

In South Africa too, the post-liberation constitution defines the powers and responsibilities of local government, and calls on local governments to give priority to the basic needs of the local communities, which are encouraged to participate actively. Subsequently, the principle of local participation was given operational teeth by the Municipal Systems Act of 2000, which requires community involvement in local development planning, the budget process, and the strategy of service delivery.

Tanzania was among the first countries in Africa to recognize the role of subnational government and the importance of civic participation, establishing in its constitution local authorities in every region, district, town and village, and affirming the objective of giving authority to the people and involving citizens in the planning and implementation of local development programs. There has been much debate on the effectiveness of the specific economic policies flowing from these principles; but it is clear that these principles, enshrined in legislation at all levels from the very beginning of the country’s independence, have been instrumental in forging a national identity and a sense of common responsibility and civic attachment to the Tanzanian state.

In Uganda, the principles, structures and functions of local government are outlined in the constitution, which also calls for provisions to guarantee participation by citizens in budget and development decisions that affect them, and are articulated in the Local Government Act of 1997. The Act requires district councils to prepare development plans that include the plans of lower-level councils in their own areas.

Zambia’s constitution, also toward the centralized side of the spectrum, does not address subnational government. However, after the major change in government following the elections of 1991, the Local Government Act established local authorities and set out their powers and responsibilities, allowing them to formulate their own regulations within certain parameters set by the central government. On participation, the legal framework is mixed, with provisions encouraging participation and others limiting it. (For example, while municipal council meetings are supposed to be public, in practice the council can exclude the public whenever it chooses to do so.)

Zimbabwe illustrates the case of a highly centralized system of government. The constitution does not even recognize local government, and the legal framework set out in the Urban Council Act and the Rural District Councils Act subordinates all bylaws of local councils to the approval of the central minister of local government. No legal provision is made for participation. There is no civic involvement in decision-making, but citizens are allowed to object publicly after decisions have been made.

**Degrees of decentralization:**

**Deconcentration, delegation, devolution**

Decentralization is neither simple nor absolute. The issues of decentralization are both highly complex and inherently relative to the local con-
text. Hence, instead of debating about “whether or not” to decentralize, it is more useful to ask which specific functions are suitable for greater decentralization (and which are not), how can decentralization of the suitable functions be more effective, and what modifications in central government role are necessary to protect the country and vulnerable groups from the risks and costs of decentralization.

Moreover, depending on the sector and function, there are different degrees of “decentralization” according to the extent of autonomy of the subnational government entities. These range from simple reassignment of a few central government employees all the way to permanent assignment of power and authority to the subnational government level:

- **De-concentration** partly shifts the management workload from central government to subordinate field staff in the regions, provinces, or districts. De-concentration is basically an efficiency measure internal to central government, and does not involve a downward transfer of decision-making authority from the national level. De-concentration can improve efficiency, but also creates a double responsibility of the employees to the local government as well as to their bosses in the capital. Thus, for de-concentration to be effective, responsibilities should be clear and the central government should give its staff in the field some latitude, within prescribed guidelines, to make adjustments to suit local conditions.

- **Through delegation**, the subnational government organization is given by central government the responsibility to perform certain functions. It may be exempt from central rules on personnel and has broad authority to implement decisions without the direct supervision of central ministries. As implicit in the term, delegation is revocable.

- **Devolution** carries the highest degree of decision-making independence and involves permanent relinquishment of certain functions to subnational governments, which can recruit their own staff, raise revenues to finance the functions, and interact reciprocally with other units in the overall government system of which they are a part. Devolution transfers both the policy formulation and the decision-making authority to the subnational government, subject only to general national standards (e.g., non-discrimination).

### The pros and cons of decentralization

Subnational government expenditures in developing countries as a percentage of total public expenditures have increased over the past two decades. In principle at least, decentralization of both expenditure authority and financial resources can strengthen the state accountability to its citizens, and attenuate the “democracy deficit” that exists in many African countries. Reality varies.

### The advantages of decentralization

In brief, decentralization offers the following potential advantages:

- Create opportunities for more accountable government. Local residents can more easily monitor and evaluate the government’s compliance with the decisions made, demand speedier government operations, and push local institutions to enhance their capabilities.

- Produce greater transparency in government, as information on planning, policies, and project implementation can be made accessible even to the remotest residents.

- Ease financial strain on the central government, since subnational governments can more readily mobilize funds by collecting fees and charges for the services they provide.

- More flexible administration, since the local government can tailor its services to the needs of the various groups and more effective administration, as local leaders can better locate services and facilities within communities.

- Foster political stability and national unity, as citizens and civil society organizations are given a stake in maintaining the political system.
The Costs of Decentralization
Decentralization carries various costs and risks as well—which are almost mirror images of potential advantages, and are potentially more serious in African countries:

- Loss of scale economies and unnecessary duplication, with underemployment of staff and equipment;
- Reduced efficiency of service delivery owing to the weaker administrative capacity in SNGs, especially in developing countries;
- Coordination problems and jurisdictional conflict may be created, subverting the overall resource distribution and macroeconomic management objectives of the central government;
- Especially relevant for multiethnic African countries, decentralization can jeopardize the civil and social rights of certain minorities, whether religious or ethnic. (For example, the argument of “states’ rights” was used in the U.S. south to preclude federal interference with discrimination against African-Americans.);
- Where resource endowments and capacities are uneven and communications difficult, as in large African countries, decentralization may deepen regional inequalities;
- Decentralization can worsen rather than improve overall governance in the country, if the legitimacy and quality of governance is lower at local level than at national level. Local corruption can be worse than at national level, and local autocrats can be as bad as or worse than central government bureaucrats.

The “message” of this section is neither against nor in favor of decentralization, but points to the reality that, even more than for other policies, specific decentralization initiatives must be subjected to the tests of whether their likely financial, economic, social and political benefits are likely to be greater than their costs, whether the risks are well identified, and whether adequate alleviation measures are in place—in light of the circumstances of the particular country. The overall conclusion is that decentralization in African countries is neither invariably beneficial nor always dangerous. But in fragile countries or in states where central government has failed to meet its essential responsibilities, there is no practical alternative to channeling some resources directly to the local communities.

The framework of public financial management at subnational government level

National-subnational fiscal interaction
Regardless of the political structure of the country, the machinery of public financial management in most SNGs is generally a microcosm of the central or federal machinery, and tends to reflect changes at national level. During the past decades, improvements made in the public expenditure management systems at the central level have found their way, in some cases very slowly, to the SNG level. The reverse has also occurred on occasion. In the UK and the US, for example, local governments have shown considerable skills in introducing budget innovations. (In the US this has been helped by the legal obligation of most states of the union to balance their budget.) In African developing countries, this emulation at the center of PFM innovations introduced at subnational levels has not yet begun. Local governments lack their own revenues and depend on transfers from the center; intergovernmental transfers are not always reliable and predictable; and transfers are not designed
either to meet interregional equity goals or to create incentives for fiscal discipline and improved service delivery.

**Size matters**

It is all too common to see the same analysis and methods applied to subnational governments in different countries. Indeed, there is a striking similarity in the reform programs supported by external aid at SNG level. Yet, aside from the differences in political structure—unitary, federal, or mixed—the size of the country and its population are basic determinants of the nature of expenditure management problems. At one extreme, a single state in federal Nigeria has a much larger population than any of the neighboring countries. At the other extreme, the entire population of the Seychelles could fit comfortably into a neighborhood in Johannesburg. It would make no sense to address the expenditure management problems of one island in the Comoros archipelago in the same manner as the problems of a Nigerian state. This simple fact requires emphasis because it is so often disregarded in practice. One must look carefully at the size of the problem before attempting to find solutions to it. There are, nevertheless, some common elements that do not depend on SNG size or population.

**The common elements**

Whether in large or small countries, in unitary, federal or mixed forms of government, all intergovernmental financial arrangements have common elements. These include: the fiscal assignments (which level of government collects, retains or distributes which resources); the determination of the division of the resources among levels of government; and rules for negotiated settlements between the various levels of government. In addition, transfers from central government (constitutionally-assured grants, general grants or specific grants, conditional or untied grants) are a growing component of intergovernmental financial relationships, and influence resource allocation and utilization in the recipient governments. In effect, these transfers determine, at the margin, the financing of expenditures at the lower levels of government.

Another common element is that PFM in subnational governments should never be examined in isolation from the overall system. The extent and nature of the interaction between the SNGs and the central government determine the possibilities and constraints for autonomous improvements in the SNG systems. Both the analysis and the policy advice must make a clear distinction between: (i) components of the system that are within the control of the SNG concerned; (ii) components over which the SNG has no control; and (iii) components over which control is shared between the SNG and the central government. Direct advice to and action by SNGs is possible only concerning the first set of components, and concerning the third set of components the main advice should be to intensify intergovernmental dialogue to find a solution that improves efficiency at both central and SNG levels.

**The key principles of fiscal decentralization**

It is evident that the specific dimensions of public financial management at subnational government levels depend in large measure on the public expenditure responsibilities assigned to the SNGs. The assignment of expenditures responsibilities should, as always, be tailored to the country context, but certain key principles govern national-local financial interaction in any country. The broad principle for expenditure assignments is embodied in Oates’ “decentralization theorem”, which states that each public service should be provided by the jurisdiction that controls the smallest geographic area that would internalize the benefits and costs of such provision. This is a pretty tough test to devise and meet in practice. The European Union has adopted a more practical approach, through its principle of “subsidiarity” for assigning responsibilities among its members. According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government.

Whatever the degree of expenditure devolution appropriate to a country, because it is impossible to provide for every situation in a law, conflict resolution mechanisms are important to assure...
smooth intergovernmental fiscal relations. The main principles are:

- The legal framework of the relationships between central and SNG governments must be clear and efficient: each level of government should have clearly assigned responsibilities. Overlaps should generally be avoided, and long “concurrent lists” of shared responsibilities are particularly ambiguous.

- Fiscal and revenue-sharing arrangements between the central and local governments should be stable. They may be amended from time to time, but renewed bargaining each year should be avoided at all costs.

- Subnational governments need to have a sound estimate of their resources before preparing their budgets, instead of having to wait for the final central government budget. Forecasts of revenues should be transmitted by the central ministry of finance to SNG and local governments as soon as they are set, and estimates of grants to local governments need to be prepared early in the budget process of the central government. (Even so, SNG budgeting suffers from special timing problems, discussed later.)

- Incentives for efficiency are needed. Central governments often reduce transfers to SNGs when they economize in spending or improve tax collection, thus eliminating all incentive to do so. SNGs must be allowed to benefit, at least in part, from fiscal improvements they introduce. (The same argument applies with respect to the commercial revenue of state agencies.)

- Multi-year agreements between central government and SNGs could be considered, covering expenditure assignments as well as revenue arrangements, including minimum standards for services rendered—provided that the agreements can be monitored and enforced.

- Revenue assignment should be fully consistent with expenditure assignment. When new responsibilities are transferred to SNGs, compensatory revenues should be provided. (Of course, if some responsibilities are removed, transfers to subnational government should be correspondingly reduced.)

- “Devolving” the fiscal deficit should not be permitted, and central government should avoid passing its financial problems to SNGs through cuts in transfers or new unfunded expenditure assignments.

- Special mechanisms are needed to control SNG borrowing (as discussed later), and related contingent liabilities.

- In case of SNG budget overruns or accumulation of arrears, legal sanctions or adjustment measures should be considered, e.g., mandatory expenditure cuts, or in extreme cases, temporarily placing the SNG budgets under the authority of the central government.

- Standards for accounting and financial reporting are critical, and budget classification and systems for budget execution, internal control, and audit for SNGs should be similar to those of the central government.

- Finally, issues of administrative and financial management capacity at SNG and local level are crucial. Mere lip service paid to their importance is insufficient, however. The implementation of sustainable PFM improvements requires an assessment of the realities of administrative capacity in far greater depth and practical detail than is normally the case.
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Selected issues of public financial management in subnational governments

Fiscal decentralization (sometimes called “fiscal federalism”) involves the transfer of expenditure and revenue responsibilities from the central government to subnational governments. Fiscal decentralization can take a number of forms: (i) self-financing or cost recovery through user charges; (ii) co-financing or co-production with the private sector; (iii) expansion of local tax and non-tax revenues; (iv) intergovernmental transfers; and (v) local borrowing.

The toolbox of public financial management in central government has grown substantially, particularly in this century. At SNG level, however, progress has been more uneven. To begin with, there is a major difference on the revenue side. As noted, dependence on outside sources of revenue is generally greater for SNGs than for central governments. For central governments, the largest non-tax revenue is foreign aid, which for a majority of countries is not a large proportion of total revenue. For most SNGs instead, transfers from the central government dominate the fiscal picture.

A growing dependence on the center

Intergovernmental financial arrangements in developed and middle-income countries reflect a growing dependence on the central government. For example, in the United Kingdom, 75 percent of SNG funds are transfers from the central government; in India, central transfers have increased to about 60 percent of the financial resources of the states. Similar trends are visible elsewhere, although accurate data are not available in many African developing countries, and reliance by the “fourth tier” on in-kind resources makes such comparisons particularly difficult. The dependence on the center entails: (a) a separation between the funding entity and the agency responsible for providing services; (b) reduced flexibility in using the resources; and (c) a structural constraint in the PFM systems in SNGs. The long physical and administrative distance between those responsible for funding and those in the SNGs entrusted with delivering the services dilutes accountability for service delivery. Detailed specification of the conditions on the use of funds empowers the grantors with extensive supervisory and inspection authority. And the structural dependence reduces management flexibility in the SNGs. The issue here is not that transfers are conditional, as “conditionality is a means for the appropriate use of the resources”. The issue is that in practice many of the conditions attached to intergovernmental grants are unnecessarily intrusive, and some are positively inimical to the efficient and effective use of the resources. All depends therefore on the assessment of the integrity and efficiency of SNG administrations—with detailed and rigid conditions more appropriate to situations where sub-national governments are corrupt or in disrepair. On balance, however, a better approach would be to “trust but verify”: imposing fewer and lighter conditions, combined with robust verification after the fact, is usually more efficient and conducive to long-term capacity development.

The timing problem:
Aligning budget preparation

The SNG dependence on the center engenders three major problems: a timing problem, a risk problem, and an administrative cost problem.

Budgeting in SNGs is subject to a special timing problem that does not affect central government budgeting. As noted in Chapter 9, good expenditure programming starts with a reliable forecast of revenue, and budget preparation requires enough time for ministries and spending agencies to prepare their proposed expenditure programs, for the negotiations to follow, and for the legislature to engage in an informed and meaningful debate on the proposed budget. Because a large portion of SNG revenues consists of transfers from the central government, SNG budgeting is subject to special uncertainty in this re-
spect. Even when the transfers are not discretionary but largely rule-based, their actual amount depends on macroeconomic developments and on aggregate resource availability at national level. Hence, the amount of transfers is normally not determined with finality until after the central government budget has been drafted. In many African countries, the budget is not approved by the legislature until just before or even after the start of the fiscal year. Subnational governments cannot begin the final phase of their own budget preparation until then, and their fiscal “year” is in effect reduced to nine months or less, adversely affecting efficiency and service delivery.

The SNG budget preparation process is thus subject to a Hobson’s choice of whether to start the process without a clear picture of available resources, or to compress the time period available for it. The first option risks producing “needs-based” budget proposals adding up to an unaffordable amount and without credibility (as explained in Chapter 9). The second option means rushing the preparation of sector expenditure programs, or short-circuiting the negotiation phase, or preventing informed debate. Both options thus weaken the budget preparation process, albeit in different ways.

The governance implications, too, are significant, for under these circumstances the power of the finance department of the subnational government entity vis-à-vis the spending agencies becomes greater than it should be; the same is true of the power of the executive branch vis-à-vis the legislature; and fiscal transparency itself (which requires time as well as resources) is compromised.

The timing problem cannot be fully resolved, but its impact may be reduced by the pragmatic combination of a very conservative revenue estimate and a two-stage SNG budget calendar. When the amount of transfers becomes known with certainty, upward expenditure adjustments can be made to an already well-prepared preliminary budget. This means that, at the start of budget preparation, only “core” expenditure proposals would be requested, with specific additional expenditure programs in certain sectors prepared on a contingency basis in the event that revenues turn out to be greater than the initial conservative forecast. Normally, such a distinction between “core” and “non-core” expenditures is inimical to the effectiveness of the budget process (especially in public investment programming), and should be avoided in budgeting at central government level. However, it may provide a second-best solution to the special timing problem of SNGs, at a cost lower than either the option of soft sectoral budget constraints or the option of a compressed budget preparation calendar.

The risk problem

SNG finance can be a major source of fiscal risk (discussed in Chapter 5). The fiscal impact of honoring guarantees given by a provincial government may be very severe, and contribute to prolonged fiscal crisis in the country as a whole. At the municipal level, judicial verdicts or major failures may contribute to bankruptcies.

The approach to addressing the fiscal risk arising from SNG finances comprises two elements: (i) data should be compiled on outstanding loan guarantees issued by SNGs—amounts, purposes, beneficiaries, etc.; (ii) SNG governments can be encouraged or required to enact legislation governing the issue of loan guarantees—including taking them into account during the budget preparation.

Other mechanisms can also be used to evaluate the quality of public finances of SNG governments and the resulting degree of systemic fiscal risk. These mechanisms include mainly rating of SNG debt by independent credit agencies, and self-evaluation in terms of clear criteria set by central government. The recommendations of credit rating agencies, however, have proven to be much less than reliable—let alone timely—as the Asian crisis of 1997-99 and the global financial crisis of 2008-2010 have shown once again. And self-evaluation carries obvious limitations unless it is validated by an independent external entity.

The administrative cost problem

Most issues of budget execution, discussed in Chapter 10, apply equally to SNGs and to central
government. One important issue, however, applies specifically to PFM at the subnational government level: the costs of administering grants from inception to final utilization.

Financial reporting assumes particular importance for SNGs, as many of the conditional grants extended by the federal governments are released on the basis of receipt of the reports required. Experience shows that in their zeal to control the lower-level operations central governments tend to prescribe too many detailed reports, which add to costs and lead to reporting delays. Reducing the coverage and complexity of these reports would be a positive step.

The general experience in the administration of federal-state financial relationships reveals high transaction costs. As noted earlier, the issue is not that all grants should be unconditional, but that conditions attached to specific-purpose grants should be both relevant and not unnecessarily burdensome. Too often, these are motivated by bureaucratic self-protectiveness rather than fostering the objective of the grant, are more intrusive than they need be, and hamper operational flexibility with unnecessary controls. (In some cases, the superfluity of conditions may even be counterproductive in terms of achievement of the objective for which the grant was designed, and lead to wastage of the resources.)

Controlling SNG debt

SNG debt is not a major source of concern for African countries. Indeed, with an increasing number of developing countries qualifying for HIPC debt relief, the overall external debt picture of Africa now looks far better than in the past, and is more favorable than in other regions. Elsewhere, however, controlling SNG debt is a major concern of central governments, and reviewing the issues is important for completeness.

Borrowing is a normal source of funds for the capital requirements of subnational governments, especially if large public investment responsibilities are decentralized to SNGs. Borrowing may also serve as a useful temporary stopgap for local deficits caused by a vertical imbalance in subnational government revenue and expenditure assignments. However, owing to the growing share of SNG debt and fiscal deficits, SNG borrowing has spurred macroeconomic concerns because of the debt crisis in the 1990s in some subnational governments in federal Brazil, the inflationary impact of subnational financing in Argentina, city-level bankruptcies in the United States, cumulative payments arrears in several Russian regions, and other developments.

Even when formal borrowing controls are strict, a weak central government may give the impression that it will carry the eventual costs of adjusting to SNG deficits and maintaining basic service provision (especially when its credibility has been damaged by previous bailouts of SNG governments or by political dependence on alliances with local politicians).

Subnational governments may obtain financing in four ways: (i) borrowing through the central government, (ii) borrowing through a public intermediary, (iii) borrowing directly from the capital markets, or (iv) financing through private participation in the delivery of public services. Financing through private participation in service delivery is a complex issue that cannot be fully discussed here. Of the other three financing sources, borrowing through the central government ensures SNGs long-term credit, but government credit is likely to become enmeshed with politics, possibly resulting in inefficient borrowing for unproductive public investments. To a lesser extent, the same risk applies to borrowing through a public financial intermediary, with the additional disadvantage that the debt of a
financial intermediary is an implicit liability of the central government and is thus less transparent. In contrast, subnational governments’ direct access to capital markets allows for the development of a more transparent and market-based relationship with lenders, and a greater chance for the central government to control the borrowing effectively. The latter option, however, is simply not available in most developing countries, where capital markets are nonexistent or are highly imperfect. Moreover, “moral hazard” is involved. The implicit central government guarantee of SNG borrowing allows imprudent action by both lenders and the SNG borrowers, with imprudent behavior carrying no penalty, and good SNG fiscal discipline earning no reward.

Clearly, there is no obviously “best” form of financing SNG budgets. The key to control of subnational government borrowing is the proper design of fiscal decentralization in general, and the definition of SNG borrowing authority, in particular. A good system of decentralized borrowing should meet the following criteria:

- Subnational governments should be required to disclose adequate and timely financial information, based on standard accounting.
- Explicit bankruptcy procedures should ensure that delivery of basic services continues, albeit at a reduced level, even during the debt-restructuring period.
- Subnational borrowing in excess of specified amounts or in violation of specified criteria should be subject to penalties.
- Subnational governments must be assured of access to revenue sources to serve as adequate collateral. Without such collateral, lenders will (rightly) assume an implicit guarantee from the central government.

Various countries use four types of mechanisms to control subnational borrowing: 11

- Control through market discipline (as for example in Canada and the U.S.) has no formal restrictions, but relies largely on market mechanisms for the assessment of subnational government fiscal risk. This mechanism assumes that: a capital market exists and functions reasonably well; that the government lets the capital market operate freely, without favoring government borrowers; and that credit rating agencies are reliable and timely. Reality suggests that developing countries cannot rely on market discipline to control SNG borrowing, in part because the market mechanisms are weak and in part because central government intervention to prevent SNG default is widespread and local politicians tend to be less responsive to warnings from the credit market.

- Cooperation among different levels of government (as for example in Australia’s earlier practice of the Australian Loan Council, a forum for the negotiation of state debts, comprising representatives from the states and the central government). For the cooperative model to work, subnational governments should be allowed to participate in the formulation of the macroeconomic and fiscal framework, in order to acquire awareness of the fiscal implications of their actions and improve fiscal discipline. Clearly, the cooperative approach works best where local officials are reasonably competent and representative, and where there is strong national leadership in economic and fiscal management. These conditions obtain only in few developing countries.

- Controls based on administrative rules and/or formal “fiscal responsibility” legislation (as for example in Brazil).

- Direct controls by the central government (as for example in Mexico, where subnational governments may not borrow at all without explicit authorization of the central government) include setting limits on subnational debt; authorizing individual borrowing; or centralizing all government borrowing, with on-lending to SNGs. Controls must generally be more stringent for foreign than for domestic borrowing. Indeed, experience has demonstrated that only fully centralized control of foreign borrowing by SNGs can prevent the contagion effect of a deterioration of the credit
ratings of one borrower on the ratings of other borrowers, and on the country as a whole.

In developing countries, including in Africa, direct central control of subnational borrowing is prevalent, and on balance, is preferable. However, it is very important to avoid cumbersome and intrusive controls, and the central government must not attempt to micromanage subnational governments through the back door of controlling their borrowing. As time and circumstances permit, the system can gradually and selectively evolve toward controls based on administrative rules. Recent experience has shown, however, the enormous risks of moving too fast in that direction, and an evolution toward indirect control of SNG borrowing must be especially cautious and monitored at every step.

Improving public financial management in African subnational governments

Improvements in public financial management systems of subnational government entities in African countries should be conceived as a part of the wider objective to improve overall economic management in the country. Thus, efforts are being made by the African Development Bank to improve the overall fiscal situation of member countries through the channel of reforms at subnational government level. These efforts have been complemented and reinforced by Bank assistance to improve the quality of and access to basic public services at local level, through a variety of measures to strengthen the revenue base of local governments and build their capacity to manage effectively.

That improved provision of public services is crucially dependent on the effectiveness of the expenditure management machinery is as true for subnational governments as it is for central government. Project-based lending and technical assistance to subnational governments have taken place in African countries for at least thirty years, but mainly to municipal governments, while support for PFM improvements at the intermediate provincial level is still in its infancy. Some initiatives have been taken, albeit with mixed success, e.g., support for PFM improvements in certain states of Nigeria’s federal system. However, the gaps are many; the knowledge of good practices and of mistakes in supporting PFM in SNGs is yet to be disseminated in Africa; and much greater coherence is required between reforms at national and subnational government levels.

A perusal of policy-based loans and grants to SNGs in African countries shows that the emphasis has been given primarily to improving budget coverage and budget preparation, as well as cash management, expenditure tracking, reporting, and debt management. This emphasis may be appropriate, but, once again, it must be in pursuit of the objective of improving the overall public financial management system of the country. It is critical to recognize the complementarity of public financial management at the three levels of general government—central, intermediate and local. Reform efforts are needed at all levels: PFM reforms focused only at the intermediate or local government level are unlikely to bring enduring results in the absence of complementary efforts at national level. The opposite is also true; focusing improvements only on central government finances may simply shift the problems to subnational government instead of resolving them. The previous discussion, however, suggests two clear priorities. From the viewpoint of intermediate governments, looking “upwards” to central government calls for simplifying the conditionality of fiscal transfers and improving their predictability; looking “downwards” to local governments calls for strengthening fiscal transparency and social accountability in local governments.
NOTES

1 Paradoxically known as the “Congo Free State”, Leopold’s immense personal domain was set on a foundation of systematic atrocities and deliberate terrorizing of the population in order to force it to collect ivory and later rubber for the world market. An estimated ten million Congolese lives were lost during that period, and nobody can guess at the number of amputations of children limbs as punishment for their parents’ failure to collect enough of the desired commodities. Hochschild, 1999, gives a carefully researched and vivid account of what must rank at the top of the long history of colonial brutalities. In contemporary times, the armed conflict of the last twenty years has caused an estimated five million Congolese deaths, mainly in the eastern parts of the country—again, basically for control and exploitation of the country’s natural resources.

2 At the University of Edinburgh, partly through his encounter with Fabian theory, Nyerere began to develop his particular vision of connecting socialism with African communal living—the later ujamaa villages. See Nyerere, 1962.

3 This section relies in part on Shall, 2007.

4 For a striking non-African example, every feature of the legislative budget system of the United States was extended to the Marshall Islands, notwithstanding the enormous size difference and other differences.

5 Such mechanisms can operate through dedicated bodies, as for example the Finance Commission in Sri Lanka, or through the legislature, or through specialized sector coordination councils common in many countries.

6 For example, budgetary control in China has been weakened by the lack of clarity in expenditure assignments, which have made it difficult to reform revenue assignment and revenue sharing mechanisms. Local governments are often forced to take unfunded responsibilities that should belong to higher-level government, thus adversely affecting the quantity and quality of the public goods and services they supply, and indirectly encouraging local corruption. (See Ahmad, Qiang, and Tanzi, 1995.) In the Russian Federation, considerable overlap emerged between the tasks of regional (oblast), county (rayon), and municipal governments after the dissolution of the Soviet Union and continues to this day.


8 When intergovernmental transfers are used as a mechanism of macroeconomic stabilization—increasing them during recessions and reducing them during boom periods—a further element of uncertainty is added to budgeting in SNGs.

9 A similar timing and uncertainty problem applies to municipal and local government in relation to the provincial levels. In most cases, however, transfers from provincial to local government are to finance investment projects, and it is possible to advance or delay certain projects depending on resources becoming available—with current expenditure (including the all-important operations and maintenance expenditure) financed from local revenues that are more easily estimated in advance.

10 The US bankruptcy code provides that in these cases only the municipalities (not the creditors) may commence proceedings and the bankruptcy court may not interfere with the local government. There are similar procedures in other countries (e.g. South Africa) where municipalities are allowed to borrow from the market.

11 See Ter-Minassian (1997)
Chapter 14:

Managing Public Expenditure in Fragile States
What to Expect

How does one approach public expenditure management challenges in the especially difficult circumstances of a fragile state, including a country affected by conflict? The basic principles and criteria of good public financial management, described in the previous chapters, apply to fragile and post-conflict states as much as to other African countries, but must be adapted very substantially to the special needs of those states. The chapter deals first with the major strategic criteria for successful reconstruction and recovery in fragile states—among others the rebuilding of social capital, the need to balance urgent needs with longer term goals, and the approach to public investment. The budgeting process in fragile states is discussed next, beginning with the fundamental PFM reform priorities and including special budgeting issues as well as the organizational dimension. The chapter concludes with a review of the arrangements for financing reconstruction and recovery—and primarily the experience with multi-donor trust funds.

The broad priorities

The experience in public financial management in Africa, reviewed in the previous chapters, and the recommendations flowing from that experience cannot be applied in their ordinary form to the special circumstances of a fragile country, especially one emerging from protracted civil conflict. However, when that experience is combined with an understanding of the special challenges of fragile states, a practical approach to budgeting emerges. Although the principles of budgeting are the same, the core requirements of budgeting in a fragile state are: (i) simplicity and (ii) adaptation to whatever limited capacity exists. Public financial management must, in the first place, be fully cognizant of the realities of depleted resources, scarce information, and especially weak administrative capacity. And budgeting must be deliberately selective, tailored to the basic urgent needs of the economy, and oriented in part toward the quick wins that are necessary to reestablish the credibility of the state and to restore hope.

Nothing in this discussion should be allowed to obscure the reality that the paramount priority in fragile and conflict-affected states is to restore public order and security. The best economic policy framework, budgeting procedures, reconstruction investments, staffing, financing arrangements, and capacity-building efforts are worth little if the country suffers a general lack of physical security and haphazard enforcement of the laws and basic regulations. The second priority is to establish the rule of law and introduce mechanisms of accountability, transparency and participation.
The strategy of reconstruction and recovery

The sad realities of frequent conflict in Sub-Saharan Africa, especially during the decade 1992-2002 have produced a substantial understanding of the key components of a strategy to deal with the reconstruction and recovery challenges in fragile African states.

Rebuilding “social capital”
Political turmoil and civil conflict—especially in its most virulent ethnic form—destroy more than human lives and physical facilities. Civil conflict also short-circuits the rules that keep human interaction constructive and predictable, targets primarily the organizations and individuals who administer those rules, erodes the mutual trust that binds people together and allows for efficient economic transactions, and wipes out most positive forms of social capital. Post-conflict reconstruction is first and foremost a social and institutional challenge.

Fundamentally, social capital is the stock of trust created through networks of reciprocal support based on common interests (Putnam 1995, 2000). The rebuilding of social capital is a strategic pillar of reconstruction, as it leads to social collaboration and more effective institutions, including public financial management. The “networks” aspect of social capital is especially important in multi-ethnic and multi-cultural countries: “Bonding” networks connect people who are similar (e.g., immigrants from the same country); create a sense of in-group reciprocity; and may form the basis of joint economic activities (e.g., in microcredit associations). “Bridging” networks are even more important in post-conflict situations, as they help generate mutually beneficial relations between different groups of people, fostering cooperation and exchange of information and beginning to dispel suspicion and resentment. The contribution of a sound public education system can be crucial in this respect.

Physical capital and social capital are complementary, and both are necessary for reconstruction and recovery. However, the most important differences between the two is that physical capital is marketable and depleted as it is used; social capital is collective and tends to grow as it is used—reliance on trust leads to more trust, and networks become stronger the more they are relied upon.

Balancing the immediate urgencies with the long term objectives
Fostering the creation of positive social capital contributes greatly to the need to balance the immediate priorities with sound long-term policy and institutional development. In fragile states, certain needs are evident, compelling and urgent. Yet, rebuilding state institutions, encouraging social cohesion and providing for inclusive economic growth are long-gestating challenges. Addressing the immediate needs is imperative—for social, human, security and political reasons—but must not be allowed to neglect the longer-term objectives of reconstruction and recovery. There is no necessary conflict between addressing the immediate priorities and pursuing the longer-term objective—provided that the urgent needs are addressed in a manner that facilitates rather than impedes the rebuilding of social and economic institutions. This theme underlies most of the analysis in this chapter, but an illustration of how to achieve that difficult balance in a post-conflict setting is provided by the institutional arrangements for road reconstruction in Liberia, described in Box 14-1.

The special importance of a medium-term perspective in post-conflict states
Reconciling immediate needs with long-term goals calls for, among other things, adopting a perspective beyond the immediate future. Medium-term expenditure frameworks (MTEFs—discussed in Chapter 7) are often considered an unnecessary luxury in a post-conflict situation. This view is absolutely correct insofar as detailed, technical MTEFs are concerned. Not only would an elaborate exercise of medium-term fiscal forecasting (even if sufficient data were available) produce no benefits in terms of budgetary out-
comes, but also it would constitute a gross waste of scarce capacity, and to that extent harm the prospects of reconstruction and recovery. However, post-conflict countries have a special need for a broad fiscal perspective extending beyond the immediate future. This need arises from a per-

Box 14-1

Institutional Transition in a Post-Conflict Setting: Moving to a Road and Infrastructure Authority in Liberia

There are good prospects that the arrangements to manage and finance road maintenance and other infrastructure in Liberia will benefit from the earlier experience with road funds in Africa, as well as the special experience of post-conflict institutional reconstruction.

A Sector Implementation Unit (SIU) was set up in 2006 in the Ministry of Public Works (MPW) to manage the implementation of post-conflict infrastructure development, primarily surface transport. The SIU is a semi-autonomous self-supporting entity, intended to evolve into an autonomous Road Authority in 2011, and charged with planning, design and implementation of projects in surface transport, water, energy and agriculture sectors—while the financial management responsibility is rightly entrusted to a unit in the Ministry of Finance (MoF).

Lessons of post-conflict reconstruction were well internalised:

» Transitional post-conflict organizations should be a bridge to permanent regular institutions rather than becoming self-perpetuating enclaves. Only the future will tell whether the SIU will in fact “move along a fast track” to give way to a market—oriented Road Authority, but it is encouraging that its transitional nature is explicit in its mandate.

» In post-conflict situations, one must work with what there is. The only capacity in Liberia for this type of infrastructure projects was in the MPW.

» It is important to twin emergency needs with capacity enhancement.

» The endgame must be aligned with tested good practice. The responsibilities of a Road Authority are well known and the Government is trying to align the SIU as close as possible to that format. Careful attention will need to be paid to the governance structure and operational modalities—in light of the mixed record of road funds in Africa and elsewhere (See Chapter 6).

Three challenges must be met: (i) the closest possible coordination between the SIU and the PFMU; (ii) prevent delays, as transitional organizations have a way of perpetuating themselves (it will be better to launch the Road Authority on schedule even if some organizational or staffing details are yet to be settled); (iii) devolve to the local communities the responsibility and resources for maintenance of rural roads, with adequate publicity. This will assure maintenance is performed, build local capacity by giving local communities actual responsibilities, and embed into the Road Authority a mechanism for social accountability.

Source: Based partly on information from the February 2008 Framework Document of Liberia’s Special Implementation Unit and Project Financial Management Unit.
verse pattern in post-conflict reconstruction financing, identified long ago but first analyzed in detail by Paul Collier (Collier and Hoeffler 1998).

Collier noted that international interest in assisting the country is at its highest in the immediate post-conflict period. This interest generates large financial support for the country, but precisely at a time when its capacity to absorb those resources effectively is at a minimum, because the country has barely come out of the conflict. As time passes, the country’s capacity to invest in and implement good expenditure activities rises, but in the meantime international interest has waned and moved on to some other crisis situation, and external financial support falls off along with it. A credible expenditure perspective, however tentative it may have to be, can help resolve this dilemma. It can provide the economic and political justification for firm donor commitments for a period of years, but to be disbursed over three or four years as and when the increase in the country’s absorptive capacity permits. Naturally, by far the main expenditure component of such a multiyear perspective will be public investment, discussed next.

Tailoring public investment to the reconstruction strategy
Aside from addressing the emergency needs that are obvious in any fragile and conflict-affected state, the program of reconstruction can be anchored by a few “strategic projects” that can enable, facilitate, or even drive further investment and economic reconstruction and recovery down the line. The question of how to identify such strategic projects has a long pedigree, going back to the debate in the early days of development economics between balanced and unbalanced growth, the basic terms of which are recapitulated next.

The conceptual foundation of investment strategies
Almost 50 years ago, Albert O. Hirschman (Hirschman 1958) made “unbalanced growth” the central theme of his approach to economic development. He started from the consideration that the scarcest factor of production in a developing country is not capital, or natural resources, or technology, or skilled labor—but the country’s ability to invest. He concluded that a development strategy needed most of all to economize on the ability to invest, which could be achieved by focusing public investment on maximizing total links—both forward and backward—by investing in the intermediate sectors (those in the middle of the input-output table). The reason is that public investment in such large projects creates a demand for inputs—and thus facilitates subsequent decisions to invest in lower-level projects that produce such inputs. It also produces inputs for higher-level activities, thus raising their potential profitability and facilitating decisions to invest in those activities. Hence, Hirschman advocated sequential and progressive investments—with public investment in strategic projects (strategic in the sense of economizing on the economy’s ability to invest) as the initial motor. This approach contrasted sharply with the “big push” program of across-the-board simultaneous investments advocated by the balanced-growth strategy of Paul Rosenstein-Rodan (1943) and others in earlier years.

An important aspect of Hirschman’s argument was that the role of different physical input constraints changes at different stages of development, with different conditions, and in different countries. Clearly, this viewpoint is far more relevant for the circumstances of post-conflict economies than the orderly and linear view of the balanced-growth approach that implicitly takes as constant most of the factors that are by definition variable. Moreover, Hirschman was one of the first development economists to understand that institutional factors are more important in development than the standard physical factors of production. This insight is particularly applicable to fragile and post-conflict countries that are in the midst of rapidly changing realities on the ground, rather than to countries in a “cruising-speed” development mode.

However, Hirschman did not take into account (any more than other development economists did until the late 1980s) that the ability to make investment decisions is very different from the ability to implement them. In turn, the issue of implementation capacity cannot be intelligently debated without explicit consideration of the quality of governance. In the absence of
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strong public accountability, government decision makers can channel public resources and aid to projects that maximize their private gain; the development impact of the project becomes wholly secondary to its rent-producing potential; and “strategic” projects risk becoming those with the largest corruption opportunities. As a former minister of planning of an African country—now under a new and democratic regime—once frankly told the author: “We don’t care about the quality of implementation or the future recurrent costs; for us, the project has served its purpose when all the contracts have been privately negotiated.” This attitude is one more reason why rebuilding stable and accountable governance is next only to restoring security as the primary challenge in post-conflict countries. Without governance improvements, the difference between balanced and unbalanced growth strategies shrinks in practice to the distinction between facilitating a lot of corruption within a brief period of time or allowing the same amount of corruption spread out over a period of years.

The special need for investment programming in fragile states

Connecting the conceptual perspective on strategic projects to the budget process explains why programming public investment (discussed in Chapter 8) is even more important in a fragile country setting than in stable developing countries. In fragile states, investment programming is needed not only on grounds of fiscal responsibility and efficiency, but even more as a way to shed light on the investment decisions of the government. However, given the extreme data and capacity limitations typical of fragile states, the investment program should be as simple, selective, and realistic as possible. In answer to the issue identified at the start of this section, a post-conflict setting gives added validity to the notion of strategic project—with proto programs formulated around a few major priority investment projects chosen to shake the economy out of the tangle of despair and disrepair generated by the conflict.

No aid without a budget, no budget without a program

Among the lessons of international experience with assistance to fragile states, none ranks higher than the need for an agreed program between the recipient government and the donors, embedded in a transparent budget. This apparently obvious requirement must be underlined because it has been violated often in practice by uncoordinated donor actions to help with a variety of different urgent problems. These well-intentioned efforts typically have led to fragmentation of activities, gaps and duplications, and dilution of government ownership.

In addition to an agreed program of reconstruction activities, the other key strategic criteria are:

- Commitment by donors to channel their aid in accordance with the agreed program;
- A good interface between donors and the government agency responsible for managing the aid and guide the reconstruction;
- Proactive communication and the fullest possible measure of transparency;
- The widest consultation permitted by the security situation;
- Aim at visible “quick wins” to rebuild government credibility and generate momentum.

The main necessary condition to meet all of these criteria is a formal government budget—realistic and public. Through a unified budget the coherent program of reconstruction activities can be reflected; through discussions on the draft budget donors and the government can interact; through the budget basic economic policies can be reflected; through the budget the allocation of resources to different activities and regions can become clear to all concerned parties; through the budget implementation and monitoring of the agreed activities can take place, in accordance with uniform rules, practices, and financial controls. Finally, and most important, through the budget the practice of public consultation, open debate, habits of compromise and mutual trust can be rebuilt. It doesn’t matter how tentative and rudimentary a post-conflict budget may have to be; what matters is that a government budget be prepared, discussed, and agreed with all major stakeholders.
In a fragile state, especially if emerging from civil conflict, transparency is especially important. The climate of reciprocal suspicion generated by the conflict means that every shadow is seen as a threat and every closed door as a conspiracy. In such a setting, no other public management practice can dispel those shadows and suspicions as effectively as a wide-open budgeting process—as consultative and participatory as possible.

Government budgeting in fragile and post-conflict situations

As noted earlier, simplicity and adaptation are the watchwords for post-conflict reconstruction and recovery. Nowhere is this more true than in the area of public financial management.

The basic PFM priorities in fragile states

Priority number one is to protect the money. In the circumstances typical of fragile states, the gaps in the systems and lack of accountability mechanisms provide easy openings for theft and corruption. The first and foremost budgeting “reform” is to try to ensure that public financial resources, external or domestic, do not disappear. Protecting the public’s money is the fundamental fiduciary duty of both the government and the donors in any country. In post-conflict countries—where almost by definition the systems are extremely weak—cash management and expenditure control are the most important priorities. Without managing the government cash, expenditure cannot be controlled and without controlling expenditure all efforts at addressing the other two objectives of public expenditure management—resource allocation and operational effectiveness—would be futile. Priority number two is to track the major expenditures to ensure that the bulk does reach the intended beneficiaries. Few things destroy the credibility of reconstruction as effectively as the population seeing the reconstruction funds diverted to local warlords or other powerful special interests.

Beyond protecting the money and assuring that it reaches the intended beneficiaries, the imperative to balance the immediate reconstruction priorities with long-term policy and institutional development means that: (a) systems for expenditure control must be designed and implemented in ways that do not jeopardize the eventual improvements in budgeting systems; and (b) a clear sense is needed of when to begin addressing strategic resource allocation and operational management challenges.

The budgeting process

The process of budget preparation in fragile states must take into account the special realities of the situation; and the budget, however rudimentary, should reflect both the most pressing needs of reconstruction and the capacity constraints of the country. In particular, the iteration between needs and resources is not the same as in a steady-state system.

It will be recalled from the discussion in Chapter 9 that the obligatory starting point for good budget preparation is a realistic forecast of revenue, which—together with clear government policies for each sector—permits formulating an expenditure ceiling on each sector. This serves to encourage both discipline and ownership in each ministry’s budget proposals. In post-conflict countries, the situation is very different.

With domestic revenue very low and highly uncertain, the starting point of the process is an assessment of needs, conducted by a “joint assessment mission” (JAM) of donors and the government and normally led by the World Bank in cooperation with the United Nations, the African...
Development Bank, and other major potential donors. The results of the needs assessment are then presented to a donor conference for the purpose of mobilizing enough resources to finance the reconstruction program. Some estimate of available resources can be obtained only after the outcome of the donor conference and a determination of the pledges from different donors and the probable timing of their contributions. The needs identified in the JAM are then articulated into more concrete projects and programs, and a rudimentary budget eventually emerges, hopefully consistent with the financial resources available. (The bulk of the financing is likely to come from donors, because in the immediate post-conflict period, domestic resources and taxation capabilities are extremely limited.)

Thus, in post-conflict countries, the forecast of (mostly foreign) revenue is only an initial point of reference for the construction of a budget, for which additional aid may well become available if the expenditure proposals are well justified and the system is ready to implement them. However, even if only as initial and approximate reference, a revenue forecast should still be used to frame budget preparation so that the country can gradually move toward a realistic resource-constrained budgeting system when the immediate post-conflict urgencies have been surmounted, and also to introduce good habits of budgeting grounded on realism rather than wishful thinking.

Fostering continuous improvement

However unfavorable the initial situation may be, the goal is to achieve the kind of steady and visible improvement in budgeting that can rebuild the credibility of government institutions and lead to the “quick wins” needed for public support. The objective of expenditure screening mechanisms is not only to reject bad expenditure proposals but also to foster the beginning of lasting expenditure management improvements. Hence, as the budget proposals are assessed, constructive feedback should be provided to the ministry and agency concerned, and the experience gained through the assessment of the first round of proposals should be incorporated into the parallel capacity-building activities.

Box 14-2 summarizes the encouraging experience of Burundi in improving public expenditure management during the post-conflict transition after the 2002 peace settlement that put an end to the major internal conflict (although serious tensions remained for several years).

Special post-conflict expenditure programs: A necessary digression

The criteria and procedures suggested in Chapter 9 for screening the different types of expenditure requests prior to inclusion in the government budget are valid also in fragile states, but must be applied in a much more flexible manner. Aside from the regular categories of government expenditure, several types of special programs are essential in post-conflict transition for internally displaced persons, former combatants, and the like. No general decision rule or screening advice is possible in these respects. The programs themselves are normally negotiated with and funded by international donors, usually in the context of disarmament, demobilization, and reintegration (DDR) initiatives and on the basis of the substantial experience gained with the compensation schemes for transitional assistance, particularly in Africa. Many of these programs have strictly political or security objectives and cannot be evaluated only on economic and financial grounds.

Whatever the objective, special programs should meet certain requirements:

- Estimate expenditures on the basis of the actual activities envisaged and with costs broadly consistent with prior experience in similar cases.
- View the transfers either as compensation for past merit or past suffering, or as a means to facilitate reintegration and transition—or both—but avoid meeting these legitimate needs by giving the individuals concerned a permanent government job. This would unnecessarily mortgage the future effectiveness of government administration. (Giving meritorious persons some preferential consideration in the hiring process is not ruled out provided they are qualified for the job.)
» Similarly, compensate appropriately hazardous assignments or locations but through temporary special bonuses and/or other forms of compensation for the duration of the assignment, not by promotion or permanent advancement.

» The cost of these special programs should be budgeted as a separate line-item for each program, without attempting to disaggregate them by economic function; since they entail inherently transitional expenditures, even if expected to continue for several years,

### Box 14.2
**Rebuilding public expenditure management systems in post-conflict Burundi**

Before the onset of overt civil war in 1993, and despite the periodic eruptions of violence and systematic discrimination against the Hutu majority, Burundi was deservedly known as one of the best-managed economies in Africa. Corruption, though present, was limited and predictable; budgeting was fairly well organized; and civil servants were competent and disciplined. This still-recent experience offers the country the memory of better times, the confidence of knowing that it has the potential to manage well the public finances, and a vision of how public management can be improved by a return to the good standards of the country’s own past. This intangible asset is very important for rebuilding the public expenditure management system in Burundi. The functional priorities in budgeting and public expenditure management in Burundi can be identified as follows:

> Pending an eventual upswing in private investment, growth and poverty reduction depend on improving public investment efficiency, which, in turn, is critical for the effectiveness of aid. Better project selection and closer monitoring have helped in this regard, but much remains to be done in public investment programming.
> The initial progress in budget preparation and execution must be consolidated, including better preparation of budget proposals by the line ministries.
> Much more robust mechanisms for public financial accountability are essential for the efficient use of resources and the fight against the widespread corruption. The focus in this respect should be to strengthen the external audit court of Burundi, while fostering its independence from the executive and reinforcing its autonomy in both management and audit operations.
> Legislators’ level of understanding about the budget process needs to be raised, and the initial moves for social accountability should be accelerated, by enlisting the cooperation of NGOs and the media in monitoring public expenditure, and eventually, participating in budget preparation.

The current institutional realities of the country mandate a resolute focus on the basics. The priorities (as in other post-conflict countries) are to ensure that basic budgeting is functioning, expenditure control is consolidated, budget execution is relatively free of fraud and misallocations, and financial accountability becomes strong enough to change the current culture of impunity. This already vast and ambitious agenda would be jeopardized by pushing unnecessary and complex budgeting practices, such as a detailed MTEF, elements of program budgeting, and fully-integrated financial management systems.

*Source:* Compiled by the author from various AfDB, USAID and World Bank documents.
they are normally negotiated and funded separately from regular government expenditure.

**Screening requests for operations and maintenance (O&M) expenditure**

O&M expenditure needs are likely to be lighter in the initial post-conflict period because many of the government’s physical assets have been destroyed, and the new assets created through the reconstruction do not require much maintenance or repairs. However, O&M should not be neglected. Four general considerations may be useful in assessing expenditure requests:

» Give the benefit of the doubt to O&M budget requests during the first post-conflict years. In general, during post-conflict transition, the costs and risks of underfunding O&M expenditure are much greater than those of overfunding. Provided that financial management and control mechanisms are adequate, overfunding is more likely to lead to under spending than to waste and abuse—which leaves the unused resources available for reallocation to other uses during the same or the subsequent fiscal year. Underfunding, in contrast, is likely to lead to malfunctioning of government from lack of necessary funds, at precisely the time when it must regain some credibility by achieving demonstrable improvements on the ground.

» Require each government agency, as part of the process of approval of the O&M expenditure request, to start a selective inventory of the physical assets that have not been destroyed and are: (a) very valuable; (b) at risk of deterioration or “disappearance”; and (c) in economically usable state.

» Related to the last point, it is unwise in a post-conflict situation to assume that just because a physical asset still exists it automatically deserves to be maintained. On the contrary, as part of the selective inventory mentioned, some assessment must be requested of whether the asset remains sufficiently valuable to warrant maintenance expenditure, or has been so degraded by the conflict and prolonged deferred maintenance as to best be written off.

» Above all, one must not rely on pre-conflict asset inventory as a basis on which to decide the allocation of new O&M expenditure.

In a steady-state situation, expenditure requests are formulated by the line ministry or agency concerned and screened by the Ministry of Finance (or Planning, for investment projects). In a fragile and conflict-affected state, the capacity to formulate expenditure proposals may be non-existent, and that of the Ministries of Finance and Planning is still at a rudimentary stage. In these situations, the aid management and program guidance agency described next can temporarily exercise those functions, or other transitional mechanisms may be created.

**A government aid management and program agency**

Aid management acquires a special importance in a fragile state, where the institutions of government are extremely weak or have been destroyed and have to be rebuilt altogether. In these cases, the “aid management unit” discussed in Chapter 11 needs to perform much broader roles than only aiding facilitation during the transitional period.

Such an agency of the recipient government is the main bridge from donors to government and the primary source of initial government ownership. It must not only interface with donors and regulate aid traffic, but also help formulate the reconstruction program, implement directly a number of activities, and in extreme cases, serve as proto-government to incubate the nuclei of capacity in the various sectors. By definition, these roles are only part of the transition and should be relinquished as and when the regular organs of government are created and begin functioning.

In fragile states and particularly post-conflict situations, therefore, a special and serious issue is the “sunset dilemma.” A special agency is necessary in the immediate post-conflict period only because the formal government structures
do not yet exist or have extremely limited capacity and also because donors require transparent and reasonably corruption-free financial management. Over time, as the regular government institutions grow, competition emerges between the governmental structures and the parallel special agency. Instead of a smooth handover of responsibility, the parallel tracks tend to persist, partly because the agency has built up greater implementation capacity and contacts with donors, and partly because accountability and financial transparency remain a necessity for donors. Thus, the “temporary” agency acquires a technocratic monopoly and stays active much longer than envisaged, competing with regular government ministries for resources and authority, and in some cases preventing their strengthening and improvement.

The key lesson of this experience is that the government and donors should agree from the outset on a clear sunset clause, by which the special agency will be closed and absorbed into the regular structure of government at an appropriate specific time. An explicit exit strategy for the agency is essential. In turn, the exit strategy should be linked to appropriate conditionality vis-à-vis the emerging government structures. Finally, during the transitional period, concerted external assistance is required to build institutional capacity in the regular organs of government: proliferation of weak or corrupt government ministries is not a sound alternative to a technocratic monopoly of decision making by the special agency.

Financing reconstruction and recovery: Multi-donor trust funds

Although aid for post-conflict reconstruction can come from a variety of donors and in different forms, the bulk of the financial assistance for the agreed program of reconstruction has often been channeled through an umbrella multi-donor trust fund (MDTF) administered by the World Bank and in Africa with participation by the African Development Bank. Substantial experience has been gained with these devices during the past fifteen years, resulting in a number of conclusions and recommendations (see especially OECD, 1998; Schiavo-Campo, 2003; Schiavo-Campo and Judd, 2005).

Structural and design issues

The main design issues of an MDTF are as follows:

» An MDTF must fulfill both a fiduciary and an executive function. The legal, accounting, disbursement, and reporting provisions required for the fiduciary function have been well defined through prior experience. The effective exercise of the executive function requires, in addition, meeting the key strategic criteria previously listed.

» Incentives must exist for individual donors to join an MDTF, including an MDTF design that gives them comfort that their aid goes for priority purposes while precluding earmarking of the aid, which would defeat the purpose of a budget support mechanism. Although all donor contributions must be commingled in a common pool, donors’ preferences can be explicitly acknowledged, and expenditures in the broad categories can be regularly reported. This procedure permits each donor to claim that its money has gone to finance its preferred uses.

» MDTF governance arrangements must provide for systematic consultation with and reporting to the contributing donors.

» Large strategic projects, humanitarian aid, or security-related programs such as demi-
ning, need not be—and usually are not—financed through an MDTF. Large projects will normally carry their own implementation arrangements, and to finance humanitarian and security programs, separate dedicated trust funds can be created.

» All other reconstruction and recovery activities—including recurrent costs—should be financed under the MDTF. The main advantage of an umbrella fund is the closer link with the recipient country’s budget, and hence the possibility of a robust dialogue on fiscal and development policy. In any case, as noted earlier, what is to be avoided is fragmentation of funding vehicles, especially between financing of recurrent costs and financing of investments.

Organizational and procedural issues
Among the organizational and procedural issues, the main ones are as follows:

» Time is of the essence for aid interventions in post-conflict situations, and a practical compromise is needed between the two extremes of waiting until all contributions are deposited and starting MDTF operations as soon as the first pledges are made.

» No compromise can be made, however, with the need to put in place measures to minimize corruption and leakages before the MDTF enters into any financing commitment.

» Non-project technical assistance (TA) for institutional development and capacity building can be financed either as a component of an umbrella MDTF or by a separate trust fund. In either case, the key requirements are an agreed framework of priorities, the closest possible involvement of the local counterparts, and tight monitoring and quality control. Non-project TA activities should be linked with a host-government capacity-building program, and every single TA contract should include a training element. At a minimum, TA should take special care not to aggravate capacity problems by introducing overly complex systems or methods unsuited to local conditions.

» Although, as noted earlier, an MDTF should be dedicated to financing the agreed reconstruction program and national budget, a financial cushion should be kept for urgent expenditure needs as they arise.

» Recurrent costs are well suited for financing through an MDTF, but it is essential to monitor the broad expenditure categories, especially salaries, on the basis of clear understandings. Also, there must be a functioning payments system. (In some post-conflict situations, subcontracting certain payments to an international firm is advisable. The firm can act as an agent to verify the eligibility and correctness of withdrawal applications and can carry out spot-checks of the validity of transactions.)

» The MDTF’s managing institution should be prepared to halt disbursements in the event of serious and uncorrected deviation from the agreed policies and expenditure composition or of substantial corruption.

The special importance of inclusiveness and participation
Consultation and participation are even more important in a post-conflict environment than in a stable situation. External feedback and civil society involvement, in some appropriate form and as permitted by the security realities on the ground, are an essential part of rebuilding a national consensus and creating positive forms of social capital, as well as a requirement for the
effective implementation of reconstruction activities. The form of civil society involvement will depend on the sector and the region, but some mechanism to systematically obtain external participation and reality checks is essential. Because post-conflict reconstruction is inherently a top-down affair, caution must be exercised lest existing NGO activities and local structures be inadvertently suffocated by the reconstruction assistance. Beyond protecting what exists, government and donors should make efforts to incorporate into the reconstruction program the contribution of local communities and of the local and international NGOs that have been laboring in the conflict vineyards for years. The potential contribution of NGOs and civil society goes much beyond assisting in implementation or even acting directly as implementing agencies. Some of the most effective components of post-conflict reconstruction programs in the past have relied on empowerment of local communities and their partnership with NGOs. Moreover, capacity building at the local level is a necessary condition for the evolution of the rule of law, accountability, and transparency, and local structures can be essential to underpin the gradual rebuilding of the social capital destroyed by the conflict.

In conclusion, it is well to reiterate that the need for quick and visible achievements must not be allowed to short-circuit long-term institutional development. Although the starting point of budgeting in a post-conflict situation must be to meet the immediate needs, even the simplest and most pragmatic approach must also facilitate the gradual development of an institutional infrastructure for public financial management. The good public financial management practices described in the previous chapters therefore provide a vision of the end point toward which all interventions ought to move.
Chapter 15:
Fostering Results: Performance, Monitoring and Evaluation
What to Expect

This chapter deconstructs the meaning of “performance”, relates it to the appropriate institutional context and underlines the pitfalls as well as the benefits of introducing results measurement to improve PFM systems. The different types of result indicators are discussed, along with a number of ground rules derived from international experience with the use, abuse and misuse of performance indicators. The relationship between the various performance measures and the management of performance through stronger accountability is then discussed. The chapter proceeds to describing the monitoring and evaluation function. Monitoring deals mainly with the question of what is happening, while the question of why certain results have or have not been achieved is at the core of the challenge of evaluation. Evaluation closes the PFM cycle by feeding into the preparation of the next budget the lessons derived from the execution of the previous year’s budget, and is thus the systematic vehicle for continuous PFM improvements. The last section accordingly contains a summary of the main principles and ways to approach evaluation, particularly in an African context. An annex on how to construct a monitoring and evaluation framework for specific expenditure programs concludes the chapter.

Why “performance”?

Since the early 1990s, “performance” in the public sector has received increasing attention. Several factors have led to this focus including the pervasive dissatisfaction with government employees’ unresponsiveness to the public; increase in relative size of government, which puts pressure on the public finances; recognition of the obvious, but often forgotten fact, that the purpose of public expenditure is to bring concrete benefits to the population and the country; and the influence of the so-called “New Public Management” (NPM) paradigm still popular around the end of the last century.¹

The accumulated experience of two decades now permits making distinctions between the useful innovations and the useless or counterproductive changes. It is important to understand the complexity of the performance issue if one wishes to adopt those performance-oriented reforms that have a good chance to be effective. Indeed, the introduction of performance-based systems as if they were easy and simple has led to mistakes and has damaged the credibility of the performance concept itself.

A focus on performance is necessary. For a government to forget the real purpose of spending monies obtained from the people eventually generates a “culture” of means rather than ends, disregard for the public, and the legendary bureaucratic mentality that considers it a success to formulate tight and internally consistent controls—regardless of whether they are necessary or even helpful in executing the functions assigned to the state. Thus, an orientation toward the results of government spending, rather than only the manner of spending, should be encouraged—provided that this does not lead to forgetting the importance of public integrity and of due process.

While an orientation toward performance is important, “performance” must be defined in a manner appropriate to the country and its circumstances. In Greek mythology, a local kinglet named Procrustes had the unpleasant hobby of either cutting off part of his guests’ legs or forcibly stretching them to make them fit his guest bed. Such one-size-fits-all approach is ill-suited to institutional reforms like performance man-
management, which by definition cannot be effective unless adapted to local realities. Because “performance” is such an attractive word and misleadingly simple concept, the first basic requirement is to define performance clearly, and in its various aspects.

What is “performance”?

**The different meanings of performance:**
**By effort or results**

Dictionary definitions of “performance” include such alternative terms as “accomplishment,” “achievement,” “realization,” and “fulfillment.” Most of these terms have to do with the objective results; but some relate to the subjective sense of satisfaction from one’s efforts. Accordingly, performance may be defined in terms of effort or in terms of results. It is generally assumed that to recognize individual effort is important only to avoid hurting people’s feelings. But to do so is also a very practical proposition. Consider what happens if you define performance only in terms of objective results. The brighter/lazier persons will almost always achieve better results and thus will be rewarded; the less capable but harder workers will achieve lesser results and thus will be penalized. The former group will therefore receive the clear message that not putting out one’s best effort carries no penalty; the latter group will receive the equally clear message that working hard carries no rewards. Because both groups are composed of rational individuals, the level of effort will decline across the board and, in a short time, the entire organization will be populated by underachievers.

Recognizing (even if not actually rewarding) genuine individual effort can do much for morale and also serve as a demonstrator for others, thus fostering the effectiveness of the organizational unit. More fundamentally, most human beings consider a sense of accomplishment a strong motivator of their action—indeed, independent of salaries, penalties or other material incentives (what the adage: “man does not live by bread alone” refers to, and Thorsten Veblen called the “instinct of workmanship”). If public reforms inadvertently remove that motivation, the efficiency of personnel is likely to decline, and with it the effectiveness of public action. In time, a reductionist view of human nature risks sharply reducing public sector effectiveness and increasing the threat of corruption. An exclusive focus on results without protecting inputs, respecting due process and recognizing individual effort will weaken process and eventually produce bad quality results as well.

The normal human drive to do things right should be harnessed, and not disregarded or depreciated. (It is certainly recognized in the more efficient private corporations.) Nevertheless, subjective satisfaction is extremely difficult to measure and impossible to aggregate, and “effort” is an excellent alibi for lack of results. Therefore, to introduce a stronger performance orientation, it is advisable to rely mainly on results but never entirely neglect the effort dimension.

**“Know Thy Context”**

All budgeting is “performance” budgeting, in one sense or another. But performance in terms of what?

It is critical to realize that “performance” is a relative and culture-specific concept. Government employees are considered “well-performing” if they stick to the letter of the rules and account for every cent of public funds, in a system where rule-compliance is the dominant goal, or they enable the achievement of excellent results in unorthodox ways, in a system where what matters is the final outcome. Government employees are considered “well-performing” if they obey to the letter their superiors’ legitimate instructions, in a strictly hierarchical system—or if they
exercise their own judgment and initiative, in a system where such initiative is viewed. Government employees are considered “well-performing” if they cooperate harmoniously for group influence and cohesion, in a system where conflict is discouraged, or if they compete vigorously for individual influence and resources, in a system where individual competition is the accepted norm. Government employees can be considered “well-performing” if they implement without question any and all orders of the political leadership, in a system devoid of accountability and transparency, or they refuse to obey an illegal order or to be silent in the face of high-level corruption and misbehavior, in a system where the rule of law and norms of integrity prevail.

This does not at all mean that all the diverse administrative cultures should be considered as equally efficient. Indeed, the objective of institutional reform in public administration is to move from a less efficient to a more efficient set of behavioral rules. But we must recognize that administrative cultures do not just happen; they evolve in response to man-made incentives and concrete problems. Even when an administrative culture has become obsolete or dysfunctional, it is still necessary to understand its institutional roots if one wishes to help improve it in a durable way. For example, the practice of advancement by seniority has been criticized for preventing the recognition of individual merit. This is generally true today, but it must not be forgotten that the seniority principle was originally introduced in the public sector largely as a reform to insulate the system from the vagaries of political pressures on government employees. (In the British Royal Navy of the 18th century, for example, promotions up to the rank of post captain depended on a variety of factors, including political pressure and family connections, but primarily seamanship and command ability. Once included in the list of captains, however, seniority was the one and unbreakable rule for further promotion, precisely in order to preclude the advancement of well-connected incompetents to admiral positions.) Correspondingly, depending on the quality of governance in a country, a change to a “merit-based” system may carry the risk of reopening the door to such pressures. The change may still be desirable, but the reform should recognize the history of the existing practices and explicitly address that risk.

**The full definition of performance**

The answer to our question is that performance is the achievement of agreed results within the resources and time provided, without diluting quality and respecting the prevailing norms of due process. It is worth reflecting on every word of this definition, because most of the mistakes and failures of attempts at introducing an orientation toward performance in the PFM system stem from neglecting or violating one or another of the clauses of that definition. Thus, performance has to do with achievement—not promises—of results that have been agreed—not imposed. A resource and time constraint is inherent in any notion of performance, because given unlimited resources and time almost anyone can produce almost any result. Finally, quality and integrity are the Achilles’ heel of performance orientation, because there is an inevitable temptation to achieve results by cutting corners in quality or by breaking the rules. The impact of lower quality and deferred maintenance is not visible in the short run and only becomes apparent when the system has fallen into complete disrepair and requires a major investment, far more costly than if the maintenance and quality protection had been assured in the first place—like a termite-infested table that looks fine until it suddenly crumbles.
Performance Indicators

**Types of performance indicators**

Four aspects of performance can be identified. Using law enforcement as an example, inputs are the resources used to produce the good or service, e.g., in this case the policemen, prisons, police cars, handcuffs. The social value of inputs is measured by their cost. The performance criterion corresponding to inputs is economy, i.e., the timely acquisition of inputs at lowest cost for a given quality. (It will be recalled that economy is the main performance criterion for the public procurement function.)

Output is the good or service itself, e.g., the number of arrests. The social value of outputs is approximated by the market price for the same or the closest equivalent service (or in its absence, as in this case, by total production cost). The performance criterion corresponding to outputs is efficiency, i.e., minimizing total input cost per unit of output. (Clearly, efficiency subsumes economy, as it is impossible to minimize the unit cost of output unless all inputs are themselves procured at lowest cost.)

In contrast, outcome is the purpose that is achieved by producing the good or service, e.g., reduction in the crime rate. The social value of outcomes is difficult to assess, except as may be revealed by public reaction in the political arena. The performance criterion corresponding to outcomes is effectiveness, i.e., maximizing outcomes in relation to the outputs produced.

Finally, process is the manner in which inputs are procured, outputs produced, or outcomes achieved. The value of good process is undetermined. For inputs, good process consists of intelligent compliance with input acquisition and utilization rules and, of course, integrity. In some areas of public activity, “due process” has its own independent validity and is a key element of good governance. For example, an increase in arrests achieved by violating civil rights would not constitute “good performance” by the police. In other areas, process indicators are a useful proxy for performance when outputs or (more often) outcomes cannot be defined with clarity. “Bedside manners” in health services, rules for free debate in policy formulation, etc., are examples of process indicators. Process indicators can be quantitative (e.g., percentage of class time dedicated to student questions) but are usually qualitative. Even then, they can frequently be transformed into quantitative indicators by feedback from users: e.g., hospital patient satisfaction assessed through a survey can be translated numerically. In any case, all indicators must be defined clearly—numerical when quantitative, in very precise language when qualitative.

Note that in the public sector several important functions are simply not amenable to intelligent use of formal performance indicators—let alone quantitative indicators. Also, not all the useful data concerning a public service are necessarily performance indicators. For example, the percentage of arrests made as a result of citizens’ direct complaints is a very useful statistic for law enforcement and provides evidence of citizen involvement, but does not necessarily say anything about the performance of the law enforcement apparatus.

Figure 15.1 shows the hierarchy among goals and the main types of performance indicators, and table 15.1 provides examples of input, output, outcome, and process indicators in various sectors. Deliberately, some of the indicators in table 15.1 are good indicators, while others are likely to reduce or distort performance rather than improve it. Readers should peruse the table and decide for themselves which is which—asking the basic question: “If this indicator is implemented, what is likely to happen in practice to determine rewards and penalties?”
Figure 15-1
Hierarchical policy goals and performance indicators

POLICY GOAL

Program objectives

Planned outcomes → Process ← Actual outcomes

(Effectiveness)

Planned outputs → Process ← Actual outputs

(Effectiveness)

Planned inputs → Process ← Actual inputs

(Economy)
Table 15.1: Examples of Performance Indicators: Good, Bad, Irrelevant

<table>
<thead>
<tr>
<th>Sector</th>
<th>Type of indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Input</td>
</tr>
<tr>
<td>General Administration</td>
<td>No. of staff</td>
</tr>
<tr>
<td>Education</td>
<td>Student/teacher ratio</td>
</tr>
<tr>
<td>Judicial system</td>
<td>Budget</td>
</tr>
<tr>
<td>Police</td>
<td>Number of police cars</td>
</tr>
<tr>
<td>Corrections</td>
<td>Cost per prisoner</td>
</tr>
<tr>
<td>Health</td>
<td>Nurses/Population</td>
</tr>
<tr>
<td>Social welfare</td>
<td>Number of social workers</td>
</tr>
</tbody>
</table>

Different indicators for different types of organizations

The nature of the organization makes a major difference in the suitability of the different types of performance indicators. In the taxonomy developed by James Q. Wilson (1989), public organizations fall into four categories: production organizations, procedural organizations, craft organizations, and “coping” organizations. An example of a production organization is the tax administration office—whose role it is to “produce” tax revenue (given legal parameters and certain process constraints). An example of a procedural organization is hospital administration—whose role is to assure the optimal functioning of the hospital. An example of a craft organization is the police—whose role is to use certain skills and authorities to implement government policy. And an example of a “coping” organization is the foreign service—whose role is to interact with foreign countries in pursuit of the government goals. The distinctions are not sharp; there are overlaps between different categories of organizations and all four organizational dimensions can coexist within the same government entity; but the distinctions are important to define the scope of accountability, and hence the mechanisms to monitor and improve the performance of different government entities.

As a first approximation in deciding what type of performance indicators are appropriate, it is very useful to keep in mind the different types of organization, as follows:

- In production organizations, both outputs and outcomes can be useful measures of performance. For example, the performance of the tax administration can be assessed by both the actual revenue collected (the output) and the impact on the fiscal situation (the outcome); the performance of the primary education department can be assessed both by the number of students enrolled (the output) and the improvement in literacy (the outcome), etc..

- In procedural organizations, output measures are useful but not outcomes. For example, the performance of hospital administrators can be meaningfully assessed by the number of patients served (given the
resource and other constraints) but not by the outcomes of improved quality of medical care or reduction in disease, for which the administrators themselves are not directly responsible.

» In craft organizations, the reverse is true: output indicators are not useful but outcomes are. For example, it would be a serious mistake to judge the performance of a police department only by the number of arrests, without considering how the arrests are made or the gravity of the crimes. But, given sufficient time, the outcome of a reduction in the crime rate could be a meaningful indicator of police performance.

» Finally, in coping organizations neither outputs nor outcomes are meaningful indicators of performance, and only process or qualitative judgments are appropriate. It is obvious that measuring the performance of ambassadors by the number of receptions they hold (an output of sorts) or the number of treaties they negotiate (an outcome of sorts) would make no sense: in the first instance, an incompetent diplomat who holds a lot of parties would be judged favorably; in the second instance, a major diplomatic success would weigh less than a number of trivial agreements. In these cases, performance is assessed mainly by asking the confidential views of a number of knowledgeable interlocutors.

Performance management and accountability

Assessing performance should not be an end in itself. Performance assessment must be viewed as part of the management of the organization and thus directly linked to the accountability of individual managers. In turn, as explained in Chapter 1, accountability means answerability plus consequences. Without consequences, “accountability” is hollow, and without a link to accountability, performance assessment is a waste of time or a device to rationalize discretionary or arbitrary personnel judgments.

“What gets measured gets managed” — Does it really?

Management consultants are very fond of this principle, repeated in its variants in all circumstances, and very easy to prescribe and to follow—if one is not too concerned about the indirect impacts and long-term implications. Even in private companies it is risky to follow this principle unquestioningly, and in the public sector it is antithetical to good public financial management or other administrative processes. To understand why, one must deconstruct the rule and then define its corollary.

In the first place, “what gets measured gets managed” works only if the right things are measured. Clearly, measuring the wrong things would result in managing them, to the exclusion of the important aspects of the activity—not something to be desired. The previous analysis of performance measures shows how easy it is to apply the wrong performance indicator, and great care is needed to identify the relevant aspects of the activity that are to be measured and thus managed. Secondly, the right things have to be measured in the right way. The methodological issues of performance measurement are complex, and inappropriate measures will lead to inadequate management.

By far the most important caveat, however, rests in the corollary to that rule. If it is true that “what gets measured gets managed”, and even if the right things are measured and are measured in
the right way, it necessarily follows that “what does not get measured does not get managed”. Yet, the main reason why certain activities are in the public sector in the first place is because their external effects, social importance, or long-term consequences for the country make them unsuitable to be entrusted to private entities. Almost by definition, these are activities where the most important dimensions are precisely those that cannot be measured. Applying the management consulting performance principle to the public sector would thus entail neglecting the management of some of the most critical functions of government.

This is not at all meant to argue against the measurement of results, when it is meaningful and possible, but to emphasize the critical need to be sure that quantitative indicators are appropriate for assessing the performance of the activity under consideration. This emphasis is all the more necessary because most of the mistakes and incorrect advice given to developing countries in this area stem from neglecting the important qualitative aspects of government functions.

The accountability chain

There is a hierarchy of results in the complex production function of public services, whereby the outcome of one stage is an output of the next stage. In this “accountability chain”, accountability is clearest and most immediate by the narrowest performance criterion (i.e., compliance with input allocations), and most ambiguous and diffuse by the broadest performance criterion (i.e., net impact). For example, it is fairly easy to hold a village nurse strictly accountable for the output of the number of vaccinations, and to reward or penalize him accordingly; it is difficult to hold him responsible for the outcome of improving the health of village children. Yet, his affirmative involvement in household sanitary conditions, or nutrition, or other health factors, may have more influence on the outcome of improving children’s health than a greater number of vaccinations; but such involvement will not be motivated by an incentive system that focuses only on the outputs.

Moreover, in the absence of close supervision, it is difficult to prevent immunizations from being performed with less than the recommended quantity of vaccine (the remaining vaccine “leaking” out of the health delivery system). Therefore, abandoning input and quality controls in favor of output indicators may carry substantial practical risks. Input and quality controls must be retained alongside the output indicators.

These considerations are not meant to suggest that output indicators are more or less appropriate than outcome indicators, but that the choice of indicator depends on the stage of the production function of public services. Other things being equal, the closer the activity is to the final user the more direct is the link of outputs to the desired outcomes. In “downscale” activities that are close to the ultimate user (e.g., waste disposal) the output-outcome link is clear and immediate enough to permit using output indicators as a good proxy for outcomes. In waste disposal, a failure to collect the garbage is immediately visible and directly linked to the risk to public health. In “upstream” activities this is not so: in the regulatory area, for example, maximizing the output of public rules is hardly a desirable measure of public performance.

The measurement issue becomes more complex as one proceeds along the scale from input measures through outputs and outcomes. Although the quality issue is ever present, there is no great methodological difficulty in defining and measuring outputs. The issue with output indicators is their relevance. Similarly, the interpretation of outcomes is rarely in doubt. The issue with outcome indicators is their feasibility as a spur to better performance. Outcome indicators are almost always more meaningful, and output indicators almost always more feasible. Combining these two considerations yields the general presumption that performance measurement is most appropriate for those government activities where there is a direct and immediate relationship between the government agency’s outputs and the desired public outcomes.

The accountability trade-off

As noted, the greater specificity associated with output indicators goes hand in hand with their limited relevance. It is possible, for example, to
hold the employees in charge of waste disposal strictly accountable for a failure to collect garbage in a particular neighborhood, but that failure is important only for that neighborhood. Conversely, the failure to achieve a particular public health outcome for the country as a whole is associated with a variety of factors and cannot be directly attributed to specific individuals. There is an accountability trade-off, whereby accountability can be either tight and narrow, or broad and loose, but never both tight in application and broad in relevance.

This means that as one proceeds up along the accountability chain, precise measurement of performance and tight accountability for outputs become less and less meaningful, and need to be replaced by a focus on outcomes—particularly in the area of public financial management. Because it is difficult to attribute outcomes to individual managers, the accountability mechanism should consist of a dialogue on results. Indeed, when such a dialogue is led by persons knowledgeable about the activity and the management systems, it can yield far more, and more meaningful, information on performance than any number of quantitative measures.

**Building a cost-effective performance management framework**

The selection of output or outcome indicators (when their introduction is appropriate to begin with) is also heavily influenced by data availability and information technology. Good data and good monitoring permit better definition of results and thus justify greater reliance on them as a measure of performance. Conversely, when data are lacking or unreliable (or monitoring is weak), measuring results generates only game playing and self-delusion. In such cases, the priority must be to strengthen compliance and responsibility for input use, and improve the relevant data and monitoring capability before considering the introduction of results-based performance elements. Moreover, data collection costs, and more generally the transaction costs of introducing performance indicators, can be very large. These costs must be assessed realistically and weighed against the benefits expected. It is often the case that performance-based systems have been introduced based on a simple argument that they would improve results. But how much improvement and at what cost?

The only valid general rule for introducing formal performance assessment in the public sector is thus the following: when results measurement is both appropriate and cost-effective, performance should be assessed according to that combination of key output, outcome, and process indicators that is realistic and suitable for the specific activity, sector, country, and time. As earlier with the definition of performance, it is worth reflecting on every word of this rule, because the mistakes and failures of attempts at introducing a result orientation in the budgeting system can be traced to violating one or another of the clauses of that rule. Thus, unless it is demonstrated that results measurement is appropriate to the activity in question and that its expected benefits outweigh the costs, it should not be introduced. No single indicator can suffice for performance assessment—a combination is necessary—and the same combination of indicators cannot be used for different sectors and activities. Nor can one just “set and forget” the performance indicators—even if they are appropriate to begin with—because the stakeholders will adapt their behavior to the implicit incentives, and the indicators must therefore be kept under periodic review, and adjusted or replaced.

While assessing performance based on one single indicator is incorrect, for practical and conceptual reasons it is problematic to use an excessive number of indicators. Practically, it’s costly to do so. Not only do the relevant data have to be collected and maintained, but each indicator requires adequate monitoring, which can be expensive if done properly. Conceptually, it is impossible to assign a specific weight to each indicator, and inaccurate to give them all equal weight, which would produce the “assessment ambiguity” that is the enemy of accountability. There cannot be a hard-and-fast prescription on the number of performance indicators, but whichever indicator is selected must be a “key performance indicator” (KPI), which implies considerable knowledge of the activity in question. A practical rule of thumb is “Two To Four”: at
least two indicators are usually necessary to ade-
quately capture the main results, and any more
than four indicators is likely to be unnecessary
and costly.

**Respecting the “law of unintended consequences”**

It is absolutely critical to keep in mind that at
the very moment a performance indicator is pro-
mulgated a signal is thereby sent to all persons
in the organization of what specific results will
determine their rewards or penalties. They can
be expected to adapt their behavior accordingly,
which leads to outcomes that may be very dif-
ferent from those envisaged by the designers of
the system. For example, if police performance
is assessed by number of arrests, an incentive
is immediately created for capricious arrests; if
the indicator is changed to “arrests resulting in
convictions”, an incentive is created to pursue the
minor misdeameors easy to prove and process
through the courts, avoiding the lengthy investi-
gations of major crimes; if the indicator is then
changed to “arrests resulting in convictions for
felonies”, an incentive is created to neglect mis-
demeanors altogether. The point here is not to
criticize one or another indicator, but simply to
underline the inevitable impact of performance
indicators on human behavior and the ensuing
need to assess the major risks and identify the
appropriate mitigation measures.

Much can be achieved by asking oneself the
simple question: “How would I act to advance
my personal interests in response to this per-
formance framework?” But the better answer to
the risk of unintended consequences lies in the
process of choosing the performance indicators.
Because both front-line staff and the service users
possess relevant information on the public
activity in question and are best able to say how
their behavior would change in response to the
implicit new incentives, they must be brought
into the process of definition of the appropriate
performance indicators from the start, as well as
be mobilized to provide feedback after the fact.
Regrettably, this is almost never done: instead,
performance indicators are chosen by central
government officials and consultants sitting in
a central ministry office. This explains much of
the disappointing record when results orienta-
tion has been introduced in the public sector of
developing countries.

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**Fostering result orientation in budgeting**

**Choosing the right key performance indicators: the “CREAM rule”**

Understanding of the complexity and pitfalls of
the measurement of performance in the public
sector has grown beyond the simplistic assump-
tions of earlier years. Generally, when introduc-
ing performance concepts and management into
the budgeting system, the key determinant of
success or failure is whether the changes were
introduced realistically, gradually, and consist-
tent with the methodological pitfalls of the topic
and the country context and realities. With re-
spect to the choice of performance indicators, the
most common mnemonic device is the SMART
rule, by which a performance indicator must be
Specific, Measurable, Achievable, Relevant, and
Time-bound. While the SMART rule is applica-
table to private enterprise processes, especially in
manufacturing, it has serious problems for per-
formance management in government. Public
activities are far more complex than private pro-
duction and many of its most important dimen-
sions are not measurable; the cost of obtaining
the information is not mentioned, nor is the cost
of monitoring; and the criterion of “achievabili-	ty” relates to the target to be set, and not to the
nature of the indicator.

For introducing performance indicators in the
public sector, and particularly in public finan-

cial management, the requirements are better summarized in the “CREAM” rule.5

A good KPI should be:

» C lear — ambiguity is antithetical to accountability
» R elevant — the activity must be well understood
» E conomical — the data collection cost should be commensurate
» A dequate — in conjunction with the other KPIs
» M onitorable — considering capacity, geographic difficulties, etc.

It is worth reiterating the two main differences from the well-known SMART rule. First, a good performance indicator for a government function need not be “measurable” if the function in question is not suitable to meaningful quantification, although it must always be clear and monitorable. Second, a performance indicator must be cost-effective, i.e., avoid generating large data collection costs out of proportion with the presumed benefits from assessing performance.

An operational guide to measure and monitor performance in public expenditure management has been produced by Collange, Demangel and Poinsard (2006). Although developed for Morocco, and thus more applicable to francophone African countries, this guide is a good example of how to approach the important issue of introducing better orientation to results, in a pragmatic way that takes into account the lessons of international experience.

**Linking to the budget process: the “KISS rule”**

Beyond the choice of the right KPIs, developing greater orientation toward results in the budgeting system calls for giving more responsibility to managers, developing cost measurement, and structuring the ministries’ budgets to set up performance indicators at the appropriate level (the activity or a subprogram). However, introducing some orientation toward results does not call for major changes in the budget system. Controlling expenditure remains the basic requirement in every middle-income and low-income country; inputs must continue as the major basis of budgetary allocation and their control as an essential safeguard of the public resources; and the link between performance and the budget should be assessed intelligently rather than quantified mechanically. Indeed, the confusion between introducing performance orientation into the budgeting system and replacing the line-item system with “performance budgeting” has led to costly experiments without any positive impact on performance orientation itself.

It is important to resist the temptation to adopt a mechanistic system whereby various performance measures are given “points” that are then aggregated and used to determine budget allocations. Not only would this process be antithetical to good budgeting and common sense, but any experienced bureaucrat would also be able to manipulate the system to produce favorable results. However, there is no purpose in monitoring budget performance unless there is some link to the subsequent budget preparation process. What is essential, therefore, is to build into the budget preparation process a systematic requirement for a robust dialogue on the results of the previous year’s expenditure—between budget managers and their minister, and between the line ministries and the ministry of finance. Ideally, this dialogue on results would be continuous. In most African countries, a good and practical start would be to require such a dialogue at least at the start of the budget preparation cycle, and if possible also during the negotiations phase (see Chapter 9).

Finally, a word of caution is needed about formal and detailed “contracts” within the budget process (or, indeed, the public sector as a whole). While an explicit, and therefore written, understanding of the key results expected for the money provided is useful for accountability, such understanding must not be allowed to expand into a detailed fine-print contract. Experience shows that if the budget system gets straitjacketed into such detailed contracts—cascading from the Ministry of Finance to the line ministries to the directorates to the division chiefs to the office managers to the district chiefs to the heads of...
deconcentrated services, and so on—the chance for genuine accountability is gone, and all that is left is a monumental paper chase. The exercise of judgment is essential, and the guiding rule for performance monitoring in the budget system of African countries remains the “KISS” principle: Keep It Simple... Sir.

**Testing the performance of the performance framework:**
**The “Missouri rule”**
The motto of the U.S. state of Missouri is “Show me.” Reforms aimed at improving budgetary performance are rarely themselves submitted to a performance test. One must demand not only a demonstration that the choice of performance system has actual benefits, but that it meets the standard criterion that the benefits are likely to outweigh the costs.

Assuming that the costs have been kept down by judicious selection of the KPIs as well as by open change management and a decent respect for the principle of diminishing returns, a passing grade would require at least a showing that fiscal discipline has been improved and expenditure control tightened as a result. An average grade would need, in addition, evidence of significant reallocation of resources to priority sectors and programs. And an honor grade could be given when, in addition to strengthening expenditure control and improving sectoral allocation, the performance management system has materially contributed to a tangible improvement in efficiency of, and/or access to, and/or quality of basic public services.

This last test has not been administered yet in most African countries, let alone satisfactorily passed. In part, this is because the requisite evidence must include a reality check based on regular feedback from service users. Thus, the ultimate judges of the performance of the performance framework itself are the service users and the citizens.

**Introducing monitoring and evaluation (M&E) into the budget system**

Essentially, monitoring ascertains what is happening when it is happening, and evaluation aims at understanding how and why it has happened and at drawing useful lessons for future improvement. The various forms of financial and physical monitoring have already been covered in the previous chapters. In this section we focus on evaluation.

**Objectives of evaluation**
As external audit closes the legitimacy loop, so good evaluation closes the effectiveness loop—by feeding into the preparation of the next budget relevant information concerning the execution of the previous budget. The objective of evaluation is to provide decision makers with information to decide whether to continue or change a policy or program, by assessing (not necessarily measuring) the effects of government policies and programs and ascribing those effects with confidence to the policy or program under examination. Evaluation is the key function that connects the past to the future, the vehicle for continuous improvements in public financial management systems. It feeds lessons from actual experiences back into the programming and the decisions for future actions.

**Elements of effective evaluation**

*Appropriate stakeholder involvement*
Successful evaluations require agreement among the affected parties, especially between the evaluator and the requester, as to the question being
examined, the resources (both money and time) available to answer the question, the evaluation method that will be used in the light of the resources that are available, and the level of confidence that one can expect to have in the answer.

For evaluations to be effective, there must be cooperation among the key participants in the evaluation process. Those who request the evaluation must work with those who perform the evaluation and those who will be affected by the results. The views of those with an interest in the outcome of the evaluation, such as the managers of the program being evaluated, must be considered in defining the question and planning the evaluation, as they are typically expected to supply data to the evaluator and often play a major role in interpreting the results and in implementing any recommendations that emerge from the evaluation. However, when stakeholders believe that their interests are threatened by an evaluation, higher authority may need to intervene to encourage or if necessary compel production of the requisite data and information.

*By objectives or by results?*

The classic approach to evaluation is to assess the degree of achievement of the objectives stated at inception of the task. The pragmatic approach is to assess the results actually achieved, whether or not they match the initial objectives. The two approaches do not necessarily lead to the same conclusions, and each has disadvantages.

The classic evaluation approach has been criticized for lending itself to excessive formalism and enabling a mutation of simple and useful ideas into monsters of red tape. A case in point is the typical abuse of the logical framework concept; initially a simple and valid tool to connect objectives, means, processes and results, it has mutated into lengthy and overly detailed matrices. Also, it is not difficult for a budget manager to define targets that appear ambitious but are in reality easy to achieve, thus virtually guaranteeing a favorable evaluation. However, the pragmatic approach can encourage sloppy definition of objectives, degrade into an alibi for perennial postponement of reckoning and accountability, and reward budget managers for lucky results caused by events outside their control. On balance, it is preferable to adopt the classic approach of evaluation by objectives, but when possible, complementing it with some form of midcourse fact-based assessments. By this approach, evaluation shades into supervision.

*In-house or external M&E capacity?*

The standard assumption is that the M&E capacity should be created within the government itself. However, it is fallacious to assume that because evaluation of government activities is important it must therefore be conducted by government. In-house evaluation has the obvious advantage of inside expertise, savvy, and intimate operational knowledge of the programs being evaluated. The other side of the coin is a natural tendency to overstate results, and, where accountability systems are weak or nonexistent, even to provide a coat of whitewash to failed programs. The advantages of external evaluation are, first, its presumably stronger independence, and, second, the greater probability that the evaluators are familiar with similar programs in other sectors or other countries. The disadvantages may be unfamiliarity with the circumstances of the country and lack of understanding of the context.

The advantages are not exclusive, however. In-house government evaluation organs can also be assured of a degree of independence close to that enjoyed by external entities—if the overall quality of governance is acceptable. Conversely, if external evaluators contribute on a regular basis, they will develop the intimate understanding of operations and of country context that is needed for an informed assessment. The disadvantages, too, are not exclusive. In particular, if the governance climate is not conducive to candid evaluations, even the best external evaluations will be suppressed or distorted to produce the desired results.

The choice is entirely pragmatic and cost-driven. A thorough evaluation requires a substantial input by economists, researchers, and auditors—personnel in limited supply in all developing countries who are best employed in designing and running sound programs, not in evaluating
them. Thus, evaluation in developing countries should be conducted largely on the basis of expertise and inputs external to the government, and in many cases, external to the country. At the same time, an organic link to the regular administrative apparatus must be created. The approach to creating M&E capacity in African developing countries should therefore rest on two complementary efforts: (a) relying on external evaluations, especially for major expenditure programs, but (b) working to create a small but strong in-house capacity to design, guide, contract, and monitor the external evaluators. Such in-house capacity must not be confined to a separate small “evaluation ghetto” but provided with systematic connections to the public finance management function and to the line ministries, in whatever modality is effective in the specific country.

Finally, the capacity to monitor and evaluate government action is too important to be left entirely to government. Once again, the service users themselves should be mobilized to provide feedback and contestability. Appropriate participation by civil society can augment the limited governmental capacity for M&E, and at much lower cost than that of permanently expanding the in-house capacity. The role of NGOs is especially relevant here. The Uganda experience, among others, has shown the potential contribution of NGOs to effective M&E as well as the NGOs’ concern with the risk of being co-opted. The issues of involving NGOs in evaluating government programs are delicate, but a balance between cooperation and independence can be struck.

Box 15.1

Some Lessons of Experience of Monitoring and Evaluation in Africa

Experience with M&E programs in Africa has yielded several important lessons:

» Simply placing M&E on the government agenda is in itself a significant accomplishment (as in Sri Lanka and Malawi).
» Also a significant accomplishment is helping to build a common monitoring and evaluation language and conceptual understanding (as in Egypt).
» Cross-fertilization of ideas and country comparisons can be helpful, as in the effective use of the Chilean experience for other countries.
» An excessive focus on “macro” public sector management issues detracts from robust M&E “at the coal face”. Better links of evaluation activities with specific line-ministry staff and service providers is important.
» Similarly, focusing M&E on the provision of services of specific sectors can be a highly promising entry point, which is often neglected.
» The mere availability of dedicated funding is insufficient to advance the M&E agenda if it is not targeted clearly on capacity building.
» Excessive monitoring, through a large number of indicators, produces little effective monitoring (as in Uganda).
» Inattention to bureaucratic realities produces delays or weak ownership.
» Overreliance on one-off workshops or similar events is not advisable. Although these events can be important to put M&E on the map, sustained capacity-building efforts are required to improve the performance of the public sector on a lasting basis.

Source: Adapted from OECD 2004.
Other lessons of experience in introducing M&E capacity in Africa are summarized in box 15.1, which concludes this chapter.

A template for an M&E framework, suitable to both low and middle-income countries, is shown in the Annex.
ANNEX

Monitoring and evaluation framework
for specific and narrowly-defined programs

MINISTRY OR GOVERNMENT AGENCY:...

EXPENDITURE PROGRAM: ...

I. Results framework (Fill in only as relevant and applicable)

<table>
<thead>
<tr>
<th>A. Outcome(s)</th>
<th>Baseline (est. 2010 level)</th>
<th>2011 Target</th>
<th>2011 Actual</th>
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<tr>
<td>(Purposes of the program; progress toward the outcome is to be assessed.)</td>
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<tr>
<th>B. Output(s)</th>
<th>(A few relevant and monitorable indicators of goods or services produced, normally quantitative.)</th>
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<tr>
<th>C. Process indicators</th>
<th>(Rules or procedural improvements, if relevant: normally qualitative but clear and precise)</th>
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<tbody>
<tr>
<td>Number of Beneficiaries:</td>
<td>(if applicable)</td>
</tr>
</tbody>
</table>

II. Monitoring (“What is happening?”)

A. Who monitors (designated ministry official responsible for the monitoring):

B. With whom:

1. In the same ministry:

2. Other government agency:

3. Civil society/user groups:

C. How and When (e.g., sample of activities, spot inspections, opinion survey, periodicity of monitoring, etc.):

1 Define as clearly and specifically as possible—everything flows from the program definition.
E. **With what** (estimated cost of monitoring, additional to normal expenditure): ²

III. **Evaluation** (“Why did what happened happen?”)³

A. **Internal factors contributing positively to results:**

1. Institutional (rules, incentives...)

2. Informational (data availability/reliability, ease of transmission...)

3. Resources (personnel skills/motivation, financial, local cooperation...)

B. **Internal factors contributing negatively to results:**

1. Institutional (rules, incentives...)

2. Informational (data availability/reliability, ease of transmission...)

3. Resources (personnel skills/motivation, financial, local cooperation...)

C. **Positive or negative external factors**

1. External to the program

2. External to the ministry

3. External to the government

IV. **Follow up**

A. **Actions envisaged to strengthen positive factors and/or address negative factors:**

B. **Estimated cost of above actions:**

C. **Anticipated benefits** (either in terms of savings or of expansion of program services or of service quality. Describe in precise words if it is not realistic to quantify the benefits.)

D. **Lessons learned** (particularly in terms of improving the performance indicators, or the monitoring mechanism, or the use of the findings in the budgeting process, or to expand the M&E framework to additional programs).

² Because monitoring should be a normal responsibility of any ministry, it does not justify additional budget or staff—and the monitoring staff should be designated from among the existing employees of the ministry. However, during the start-up period of a new program the additional operations and maintenance costs directly associated with the monitoring may justify additional funding from the ministry of finance. After the initial start-up period, as program efficiency increases the resulting savings should make the monitoring self-financing and produce further savings and/or an expansion of services.

³ Brief, simple and focused on the main causes for the results. The evaluation is intended to serve mainly as a basis for internal reflection and dialogue with the ministry of finance. Mechanical links between the evaluation findings and the budget should be avoided.)
NOTES

1. The genesis of the NPM can be traced to the early 1980s (essentially starting from the Thatcher reforms in the United Kingdom), and its heyday was marked by the completion in the early 1990s of the public sector revolution implemented in New Zealand and Australia. For an exposition of the NPM, see Hood 1991. For a summary of the arguments for and against the NPM see, respectively, Borins 1995 and Savoie 1995.

2. These measures are discussed in a variety of sources, e.g. the old but still current volume by Beeton 1988.

3. Impact, often used as a synonym for outcome, is more properly defined as the value added from the activity, i.e., the “gross” outcome minus the contribution from other entities or activities. The notion is important in that it takes some account of favorable or unfavorable circumstances beyond the control of those responsible e.g., a poorer child population. However, impact (in this sense of value added) is nearly impossible to measure, and is not discussed further in this paper.

4. The genesis of the acronym has been variously attributed to different authors (G.T. Doran being the most likely originator), and the acronym itself has a number of variants.

5. A different well-known acronym for a good performance indicator is SMART: Specific, Measurable, Adequate, Relevant, Timely. The main difference is that a good indicator need not be “Measurable” if the function in question is not suitable to meaningful quantification, but it must always be monitorable. Also, the SMART acronym does not contain the important requirement that a performance indicator must be cost-effective, i.e., economical, and avoid generating large data collection costs out of proportion with the presumed benefits from assessing performance.

6. The United States has created a framework to address this problem. Line agencies are required to rate the performance of all their programs. These self-ratings are reviewed—and often overridden—by the Office of Management and Budget (OMB), which manages the budget process in the federal government. OMB’s reviews of the agencies’ self-ratings include an assessment of the reliability of the agencies’ M&E findings and constitute, de facto, a critique of agencies’ M&E methods. However, these approaches are much too demanding in terms of data and resources to be of value in an African context.

7. Chile is one of a small number of countries that rely largely on commissioning independent evaluations, although the process is managed by a government ministry. In contrast with the U.S. approach, the cost-effectiveness of the Chilean approach may be a useful example for African developing countries.
Chapter 16:

Assessing and Improving African Public Financial Management Systems
What to Expect

This chapter begins by outlining the methodologies of assessing the strengths and weaknesses in public financial management systems. Partly in that light, it proceeds to recapitulate the main reform priorities in the various aspects of public financial management discussed in the previous chapters, based on actual reform experience in developing countries and Africa in particular. The common theme is the need to avoid introducing advanced systems until the basic building blocks of good fiscal and expenditure management are in place, but then moving rapidly to do so when circumstances permit. Although isolated reforms are less likely to succeed than realistic packages of complementary actions, “platform” approaches or other rigid prescriptions should be eschewed. The key consideration in these strategic reform choices is the country’s clarity of policy direction and the government’s institutional and administrative capacity, without which the best-designed reforms cannot be implemented.

What is “reform”?

As the title of the chapter implies, the overused term “reform” should be avoided except when it is truly appropriate to a major change in policies, systems or practices. The term that is both more accurate and generally applicable is “improvement”. Using this more modest term also provides the right signals of the need for (1) gradual progress and (2) working with what there is. The first obligation of those who would encourage and support changes in a public financial management system is to assess the current situation—the strengths as well as the weaknesses. Change for its own sake is not only wasteful, but in a limited-capacity low-income country, is also likely to be costly and to produce unintended consequences. Change in PFM is by definition institution-intensive, and as explained in Chapter 1 there is no such thing as rapid institutional reform. Improvements, however, are always desirable and in most cases feasible. Accordingly, the first part of this concluding chapter deals with the important issue of how to assess PFM systems properly in all their major respects. The priorities and criteria for improving PFM systems are addressed in the second part.

A variety of international technical assistance activities have been undertaken for at least three decades to improve public financial management in developing countries. The explicit incorporation of PFM reforms in African policy programs supported by adjustment assistance is somewhat more recent. Beginning around 1990, it was recognized that effective budget support requires an agreement on the government expenditure program as well as management systems adequate for its implementation. Because of lack of prior experience, however, guidance concerning the more urgent improvements and a realistic sequencing of reforms was rarely provided.
Assessing public financial management and accountability systems

The evolution of thinking on aid and public financial management

Until the late 1970s, although some efforts were made to improve financial integrity and aid effectiveness, most external assistance to developing countries consisted of individual projects, and the focus was on good internal financial management of each project. Moreover, the prevailing consensus made a sharp distinction between “development” and “non-development” expenditure—with development spending identified with investment and growth and non-development spending identified as current expenditure. This distinction was consistent with the “golden rule” of budgeting, which permits governments to borrow only for investment, and otherwise to assure that other domestic spending is fully financed by domestic revenue. In turn, this approach was viewed as essential to assessing whether the new debt service incurred by the borrowing for new investment would be more than offset by the increase in the country’s debt-servicing capacity that the new investment made possible by generating new production to either replace imports or increase exports. This logical but narrow perspective did not allow for any attention to the recipient country’s policies and management systems.

Over the past thirty years, four developments have produced far-reaching changes:

» The recognition that all financial resources are fungible meant that aid earmarked for a specific project could release government resources to finance some other project of which the donor knows nothing. Moreover, safeguards to protect the integrity of the donor financing of the project mattered little if there were no such safeguards to protect the government resources. Therefore, it became necessary to conduct public investment reviews to assess the entire public investment portfolio, rather than only each individual project in isolation.

» With the mounting evidence of the importance of social factors, the strict identification of development spending with investment lost meaning. If new nurses and medicines are just as important to health services as the new hospital itself, current and investment spending should be viewed in integrated fashion and the public investment reviews should be expanded into public expenditure reviews.

» The understanding that economic and social policies have a major impact on the effectiveness of the individual projects, and that it is difficult to have a good project in the midst of a flawed policy climate, led to linking part of the assistance to improving those policies rather than earmarking to individual projects. In turn, decoupling aid from specific projects and shifting to policy-based “adjustment lending” entailed a need to pay attention to the recipient country’s own systems of public financial management—which began in the late 1980s and intensified thereafter.¹

» Finally, the recognition after the mid-1990s of the destructive impact of corruption—official and private—gave new urgency to the need of donor agencies to assure their constituencies that the money would not be diverted to personal use or misallocated to activities not conducive to economic and social development, and to that extent heightened the focus on improving PFM systems and safeguards in the recipient countries.

From assessment recognition to assessment proliferation

As explained in Chapter 10, the narrow definition of “fiduciary risk” is the risk that the budget is not executed consistently with the approved budget. To that extent, donor resources provided for supporting an agreed budget would not be used appropriately. The broad definition of fiduciary risk is that the budget is not executed efficiently and effectively, in which case the donor resources
too could be considered as partly wasted. In order to provide untied budget support, a donor would therefore have to be satisfied that the country’s PFM systems are reasonably adequate to protect against both narrow and broad fiduciary risk—and for this purpose some assessment would have to be conducted of the procedures and systems of expenditure management, in terms of accountability, transparency and predictability. (As will be reiterated later, the required assessment is only diagnostic—a map of strengths and weaknesses in the system—and is not intended to guide the priorities for improvements and reform, the identification of which depends on in-depth analysis and a number of other factors.)

Because donor agencies are accountable to their own constituency, each of the major ones developed its own assessment instrument and administered it individually. Although grounded in each agency’s specific concerns, the various instruments shared many objectives and methods. As of the beginning of the century, the main such assessments included the following:

» The World Bank’s Public Expenditure Reviews (PER). When the World Bank moved to budget support (adjustment lending) from the late 1980s, it needed to analyze budgets being supported, and the public investment reviews were replaced by the broader public expenditure review covering also current expenditure. The PER covered mainly “upstream” PFM issues up to and including budget approval, but generally not budget execution.

» The World Bank’s Country Financial Accountability Assessment (CFAA) was introduced shortly after the PERs, to assess the “narrow” fiduciary risk and thus covering mainly “downstream” issues of budget execution—except for those relating to procurement of goods, services, and works.

» The Country Procurement Assessment Review (CPAR) complemented the triad of assessment instruments by focusing on economy, efficiency and integrity of procurement.

» The International Monetary Fund Fiscal Report on Observance of Standards and Codes (Fiscal ROSC) was developed in response to the 1997-99 Asian financial crisis, mainly to examine and report on the countries’ observance of the provisions of the Code of Fiscal Transparency (first developed in 1998—see Chapter 1).

» The joint IMF/World Bank Public Expenditure Tracking Assessments and Action Plans for Heavily-Indebted Poor Countries (HIPC AAP) was elaborated after the introduction of the HIPC debt-reduction initiative to assure that the resources released by the debt reduction would be devoted to poverty reduction and other priority development expenditures.

» European Commission “Audits” were not really audits as such, but periodic ex-post assessments of whether EU budget support was used in line with prior agreements; they formed part of the basis for subsequent decisions on whether to extend additional budget support.

» Around the same time, the United Nations Development Program developed its own instrument, “CONTACT”, a comprehensive checklist/questionnaire comprising over 600 individual items.

» The U.K. Department for International Development (DFID) was beginning to implement its own approach to assessing fiduciary risk in the broad sense, based on a methodology similar to that of the HIPC AAP.

Assessment indigestion and the emergence of the “PEFA approach”

While understandable in light of the responsibility of each donor agency to its own mandate and constituency, the proliferation of assessments and different donor requirements for information, meetings, and understanding carried heavy disadvantages both for the donors and for the recipient countries. Mainly, the proliferation of assessments:

» led to superficial and overlapping analyses, providing neither donor nor recipient with a clear picture of the likely fiduciary risk or the basis on which to make aid decisions or improvement efforts;

» precluded clear consensus among donors, and confused the reform picture instead of facilitating it;
was costly for the donors themselves; and, most troubling,
generated huge transaction costs on the host countries, and strained their already limited capacity for little or no good purpose.

Donor missions followed one after another and sometimes overlapped—everyone requesting similar but not identical information, taking up an inordinate amount of time of busy policymakers, interfering with the everyday work of local officials (sometimes even during the most intense budget preparation periods)—and in the final analysis, made much more difficult the already challenging job of managing the budget, let alone improving the PFM systems. A variety of ad hoc attempts at coordination (e.g., joint missions) did not help, because each donor agency was still obliged to follow its own requirements, and the transaction costs of separate donor missions were replicated in giant joint missions taking up a month or more in the field. Assessing countries’ PFM systems had become necessary, but the attempt of each donor agency to do so was unnecessary, costly and ultimately unsuccessful to boot. This untenable situation gave rise to the Public Expenditure and Financial Accountability (PEFA) initiative.

The PEFA initiative

Genesis and evolution
The PEFA Performance Management Framework is managed by the PEFA Secretariat, located at the World Bank but is supported and financed by the World Bank, EC, IMF, DFID, France, Switzerland, Norway, and the Strategic Partnership for Africa as a joint entity.

Based on the approach and recommendations formulated by Allen, Schiavo-Campo and Garrity (2004), the PEFA Secretariat developed a detailed assessment methodology, comprising ratings on 28 indicators (from D for weakest through A for best) covering the entire range of PFM issues, from legal matters to revenue forecasting, expenditure programming, budget execution, accounting, reporting and audit, and administrative and financial management capacity. (Three other indicators address donor practices.) In addition, the PEFA reports contain a qualitative narrative, based on the ratings but providing a broader context. (The Annex provides the full list of PEFA indicators, and the detailed description of the methodology is found at www.pefa.org, and can also be seen “in action” by perusing any of the country reports listed in the website.)

After the June 2005 launching of the PEFA methodology, over 200 PEFA assessments have been conducted. Although the assessments are by their very nature joint among several donors, until mid-2010 the World Bank had taken the lead in most assessments. Recently, the European Commission has taken a more active leading role and as of October 2010 had led a total of 85 assessments, or about the same number as the World Bank. Within that total, the EC has concentrated on leading most of the PEFA assessments at subnational level, which accounted for about one quarter of assessments (most of which are on states in federal systems, as can be expected). About five percent were self-assessments by the country’s own authorities, and another five percent were led by the IMF or DFID. Africa has had by far the largest coverage, with only a handful of African countries declining to conduct PEFA assessments and several countries with repeat assessments—which are particularly important to obtain a sense of changes over time in the various PEFA indicators. (For details, see PEFA, 2010.)

Assessing the assessment
To address the issue fairly, it is necessary to underline what PEFA is and is not intended to accomplish. The PEFA performance measurement
framework is not intended to address issues of fiscal policy, nor to diagnose the many reasons for good or weak PFM performance, and certainly not to identify reform priorities. The PEFA assessment is a diagnostic assessment, intended to provide a “map” of the strengths and weaknesses in the PFM systems. Such a map can serve as an important starting point from which to initiate an in-depth analysis and dialogue on which aspects of the system to improve and how best to do so, but only as a starting point. Aside from a variety of practical considerations, the fact that a particular indicator is rated D and another B does not at all dictate—or even suggest—that improvement efforts should focus on the first indicator. Each of the 28 indicators carries a different weight of importance; several ought to be viewed jointly as part of the same strength or weakness of the system; actually implementing changes can be much harder for one indicator than another; and the payoff from further improving a positively-rated indicator could be higher than that of improving a poorly-rated one. Numerical ratings are no substitute for country-based analysis, judgment and dialogue.

If understood correctly and within its limitations, the PEFA initiative has largely succeeded. To begin with the most practical and most important accomplishment, the initiative has drastically cut down on the multiplication, ambiguities and overlaps under the previous uncoordinated donor assessments, and the resulting transaction costs borne by the host countries. Depending largely on the quality of the assessment teams, it has also produced sound PFM diagnostics of a large number of countries, and simply by providing the venue and the occasion for reflection by the host government authorities themselves, PEFA has enabled better understanding of the PFM systems, and in some cases a stimulus for important reforms.

The PEFA assessments have become the starting point for discussion of PFM reform programs in Africa and elsewhere; also, the dataset is helpful to researchers worldwide and the assessments are widely used by donors in their decisions on whether to rely on the country’s own fiscal and financial management systems. While it is appropriate to use PEFA assessments as one starting point for discussing PFM improvements and as dataset for researchers, the latter use of PEFA assessments by donors can be problematic. If a PEFA assessment is used in mechanical fashion (especially, as happens all too frequently, by focusing only on the numerical indicators rather than the narrative part of the report), it may result in placing excessive weight on certain judgments the value of which is, in part, contingent on the competence of the specific assessment team. Moreover, when confronted with a choice between fiduciary caution and moving toward greater reliance on country systems—which is the only route to long-term capacity development—the understandable tendency of donor agencies and their representatives is to exceed on the side of caution. This risk that PEFA assessment can become a hindrance to capacity development is not, of course, a criticism of the PEFA approach or methodology. Yet, precisely owing to the growing utilization of the PEFA framework, it is important to underline that risk.

There are valid criticisms of the PEFA methodology (that it has become too complicated and mechanistic) and of its application in certain cases, but these criticisms can be addressed and remedied. The main problem with PEFA is neither with its methodology nor with what it has achieved—but the risk from wrong and exaggerated expectations of what it is meant to achieve. The temptation arises to over-interpret the PEFA assessment results and to use the database as a prescriptive reform platform or a basis for number-crunching; this risks producing wrong advice, misallocating support, and devaluing PEFA itself. PEFA assessments are a tool, and as with any tool they should be used for the purpose for which they are intended, and stop there.

Assessing PFM systems in Africa: The recent evidence

From 2005 through mid-2010, 56 PEFA assessments have been conducted on African countries. Repeat assessments were conducted in about a dozen countries, and only a handful of countries have not yet had a PEFA assessment. Some have advocated averaging the scores on the 28 indicators into a single aggregate “PEFA score” to
measure the overall quality of a country’s PFM. However, doing so is conceptually incorrect and could lead to gravely misleading conclusions and wrong policy implications. A single score implicitly gives equal weight to aspects of PFM systems that are different in principle, and carry vastly different importance depending on countries’ circumstances. There is no perfect substitute to a careful examination of the entirety of the evidence on the country concerned.

Nonetheless, it is necessary to try and formulate some meaningful generalizations. For this, one may select out of the assessments those indicators viewed as especially important under the circumstances, and compare the evolution of their average scores through time. Even though the selection is a personal judgment of which aspects of PFM systems are most basic, it may be an acceptable compromise between the extremes of a single aggregate score and a comparison of all 28 indicators taken individually. A complementary approach consists of comparing the frequency of the especially low and the especially high scores in different years to provide a rough picture of change in the strongest and weakest points of the PFM system.

Tables 16-1 and 16-2 provide a summary picture based on the practical compromise suggested above between aggregating assessments into single scores and comparing entire assessments to one another. Because in about half the cases the governments concerned have not given permission to publish the PEFA reports, country details cannot be given here, but the tables are based on all 56 assessments. (The PEFA website, www.pefa.org, contains the links to all the countries for which reports have been published.)

### Table 16-1:
**Average Scores on Selected PEFA Indicators, African Countries, 2005-May 2010***

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<tr>
<td>PI-2</td>
<td>2.75</td>
<td>3.13</td>
<td>2.80</td>
<td>2.63</td>
<td>2.60</td>
<td>2.78</td>
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<tr>
<td>PI-3</td>
<td>1.52</td>
<td>2.00</td>
<td>1.73</td>
<td>2.56</td>
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<tr>
<td>PI-7</td>
<td>2.77</td>
<td>3.00</td>
<td>2.38</td>
<td>2.71</td>
<td>2.60</td>
<td>2.69</td>
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<tr>
<td>PI-16</td>
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<td>2.60</td>
<td>2.31</td>
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<tr>
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<td>2.06</td>
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<td>2.25</td>
<td>1.63</td>
<td>1.50</td>
<td>2.33</td>
<td>1.92</td>
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* The selection of the five indicators (out of the 31, including the aid-related indicators) is a personal judgment by the author of which aspects of PFM systems are most basic. Data availability was also determinant, however. For example, the use of PI-1 (Aggregate expenditure out-turn compared to original approved budget) would be more appropriate but the scores were not available, and PI-2 was used instead. The table must therefore be seen as a general indication of trends. The letter scores have been converted as follows: D=1; D+=1.25; C=2; C+=2.25; B=3; B+=3.3; and A=4. This differs from the PEFA practice of assigning mid-values to the “+” ratings, e.g., 1.5 for D+. The trends are not affected.
Table 16-2:  
Summary of Lowest and Highest PEFA Scores, 2005-May 2010*  
(in percent)  

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<tr>
<td>D+ and below</td>
<td>25</td>
<td>21</td>
<td>33</td>
<td>29</td>
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<td>28</td>
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<td>B+ and above</td>
<td>10</td>
<td>21</td>
<td>14</td>
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<td>Not scored</td>
<td>17</td>
<td>20</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>Memo: Number of countries</td>
<td>10</td>
<td>8</td>
<td>16</td>
<td>17</td>
<td>5</td>
<td>11</td>
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</table>

* Because PEFA assessments were repeated for only some countries during the 2005-2010 period, the countries covered are different in each year and changes must be interpreted with caution and only as a general indication. Seven indicators were not scored, and the average assuming equal weights was calculated using the subcomponents for each indicator when available. “Not scored” category includes: not scored due to insufficient information, not applicable and not assessed (NU). Indicators without actual scores are not included in the total.

The progress in budget management registered during the first years of the century did not continue in recent years. While the PEFA assessments suggest an improvement in revenue forecasting, the indicators most closely related to the key criteria of budget comprehensiveness and budget reliability showed an actual decline over the last five years, including the important aspects of funding predictability and procurement.

Nor is any PFM improvement visible in the frequency of low/high PEFA scores. While the percentage of indicators scoring B+ and higher remained at around 10 percent, the percentage of indicators scoring D or D+ increased from 25 to 30 percent between 2005 and 2010. The weak points in PFM systems in many African countries appear to have become somewhat weaker still.

Some explanations are advanced in Chapter 1 on the directions and sequencing of reforms.

Perhaps most disappointing for long-term capacity development is the contrast between the strategic goal of the international community, stated through the Paris Declaration of 2005, of greater reliance on national systems and procedures, and the lack of actual progress. The PEFA indicator of the proportion of aid managed by national procedures remained at around the same level between 2005 and 2010. Indeed, since the comparatively higher score for 2009/10 is from only five of the fifty-six PEFA assessments, the trend over 2005-2010 appears one of somewhat lower reliance on national systems. (The issue of aid harmonization and capacity development was discussed in Chapter 11.)

Why the disappointing record?

**Insufficient attention to governance and social accountability**

The evidence justifies certain generalizations. First, the attention given to the governance context and the organizational architecture has been insufficient. More analysis should be done in this area, especially concerning the effectiveness of cabinet-level procedures for key decision-making and of the inter-ministerial (and intergovernmental) mechanisms for coordination and arbitrage of expenditure choices. Many of the problems of budgeting in African countries stem not from technical difficulties, but from governance weaknesses and lack of political-level mechanisms to make policy choices and stick to them during budget preparation and execution.
Improved technical gate-keeping to screen out ineffective or unaffordable expenditure proposals cannot accomplish much without improved political gate-keeping. What is at issue here is emphatically not a technocratic illusion to “take politics out” of the budget process, but the need to strengthen the fabric of governance, make the key policy choices at the start of the budget process, and build mechanisms to assure the political restraint down the line that is necessary for those policy choices to be implemented.

Second, there has also been very little attention to the issue of the relations between government and civil society on public expenditure matters. Especially in SNGs more so than at national level, appropriate public participation can make an important contribution to the design of expenditure programs, the effectiveness of their implementation and, indirectly, fiscal transparency and anti-corruption. However, while lip service to participation is quite common, meaningful actions to increase participation in budgeting are conspicuous in their absence.

Third, as previously noted, the comparative neglect of administrative capacity issues in PFM reform programs is very problematic. PFM improvements are inherently a capacity-intensive challenge. Moreover, serious mistakes have been made in the past by external entities encouraging developing countries to introduce complex budgeting modalities entirely out of line with the capacity to implement them. Adjustment lending thus needs to be complemented by appropriate technical assistance. Because countries usually prefer, and rightly so, not to borrow for technical assistance, the capacity-building requirements of PFM reforms are a powerful argument in favor of either adjustment grants or of partnering with a development agency that does provide substantial amounts of TA on a grant basis.

Regrettably, accountability for the quality of technical advice in PFM has been weak to nonexistent in donor agencies, including the World Bank. Because host country governments understandably believe that solutions advanced by donor agency “experts” are the correct ones, the actual damage has been substantial. This is not to deny or diminish the reality of lack of significant progress in PFM in many African countries, but to signal the concurrent responsibility of donors to select persons capable of arriving at nuanced assessments and providing appropriate advice. “Do no harm” remains the first commandment of foreign aid.

The pressure to lend and borrow

Governance and regulatory weaknesses can dilute or cut the normal link between money and impact. In public financial management, the correlation between the amount and the impact of financial assistance is especially loose, and in some cases even negative.

The critical component of most interventions to improve the management of the public sector is good advice—that is, advice that is conceptually sound, grounded on comparable international experience, and befitting the institutional and human capacity realities of the country. However, the provision of such advice is much less expensive than equipment or large-scale training, and is thus not conducive to meeting lending targets. Donor agencies should introduce ways to reward staff not only for the quantum of assistance they negotiate but also for the quality of advice they provide. Host governments should give at least as much attention to the reform dimension of the project as to the procurement of expensive
equipment and works. Both sides should try to refocus the project implementation dialogue on the institutional aspects of the project.

**Lack of balance between fiduciary duties and capacity development**

Confucius is reputed to have said: “If I hear, I forget; if I read, I remember; if I do, I understand.” The route to sustainable capacity development in Africa goes through actual practice in expenditure programming, financial management, procurement, etc. The lack of progress toward the strategic goal to foster long-term capacity development by increasing donor reliance on national systems is perhaps the signal failure of the last five years. Donor agency concerns with mitigating fiduciary risk is understandable, and how to balance that concern with the objective of fostering capacity development is one of the oldest dilemmas in development assistance, but there can be no doubt that over time the emphasis must shift toward African implementation through African systems. An explicit transition strategy is needed, twinning in every aid intervention strong fiduciary safeguards with a variety of practical capacity-building provisions that will allow implementation to be gradually and responsibly devolved to the client. Unfortunately, the important initiatives taken in some African countries in this direction during the last five years have not yet been replicated or scaled up.

**Reforming PFM systems: General lessons of international experience**

**If it ain’t broke, don’t break it—but if it’s broke, fix it**

Among the key lessons of experience, the most general one is that injecting major changes into the budget process must be done gradually and with close monitoring of actual implementation. International experience with PFM reforms and attempted improvements also suggests the following:

» Never confuse the end of better budgetary outcomes with any specific means for achieving it. There may be a variety of ways to improve fiscal discipline, resource allocation, and operational management that do not entail making formal changes in the budgeting systems.

» If an aspect of the PFM system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. But conversely, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.

» Consider carefully the probable effect on individuals’ behavior, especially in multiethnic societies or very small economies. For example, contracting out the delivery of some public service (which has a spotty record in general) can lead in African countries to patronage, discrimination, internal resentments and conflict, and an increase in costs.

» If major changes are introduced, ensure robust monitoring and swift and predictable consequences. Nothing causes reforms to fail faster than the realization that those involved will be required to make greater individual efforts but will receive no reward for success of the reform and no penalty for its failure.

» In both the design and the implementation of the reform, try and ensure systematic feedback from front-line staff, service users, and the public.

**The first priority: Protect the money and combat corruption**

If the government budget is to become the financial mirror of society’s economic and social choic-
es, as emphasized in Chapter 4, the first obvious requirement is to protect the resources mobilized from society or provided by donors to assist in the achievement of society’s goals. Preventing public resources from being stolen or otherwise misappropriated is the paramount fiduciary duty of public financial managers. Protecting the money is the basic prerequisite from a technical viewpoint as well. If you cannot protect the money, you cannot control it; if you cannot control it, you cannot allocate it; and if you cannot allocate it, you obviously cannot manage it well.4

Corruption is an outgrowth of bad governance, not a cause of it, and is the greatest single impediment to effective management of public financial resources. Conversely, improvements in PFM are at the center of the struggle against corruption. Preventing corruption in financial management must therefore be the priority, especially in countries that, from past civil conflict or other reasons, have extremely weak revenue forecasting and cash management systems.

As reviewed in Chapter 1, most African countries regrettably score low to very low for public integrity, except for the Group of Eight best governed countries. The “G-8” includes Botswana, Cape Verde, Ghana, Mauritius, Namibia, Sao Tome and Principe, Seychelles and South Africa.5 The good news is that public integrity appears to have improved over the past decade for most of the African countries that do not suffer from severe internal security problems. Also, image tends to lag behind reality, and the positive changes in public expenditure management of recent years in many countries will soon be reflected in more favorable international perceptions, including the Transparency International ratings. Yet, corruption remains the bane of most African economies and a heavy burden on the average African citizen.

In a few African countries, the source of corruption is regrettably simple: public resources are appropriated for personal use by the ruling elite. No analysis is needed or reforms possible short of a major systemic change in the quality of governance. In most other countries, improvements are possible and should be focused on the public financial management areas in which corruption problems are especially widespread: extractive resource revenue, large public works, tax administration, customs, public procurement, and local government. The issues of extractive resource revenue were addressed in Chapter 3, and in low-income countries issues of corruption in public investment are intertwined with issues of aid management and the fiduciary responsibility of donor agencies, which were discussed in Chapter 11. Below we focus on the other four main sources of corruption in PFM systems.

Tax administration
In domestic taxation, the problem of corruption may be masked by the apparently reasonably good “fiscal marksmanship” on the revenue side (that is, the close correspondence between revenue actually collected and revenue forecast at the beginning of the fiscal year). The forecasts of tax revenue may appear reliable both in relation to previous years’ revenue and in relation to tax revenue actually collected. However, the right question when looking at public financial corruption is not whether actual revenue is close to the estimated amount, but whether it is reasonably close to the potential revenue that should be collected on the basis of the tax rates and the profile and number of taxpayers. Sometimes, even the number of taxpayers is not known with certainty. Such ignorance is convenient, because it precludes the estimation of potential tax revenue and hence permits avoiding the question of whether actual revenues are anywhere close to the potential and, if not, why. In these cases, the first reform priority is to conduct a comprehensive census of all taxpayers and, on that basis, to re-estimate potential tax revenue. The taxpayers’ census and the results of the estimates of potential tax revenue should be made public, and include disaggregation of the potential-actual revenue gaps between the different forms of taxation and between different groups of taxpayers. The focus should first be on large taxpayers. A second necessary reform is to introduce a single identifying number for taxpayers, to combat tax evasion.

Customs
Customs duties are the oldest form of taxation, owing to the simplicity of collection when goods
cross the protected state borders. Other than smuggling, which is largely a law enforcement issue rather than a corruption issue, the main tried-and-true corruption techniques in customs are: falsification of certificates of origin; deliberate misclassification of the imported item into a lower-tariff category; abuse of exemptions and exonerations; outright manufacture of false documents; and, when the exchange rate is out of line with market conditions, under-invoicing of imports. When problems of corruption in customs are widespread, even a cursory look at the volume of imports and their composition will reveal a large undershooting of customs revenue officially collected compared to the revenue to be expected.

Corruption in customs is an especially hardy weed. The single most effective anticorruption measure would be to drastically reduce the exemptions regime and make the tariff rate structure more uniform. Other avenues of improvement may include reducing individual discretion by greater use of electronic technology. However, the introduction of information technology without complementary changes in the incentives framework has proven to be ineffective, not only in customs, but also in public sector management in general. The same is true of better training of customs officials, when the issue is not their insufficient skill but dishonesty combined with inadequate oversight. Changes in the incentive framework may include giving more authority to lower-level customs officers to make routine decisions, thus limiting the excessive involvement of higher-level officials. A bonus system linked to actual customs duties collected may perhaps also be considered.

However, all of these measures have a spotty record of success and carry risks as well as potential benefits. In particular, bonuses to customs collectors (like all tax farming) generate abuses of power and destructive competition for the jobs to which they are attached, thus eroding government legitimacy. Cleaning up customs has proven a tough challenge in every country. In general, reducing the occasions of face-to-face contact between traders and customs officials serves to shrink the opportunities for bribery and extortion. Careful consideration of all implications is needed before any action is taken, and a package of modest, mutually reinforcing measures has proven more effective than searching for a “magic bullet”.

**Procurement**

Lack of integrity in the procurement process is a major problem of public financial management in all countries and at all levels of government and administration. Corruption can occur mainly: when regulation is excessive, unclear, or not accessible to the public; the bid documents are poorly drafted or ambiguous; the specifications and standards are not clear; and contract monitoring is loose. The following practices are most frequently used to extract bribes:

- tailor the bid specifications to benefit particular suppliers or contractors;
- restrict information about bidding opportunities only to some potential bidders;
- claim urgency as an excuse to award the contract on a sole-source basis;
- give “preferred” bidders confidential information on offers from other bidders;
- disqualify potential suppliers through improper prequalification or excessive bidding costs; and
- collude directly with the bidders or outside influences to distort the entire process.

However, the most direct approach to bribery is to avoid competitive bidding altogether, and manage to have the contract awarded to the desired party through direct negotiations and without any competition (sole-source contracting). Frequently, special urgency is alleged to justify exemptions from the rules against sole-source contracting. Even when the urgency of the purchase is genuine, however, the source of the timing problem is most often found in inadequate procurement planning.

It should not be assumed that corruption in procurement is exclusively associated with budget execution. Collusion can begin with the process of budget preparation. For example, a favored bidder can be told in advance that the budget will include a particular item, at an inflated cost.
estimate, and the item specifications. After the budget is approved, the bid announcement can specify a very limited time for submissions—with the favored bidder able to submit in time owing to his prior knowledge of the specifications and date of the announcement. The problem is especially difficult to detect because an ex-post audit of the bidding process and contract award will not show any violation of procurement rules.

After the contract is awarded, other bribery opportunities arise during the execution phase—deliberate failure to enforce standards, agreeing to pay for shoddy construction or delivery; accepting fictitious claims of losses; permitting "low-balling" (accepting artificially low bids, which are then jacked up by mutual consent); unduly delaying payments, etc. But by far the easiest, quickest and most profitable form of corruption in public procurement or works is simply to not deliver the goods or build the works. In countries with weak accountability systems, very low administrative capacity, or widespread systemic corruption, it is not a difficult matter to falsify delivery documents or certificates of work completion. It is in this area that citizens’ feedback can be a particularly powerful weapon against corruption. The farmer who still gets wet when crossing the river is best placed to know that the government bridge was not built, regardless of what the paperwork says.

Problems in public procurement, arise mainly in bulk purchases of goods, because corruption in large public works is limited (although not eliminated) by the direct oversight of the external donors who fund most large projects in African countries, owing to the limited domestic resources of the government. In purchases of goods, the extent of the problem is illustrated by the frequency of sole-source contracting, notwithstanding legal provisions in most countries specifying in detail the circumstances in which sole-source procurement can be permitted. The direct result is gross overbilling of the government, with documented cases of goods and services for government use purchased for between 10 to 20 times the international price, and repeated purchase contracts given to the same individuals. The indirect result is the draining away of financial resources from operational and maintenance expenditure needed to perform the ordinary functions of government.

Even when procurement is formally on a competitive basis, the rules can be easily sidestepped. A typical mechanism works as follows. An "understanding" is reached between the public official and the private "partners" to supply a certain amount of a commodity or a service at the (inflated) price to be officially charged. The corresponding expenditure is then introduced by the public official into the government budget. After budget approval, the tender is subsequently tailored to make the private partner appear most qualified and is also launched with a timetable too short to give potential competitors enough time to submit their bids, except, of course, for the private partner, who had months of advance warning.

In a few countries, procurement laws and rules are inefficient or obsolete, and the reform priority is obviously to modernize and improve them. However, the attention given by donors to reducing fiduciary risk and the requirements of the Heavily Indebted Poor Countries (HIPC) initiative’s process for debt relief have led most countries to introduce sound procurement legislation and standards. Corruption comes from lax enforcement and violation of the rules. Where procurement laws and formal procedures are generally adequate, the main recommendation on how to fight corruption in procurement is self-evident: enforce the law. Equally evident is the locus of responsibility for doing so: the ministry of finance, which has the legal authority in all countries to approve all state expenditure. The ministry of finance is also the sole organ that can prevent the previously described procurement corruption scenario through improved scrutiny of expenditure proposals. Finally, the budget documentation should systematically include a report on questionable major bulk purchases made during the previous fiscal year. Naturally, uprooting corruption in the ministry of finance itself is fundamental.

Local government and petty corruption

One should not look for public financial irregularities only in central government. In most
countries, including in Africa, local governments and municipalities are also a source of the problem, with bribes required to obtain most services, permits, certifications, or licenses. The magnitude of corruption may be less, but its effect on the everyday life of citizens may be heavier. The issue of corruption in local government is given added emphasis by the current efforts of donors to support decentralization initiatives.

One useful pointer, among others, is to look at the local government budgetary allocation for “travel”, “information gathering”, and “entertainment”—easy sources of illicit cash in conditions of inadequate expense recording and monitoring. But, in general, the issue of petty corruption cannot be tackled successfully by prosecuting a few small malefactors. When, as in many African countries, badly inadequate government salaries are a reason or an excuse for bribery, corruption must be addressed in the context of a comprehensive reform of the civil service that would provide a living wage to lower-level employees and adequate market-related compensation to higher-level officials. However, doing so in isolation would simply produce better-paid crooks. Thus, a salary review and increase must be preceded—or at least accompanied—by credible strengthening of the performance monitoring and accountability mechanisms, with swift and certain penalties for malfeasance, especially for higher-level personnel.

The entry points

The two main avenues to begin improving public financial integrity are found at the very start of the budget process and at its end. Ex-ante, to begin addressing corruption in procurement, the ministry of finance could exert closer scrutiny of expenditure proposals before the inclusion in the budget to determine the soundness of the proposed procurement, the need for and expected use of the goods, the unit price, the availability of budget funds, and the tendency toward respect for legal requirements. This scrutiny could be accompanied by a procedure for spot-checking smaller proposed contracts to prevent contract splitting. Ex-post, as Aristotle recommended 23 centuries ago, a strong and independent external audit function is important: “Some officials handle large sums of money: it is therefore necessary to have other officials to receive and examine the accounts. These other officials must administer no funds themselves ... we call them inspectors or auditors.”

In the medium and long term, a variety of additional reforms are needed, depending largely on the characteristics of the specific country. There is no magic remedy for corruption in public financial management, no guarantee that progress in any one area will be irreversible, and no approach that is exactly suitable to all countries. Nevertheless, the generally effective efforts in anticroruption follow the broad example of the Hong Kong, China, independent commission against corruption, which emphasized three concurrent efforts—awareness raising, prevention, and enforcement. Like the three legs of a stool, each of the three efforts is necessary; none is sufficient alone in the long run. Prevention and enforcement cannot succeed if corruption is viewed as normal or inevitable, awareness and strict enforcement cannot be effective if the opportunities for corruption are too many and too easy, and limiting opportunities for corruption combined with awareness may be equally ineffective if enforcement is lax or nonexistent.

Major exceptions exist. “Stroke-of-the-pen” reforms abolishing key controls (for example, on prices and exchange rates) can instantly eliminate a major opportunity for corruption. Unifying dual exchange rates at a market-clearing level, for example, removes all possibilities of obtaining foreign exchange at the official rate only to sell it on the black market at a higher rate—the single quickest, cheapest and most effective form of corruption. Or, enforcement may in some cases be the urgent priority. Beyond the immediate effect, however, concerted action on all three fronts is necessary if official corruption is to be reduced across the board in a sustainable manner.

In low-income African countries, where reliable data are notable for their absence, the awareness-prevention-enforcement model needs to be adapted and expanded into five major avenues of reform and intervention:
Find the detailed facts about the loci and circuits of financial corruption, through surveys, targeted expenditure tracking, and other means.

Disseminate the knowledge, and enlist civil society to shed light on bribery problems and blow the whistle.

Prevent corruption through appropriately streamlining the regulatory framework.

Strengthen enforcement, beginning with the highest levels of officialdom.

Build the capacity of public financial accountability institutions.

The challenge of reform sequencing

Since it is impossible to reform all aspects of a complex system at once, it is evident that PFM reforms must be “sequenced” in some fashion. Clearly, reforms should be advanced as fast as possible when circumstances permit, and as slowly as necessary to permit accountability to catch up, capacity to grow, or public consensus to be built. I have suggested elsewhere (Schia-vo-Campo and McFerson, 2008) that the motto of the reformer should be “torto-hare”. This was the slogan—tarta-lepre in Italian, combining tortoise (tartaruga) and hare (lepre)—coined by the Italian traffic police in the 1960s to describe optimal driver behavior: drive fast or slow, but always depending on the circumstances. The worst approach to driving in erratic traffic and poor visibility is to go on cruise control, whether at high or at low speed. The reform sequencing challenge is thus to identify the areas where it is feasible to move very fast, and the areas where it is essential to build slowly a solid institutional foundation, and even occasionally to effect tactical retreats. This is especially true of PFM reforms, with their heavy component of institutional change.

It is also evident that any such sequencing must take into account the specific country realities. The difficulty arises when attempting to identify a sequence of improvements that is valid in all situations, albeit still adapted to each country. Attempts at identifying a universal sequence of reforms are not only unrealistic, but also undesirable because they carry the twin assumptions that the sequence is both linear and unidirectional. But progress moves in ellipses, fits and starts, slippages and occasional reversals.

On balance, the capacity issue underlined in the next and last chapter strongly recommends to (i) focus on the basics and (ii) gradually introduce improvements in the PFM systems as and when the government is willing and able to do so—in the spirit of the approach to PFM reform adopted, among other countries, in Ethiopia (Box 16-1).

Partly in reaction to the failure of isolated PFM measures, a “platform approach” to reforming public financial management was elaborated by Peter Brooke (2003) in the aim of identifying a set of “platforms” of interrelated reforms, on which a country can progress from one platform to the “higher” one, and so on. The approach has been adopted in a number of countries, in varying ways, but has been criticized by many (e.g., Allen 2009) as an overly prescriptive one-size-fits-all model. (Also, the analogy to building construction is as inapplicable to social processes as it is attractive.)

The aspects of the argument are too many and too technical to be discussed here. The consensus appears to be as follows. On the one hand, the interdependence of the various aspects of a PFM system demands consideration of the complementary measures required for the success of a particular reform. In this sense, one should seek to identify a “package” of measures, and not only focus on individual targets of opportunity. On the other hand, there is no single and universally val-
id sequence of reform “packages” any more than there is a specific lock-step sequence of individual reform measures. While agreeing on the need to eschew isolated reforms and to assemble reform packages, no two persons are likely to agree on the exact content and number of reform “platforms”. Thus, there isn’t a platform approach. There are as many platform approaches as there are public finance economists and ministers of finance, sequenced in as many different ways as there are countries with different problems.

Thus, while adopting the valid spirit of the platform approach, the conclusion remains to identify and support those particular packages of reforms that are appropriate and feasible in the specific country, and of course, can command genuine ownership rather than lip service or benign neglect by the government. By and large, in low-income, limited-capacity countries, those packages should focus on the basics of PFM.

It is well to stress, however, that even PFM reforms that appear well consolidated need constant surveillance, because they can always degrade. A focus on the basics does not mean achieving a basic improvement and storing it away. The PFM system as a whole needs constant oversight and maintenance—just as valuable physical assets do.

Box 16-1

**Budget Reform in Ethiopia**

In the late 1990s, Ethiopia adopted a gradual approach to PFM improvements, on the premise that budget improvements must reflect the stage of evolution of the financial system.

The first building block of budget reforms was to strengthen the line-item budget, to promote effective expenditure control, necessary because decentralization was moving budget responsibilities to lower administrative levels with little or no experience in budgeting. Furthermore, because the accounting system does not provide prompt reporting, the budget performs a critical role in financial control through the system of monthly request and disbursement, which is based on the budget allocation and chart of accounts. For all this, it is essential to retain line-item budgeting.

The second building block was the improvement in the management of external assistance, by specifying in the budget the specific external source of funding and the amount by line-item of expenditure. The priority was on adopting capital budgeting, rather than trying to move to an integrated capital and recurrent planning process.

The third building block was to improve the composition of expenditure.

The approach has been criticized for “insufficient ambition”. Yet, the conditions on the ground and the state of development of the Ethiopian financial system at the time made the approach the only realistic one. A more ambitious approach would have been unsuited to the country circumstances and hence, by definition, the wrong approach. The test of a sound reform is not its “ambition” or “attractiveness”, but its lasting results in terms of improving budgetary outcomes. The underlying issue in the country relates to governance weaknesses, not to the appropriateness of the PFM reform approach.

**Source:** Adapted from Peterson, 2000.
Improvements and reforms in the major PFM areas

The following attempts to give general suggestions on the sequencing of reforms that may be appropriate to improving PFM systems in African countries. However, these suggestions are only a starting point rather than firm recommendations valid for all African countries—except for the first priority to protect the money and fight corruption. The menu of options and possibilities for improvements in the various aspects of PFM is based on the material presented in the earlier chapters, but is not intended to be fully comprehensive. Other measures may be necessary and feasible. These options for improvements are listed in order of importance, beginning with the most basic ones, but without any intention of suggesting a rigid reform sequence. The actual sequencing of reforms in a particular country will depend primarily on their political feasibility and on the capacity to implement them effectively.

The legal and organizational framework for PFM

Weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility lead to inefficient budgeting and perverse outcomes. The legislative and regulatory framework for budgeting and policy formulation should be explicitly designed for three purposes:

» Clarifying roles and accountabilities;
» Enabling coordination and cohesion in decision making;
» Keeping political decisions at the right political level and thereby avoiding both technical intrusions into policy choices and undue political interference into technical programming and budget execution.

The locus of overall public financial accountability resides in both the executive branch and the legislative branch of government. Hence, in the legal area the basic priorities include the following:

» As the obvious first step—too often disregarded by outsiders—examine the country’s Constitution to assess whether the actual PFM processes deviate from it, as well as to make sure that eventual recommendations for improvements are not inconsistent with the Constitution. (Few things are more futile or more insulting to a legitimate government than recommending PFM changes that would require a constitutional amendment.)
» Next, ascertain that proposed budgetary reforms are consistent with the existing or- ganic budget law or equivalent, and if not flag the legal amendments the reforms may require.
» Verify that the legal framework stipulates that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or amendments.
» Seek information on how expenditure policy decisions are made at the political level (see Chapter 2).

Attention should be given in particular to the strength and effectiveness of the executive mechanisms for policy making and the legislative role in budgeting, by the following measures:

» Assess the political mechanisms for policy coordination and strategic decisions, and make appropriate recommendations based on experience elsewhere that are consistent with the political structure and context of the country with cabinet offices, government secretariats, and similar policy support bodies.
» Give the legislature adequate information and means to review policies and the budget.
» Present the budget to the legislature on time, to allow for proper scrutiny and com-
completion of the budgetary debates before the start of the fiscal year.

- Review revenue forecasts, expenditures, and fiscal targets together.
- Evaluate the appropriateness of limits on the powers of the legislature to amend the budget (for example, a pay-as-you-go provision, by which any amendment that increases expenditures or decreases revenues must be accompanied by a counterbalancing measure to maintain the initial deficit target).
- When appropriate, consider fiscal responsibility provisions (see Chapter 3), whether through formal legislation or other means.

### Revenue forecasting

Good expenditure management always begins with realistic forecasts of revenue. Indeed, without a reliable idea of the resource constraint, all planning is an empty paper exercise—and budgeting is no exception. Accordingly, the basic priorities are:

- Examine on an annual basis the historical differences between actual revenue and budgeted revenue, and unpack the deviations for each source of revenue.
- Consider a “mechanical” adjustment in revenue forecast for the next budget year corresponding to the average differences in a few prior years.
- Set in motion a ministry-by-ministry review of the historical accuracy of their revenue forecasts.
- Ensure that the database of taxpayers is accurate, or if not, conduct a census to establish an accurate database; and on that basis estimate potential revenue and compare that estimate with actual revenue.
- Introduce a single identifying number for each taxpayer.

Subsequently, systematic attention can be given to improving “fiscal marksmanship”:

- Improve the methodology of revenue forecasting, tax by tax and nontax revenue by nontax revenue.
- Examine realistic possibilities for more advanced automation and more timely communications through information and communication technology.
- Establish appropriate institutional rewards for greater accuracy in revenue forecasting.

### Budget coverage and budget systems

In budget coverage, basic priorities are

- A reasonably comprehensive coverage of the budget;
- Inclusion in the budget documentation of all revenues and expenditures of extra-budgetary funds, in gross terms;
- An expenditure classification system that covers all government expenditures, including those of extra-budgetary funds;
- Disclosure of all policy decisions that have an immediate fiscal effect, such as tax expenditures and quasi-fiscal expenditures, and of those entailing fiscal risk, such as loan guarantees and other contingent liabilities.

Subsequently, improvements can include the following:

- Put in place instruments for better assessment of fiscal impact of actual liabilities, contingent liabilities, and policy commitments with major expenditure implications—in the context of some form of multiyear expenditure perspective (discussed in the next subsection).
- Review options for the gradual elimination of unjustified extra-budgetary funds and incorporation of their activities into the normal budgetary allocation process and for improved transparency and governance of extra-budgetary funds that will continue to exist.
- Develop special management arrangements for some expenditure programs (for example, user chargers and service delivery agencies) that can improve their operational efficiency without weakening expenditure control and accountability to the legislature.
- Strengthen line-item budgeting and expenditure control while improving flexibility by: (a) reducing an excessive number of line items, (b) providing greater discretion for transfers between items, or (c) both.
» Set up a classification of expenditure by activity and program, to allow the definition of the right performance indicators at an appropriate level, although without introducing formal program or performance budgeting systems. This classification can and should be selective, by focusing on the definition of programs of major economic and social significance, and should complement—rather than replace—the line-item classification.

» Examine the various possibilities of strengthening the performance orientation of the budget system short of abandoning cash-based line-item budgeting—for example, by identifying expenditure programs of key economic or social interest and systematically reviewing results in the context of annual budget discussions.

Multiyear fiscal and expenditure perspective
To strengthen the link between policy and the budget, and because the discretionary expenditure margin on a year-to-year basis is typically very small, the annual budget preparation should be framed by a multiyear perspective. This perspective requires, as basic priorities, the following:

» A set of medium-term macroeconomic projections, even if at a highly aggregated level, showing the interrelationships among the balance of payments, the fiscal accounts, real sector developments, and the monetary accounts;

» Within the above, a medium-term fiscal framework consistent with fiscal sustainability (that is, stabilizing the ratio of debt to gross domestic product while providing adequate resources for priority economic and social expenditures) and with realistic revenue forecasts;

» Aggregate expenditure estimates, based on realistic estimates by functional category and broad economic costs of major programs.

Investment programming
As discussed in Chapter 8, PIP improvement priorities include the following:

» Design ironclad procedures against the birth of “white elephant” projects. Once a project of large size is on the drawing board, the bureaucratic dynamics from both donor and recipient sides make the project very difficult to stop. Among these procedures, the involvement of high-level policy makers (and, for very large projects, the cabinet) must be built in at a very early stage.

» Also basic is the need for reasonably sound economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable to sophisticated ones. Also, selectivity is needed: only projects of significant size should be analyzed in detail, with smaller projects bundled and the bundles evaluated only for their general correspondence with sectoral policies and common sense.

» No project should be included in the PIP, even for the out-years, unless financing is reasonably assured.

» An agile procurement process that permits managerial efficiency while minimizing the opportunities for corruption is needed.

» Also needed is effective physical monitoring of project implementation and completion. Obtaining systematic feedback from local entities can be extremely useful to strengthen monitoring of project progress and completion.

» A realistic procedure and a minimum capacity for estimating the total cost of investment projects and their recurrent costs are essential. This priority is always preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process, and of the broader medium-term expenditure framework. Conversely, the experience gained through these forward estimates of recurrent costs of investment projects can be invaluable for the eventual move to a comprehensive multiyear program.

» Finally, setting up a technical “kick-the-tires” group, responsible to the core ministry of finance or planning but with full operational
autonomy, can be useful to ascertain that line ministries have followed the required procedures in preparing and appraising large projects and to give clearance for the inclusion of such projects in the investment budget. (One contemporary example of such a technical group, in Algeria, was described in Chapter 8, box 8-1.) Although the country’s income level and other characteristics differ from those of most Sub-Saharan African countries, some features of the Algerian technical group are likely to be generally applicable.

Budget preparation
In this area, as discussed in Chapter 9, the basic priorities are as follows:

» Set and announce the aggregate expenditure envelope and spending “ceilings” for each line ministry and spending agency (these ceilings can be “soft” and only indicative in a first stage) in order to begin to build the fiscal discipline habit. They can progressively be hardened as time, data and capacity permits.

» The ceilings for each spending agency can be defined at first on an incremental basis but strictly consistent with the overall availability of resources (see the previous discussion of revenue forecasting), and included in the budget circular that sets the process in motion). 

» Assess coordination problems in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from extra-budgetary funds, and so forth).

» In countries where responsibilities for capital budgeting are separate from those for the current budget, as an initial priority require joint reviews of the two components of the budget at each stage of budget preparation and at each administrative level.

» Pay some attention to budgeting capacity in at least one or two line ministries rather than only in the core ministries of finance and planning, and begin selected budgeting capacity-building activities in those ministries—monitoring the results to replicate and scale-up the capacity building to other ministries.

» In the review of budget proposals, the most fundamental needs are to ascertain the correctness of the payroll of government employees, establish provisions for maintenance of the database, and build strong safeguards against fraud and error (as shown in Box 16-1 for Liberia).

» Provide support to the legislature in its role to debate and approve the budget.

Subsequently, strengthening budget preparation requires the following:

» Progressively “harden” the expenditure ceilings for ministries and agencies, and eventually refuse to even consider budget proposals that exceed the ceiling in any amount.

» Devise positive budgetary incentives for ministries that submit more timely multi-year cost estimates of ongoing policies and programs better linked to sectoral government policies.

» Establish and enforce rules for better cooperation between the core ministries of finance and planning (or the different departments in a unified ministry) and for coordination between the core ministries and the line ministries.

» Review distribution of responsibilities in budget preparation and the structure of controls with a view to giving the line ministries sufficient authority to formulate their programs and making them accountable for implementation.

» In aid-dependent countries, pay more attention to the programming of expenditures financed with external aid, and review the budget as a whole, regardless of the source of financing (even though the project approach adopted by donors creates a tendency toward fragmentation in budgeting).

» Strengthen further the legislative committees with budget responsibilities.

» Seek appropriate participation of civil society in budget preparation, beginning with the customary legislative hearings.

» Explore practical ways to foster capacity in the media to understand, question, and explain the government’s public policy and financial management decisions.
Budget execution

As explained in Chapter 10, an unrealistic budget cannot be executed well. Thus, improving budget preparation is in many ways a prerequisite for improving budget execution. However, it is quite possible to execute badly a well-prepared budget; good execution is not automatic. Given a realistic budget to begin with, the following measures ensure conformity with the budget and expenditure control:

» Formulate a cash plan, conforming with the budget authorization and taking into account ongoing commitments, that is based on seasonality of actual revenues and expenditures and is progressively more detailed on the basis of experience.

» Release funds on a timely basis consistent with the cash plan.

» Put in place adequate cash management mechanisms, providing, first, for centralization of cash balances (not necessarily of payments) to prevent large idle balances and,
eventually, for a more sophisticated system to maximize the returns from government cash and minimize borrowing costs.

» For payments, in African countries where the payment system is in disrepair (mainly post-conflict countries) a centralized treasury system may need to be built from scratch. (Such a system is already in place in almost all francophone countries and about half of Anglophone countries.) In other countries, centralized or decentralized payments may be appropriate, depending on the geographic distribution of the payments offices, the banking and telecommunications infrastructure, and the possibilities offered by information technology.

» Introduce effective controls at each stage of expenditure (commitment, verification, and payment), at first with direct oversight by the ministry of finance and progressively relying more and more on internal controls in the spending ministries.

» Set clearly defined procedures for registering commitments. (These procedures can be simple and don’t require extensive computerization or accounting changes)

» Centralize monitoring of financial transactions.

» Establish transparent and efficient procedures for procurement and, where they already exist, improve their enforcement.

» Strengthen debt management, at first by ensuring timely tracking of borrowings and repayments (on accrual basis) and eventually on a more sophisticated basis to minimize debt service costs and reduce fiscal risk. (For African countries that received large debt relief through the extended HIPC process and expect future assistance, largely as grants, the debt management capacity need not be large.)

Subsequently, after expenditure control is in reasonably good shape, operational efficiency and effectiveness in budget execution can be improved:

» Introduce more flexible rules for virement (transfers between line items) and regulated carryover provisions, especially for capital expenditure.

» Progressively decentralize controls (after a reinforcement of procedures for auditing and reporting).

» Gradually introduce clear, simple performance indicators for major expenditure programs capable of being monitored, with maximum feasible participation by frontline civil servants and service users and feedback into the budget preparation dialogue, not a mechanistic link between results and funding. (The critical issue of performance measurement and monitoring is discussed in some detail later in this chapter.)

» Most important, create new opportunities for participation and systematic public feedback on the integrity and quality of expenditure.

**Accounting, reporting, and audit**

Financial accountability requires independent scrutiny, which in turn depends on timely and reliable accounting and financial reporting. The emphasis should be on strengthening cash accounting, ensuring simple and regular financial reports, building reliable management controls, and ensuring the effectiveness of the external audit function. In all cases, improve as much as possible on the existing procedures before jumping to more complex systems.

**Accounting and reporting**

The basic priorities include the following:

» The cash-based accounts must be clear and prepared on a timely basis.

» Move from single to double-entry bookkeeping.

» In countries that monitor only payments, introduce a commitment register and an ancillary book for outstanding payments.

» Prepare regular reports on debt.

» Report on operations of extra-budgetary funds on a consolidated basis, following the same classification.

» Loan guarantees should be individually recorded, and statements prepared and published, including amounts and beneficiaries.

» Basic financial statements should be published, in a form accessible to the public or...
at least the media. (In most countries, substantial assistance to the media is likely to be needed, to raise their capacity, integrity, and professionalism.)

Subsequently, the following measures can be considered:

- Recognition of all liabilities (including pensions and other entitlements);
- Systematic registration and publication of contingent liabilities;
- Introduction of modified accrual accounting by also recognizing all financial assets (but not all physical assets);
- Construction of selective physical asset registers, focusing on categories of assets that are both valuable and at risk of wastage or theft, and thereafter monitoring their use and including it in the context of the dialogue on preparation of the next budget.

When (and only when) the enumerated reforms have been implemented and tested and are on a solid basis can one consider a move toward accrual accounting and the accompanying financial reporting be considered. For several high-income countries, most middle-income countries, and all low-income countries, a possible net benefit of moving to accrual accounting lies in the very distant future, owing to the very high costs and implementation requirements, and questionable benefits in terms of the essential budgetary outcomes of expenditure control, strategic resource allocation, and operational effectiveness. Even at that future time, accrual accounting should be implemented very gradually and in stages, beginning with agencies in which the need to assess full costs is more urgent.

**Internal audit**

Internal audit is frequently misunderstood as an additional layer of financial control by the ministry of finance over the line ministries. Indeed, several francophone African countries still follow the old French practice of placing financial controllers from the ministry of finance in each line ministry. But properly understood, internal audit is a management support function, aimed at reporting to and advising the head of the agency on the soundness of the internal accountability mechanisms and financial control systems in the ministry or agency. Therefore, internal audit capacity can most usefully be developed only in countries where the system of financial controls is already reasonably solid and in place. It makes no sense to invest time and effort to set up a capacity to advise on weaknesses and risks of financial control systems when those systems do not exist. Nevertheless, from lack of easy opportunities for meaningful improvements in other parts of the PFM systems, some donors have encouraged the introduction of internal audit units in countries where the priority is to establish control systems in the first place.

This does not at all preclude introducing an inspection function to guard against corruption, nor initiating internal audit in specific ministries that administer specific programs of major importance. Also, it is possible to consider establishing a small unit in the ministry of finance to elaborate the standards, parameters and modalities of internal audit, in preparation for a future time when control systems will be in place and internal audit will therefore become relevant.

**External audit**

As noted, the fundamental criterion of financial accountability is that the resources must be spent by the executive branch of government in conformity with the budget approved by the legislative branch. External audit closes the legitimacy loop in PFM, by providing the legislature with information concerning the uses of the money that it had authorized. Therefore, the key requirements of effective external audit (whether through a court of audit as in Francophone African countries or an auditor general’s office as in Anglophone African countries) are:

- Independence from the executive branch;
- Reporting to the legislature;
- Total freedom of access to public financial information;
- Predictable source of funding;
- Full management and operational autonomy;
- Adequate internal capacity.
Accordingly, strengthening the supreme audit institution is a critical component of PFM reform. In many African countries some of these requirements are met but not others—in some cases for acceptable reasons of gradual progress and maintenance of due process. (It may be acceptable on a transitional basis to have the external auditor report to the head of the executive branch rather than the legislature.) However, countries must continue to make steady progress toward meeting all of the requirements for robust external audit. Technical assistance for this purpose can usually be obtained from the International Organization of Supreme Audit Institutions (INTOSAI) or by “twinning” the external audit entity with that of an industrial country.

The external audit entity, too, bears responsibility, not only to function with integrity and courage, but also to focus its limited capacity on the priority problems in the country. Thus, as a general rule, considering the state of affairs in public financial management in many African countries, external audit should focus on financial integrity and compliance. Value-for-money issues should be addressed only if and after financial and compliance audits are on a solid basis and corruption ceases to be a major concern. However, efficiency audits of specific programs of major economic or social importance can take place, preferably subcontracted to specialized firms, although under the guidance and leadership of the country’s supreme audit institution.
NOTES

1. The World Bank’s 1989 public expenditure review for Madagascar (Madagascar: Public Expenditure, Adjustment, and Growth) was the first to include a major institutional component.

2. As protection, when a country has significant disagreements with the PEFA assessment, it can refuse to consent to publication of the PEFA report—in which case the report is kept by the lead agency in strict confidentiality. In low-income countries, however, this generates a presumption that serious problems have been identified in the country’s public expenditure and financial accountability systems—which creates a negative image with adverse consequences. Middle-income countries can more easily hold to their position on the merits without necessarily creating image problems for themselves. Low-income countries are therefore under substantial practical pressure to give ground, and allow publication of PEFA reports, even when the government considers that the assessment is incorrect in certain material ways. Evidently, this is not a problem of the PEFA assessments or methodology itself, but yet another caution that deserves being raised.

3. For example, more public spending on health reduces child mortality only where governance is good (Wagstaff and Claeson 2004). Similarly, investing in roads in Africa does not in itself reduce transport costs in a lasting manner in the presence of governance and regulatory problems. Instead, the elimination of barriers to entry in road transport, by closing corruption opportunities, can lead to major reductions in transport costs without additional investment in maintenance or construction, as in Rwanda (Teravaninthron and Raballand 2008).

4. A recent International Monetary Fund study (Diamond and others 2006: 8) lists among the major weaknesses in governance that have caused problems in PEM in Africa the failure to “restrain politicians and senior bureaucrats from benefiting personally from lax fiscal controls”. That study, covering in some detail 10 Anglophone African countries, concluded that the record of budget reform had been comparatively good in Tanzania and Uganda, disappointing in Kenya and Zambia, and mixed in the other six countries (Ethiopia, The Gambia, Ghana, Malawi, Nigeria, and Rwanda).

5. See the Transparency International Web site, http://www.transparency.org. Transparency International’s Corruption Perceptions Index measures the degree to which corruption is perceived to exist among a country’s public officials and politicians. It draws on several surveys of opinions of business people and analysts, and it covers 159 countries (no reliable data are available for the other countries).

6. Even the UN Development Program’s Automated System Customs Data Administration (ASYCUDA), praised as good practice and used in almost 100 countries, has been highly effective in only one-third of the countries, and wholly or partly ineffective in the remainder.


8. The commission was highly successful and, over a few years in the 1990s, turned Hong Kong, China, from one of the most corrupt administrations to one of the most honest in Asia—second only to Singapore.
Chapter 17:

Capacity Development: The Critical Link
What to Expect

This very brief concluding chapter highlights the importance of a coherent and comprehensive treatment of public financial management issues, and the potential contribution of this book as a platform for policy dialogue between African governments and their development partners and as a vehicle for development of capacity in all its different dimensions, including training.

The basic issue

Without sufficient institutional, administrative, technical and human capacity to implement them, the best reform programs and carefully designed measures are hardly worth the paper they are written on. A PFM reform strategy paper—indeed, any strategy paper—is just a paper, not a strategy, unless it addresses convincingly and realistically the questions of how the reforms are to be implemented, with what resources they are to be implemented, when they are to be implemented and, most importantly, by whom they are to be implemented. In all developing countries, including African countries, the issue of capacity building stands left, right, and center of the policy dialogue agenda. Yet, budget reform programs have been too often designed and pushed onto African countries’ governments with no attention to implementation requirements, no consideration of all the other commitments the civil servants have to meet, and obliviousness of the red tape and transaction costs imposed by the reforms on the public administration. The overriding lesson of international experience in PFM reform in developing countries is the imperative to tailor the reforms to local institutional and administrative realities, and build capacity alongside with the gradual implementation of the reforms.

As previewed in Chapter 1, capacity development is much more than training. It includes also development of institutional capacity, i.e., a move to a more efficient framework of rules and norms; organizational capacity, i.e., a better structure within which to implement the institutional rules; and information capacity, i.e., the design and implementation of information systems appropriate to local needs and circumstances. Training is necessary but not sufficient: undertaken in isolation, training cannot achieve sustainable capacity development.

Regrettably, experience over the past 50 years shows a troublesome supply-driven dynamic at work, whereby external technical assistance and some international consultants have often pushed complex new budgeting practices onto a reasonably well-functioning system and thus created capacity constraints where none may have existed. In turn, these “capacity limitations” are then used to justify the need for large training programs and continued assistance, requiring involvement by the advocates of the new practices. Moreover, the lending pressures to which many donor agencies are subject lead to an incentive to invest in expensive works and hardware. This has been particularly the case of systems for information and communication technology, which allow substantial disbursements of aid at a much lower per dollar administrative and supervision cost than good technical advice and institutional support—even when the latter are much more important for improving the effectiveness of public sector activities.

Informatics and communication capacity

The monumental change wrought in every field by information and communications technology (ICT) is still only in its initial phase in African
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developing countries. The subject is too vast to be adequately discussed here, but certain considerations are generally applicable:

» ICT is a tool, immensely powerful yet essentially no different from a photocopier or a bulldozer in the sense that the needs and requirements of the users must dictate whether and how the ICT tool should be used. For certain functions, a pencil, a telephone, a face-to-face meeting, or a visit to the document center is far more effective than computers or the Internet. This obvious point must be stressed, because some observers have argued that ICT innovation is now largely supply and marketing driven rather than dictated by the needs and requirements of the users. Therefore, assessing realistically the costs of a given ICT change and comparing it with the benefits expected are essential.

» Neither the ICT “techie” nor the budget manager should work in isolation from each other. As noted, improvements in effectiveness stem largely from better rules and organization in the entity concerned. On the one hand, to apply advanced ICT to obsolete or inefficient rules and processes means in effect to computerize inefficiency. Doing the wrong thing faster is not progress. On the other hand, the absence of technical ICT competence risks either costly mistakes or missed opportunities for dramatic service improvements.

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

» Integrated public financial management information systems carry correspondingly greater potential risks for the integrity of the data and can even jeopardize the PFM system if developed carelessly and without sufficient checks, controls, security, and virus protection. Indeed, the first advice to an African government moving from a partly manual public account-

ing and recording system to a fully computerized one should be to keep the manual ledgers going alongside the new system until the new system is working well and is free of risk.

» ICT can substantially reduce corruption. Nevertheless, although computer technology does eliminate almost all opportunities for corruption for those who do not understand fully the new technology, it also opens up new corruption vistas for those who understand the new systems well enough to manipulate them, particularly when their hierarchical superiors are unfamiliar with the new systems.

In sum, the adoption of more advanced ICT should meet the following criteria:

» Always fit the user requirements and the real objectives of the activity.

» Ensure that the more advanced ICT goes hand in hand with improved rules and processes.

» Protect data and systems integrity.

» Aim at an integrated strategy, and avoid a piecemeal approach (which can fit specific needs but adds up in time to a ramshackle and even dangerous system).

ICT offers a wonderful potential in Africa for increasing government accountability, transparency, and participation; improving the efficiency and effectiveness of public sector operations; widening access to public services; and disseminating information to the public and getting feedback from relevant stakeholders and service users. The payoffs from a well-functioning Financial Management Information System (FMIS) include greater fiscal transparency; the associated potential for stronger public financial accountability; the capability of tracking expenditure at its various stages; and, in general, better budgetary outcomes and public services.

However, the heavy costs and capacity requirements of an FMIS have not been highlighted with
the same enthusiasm as the potential benefits, and both the cost and the time required for its effective introduction and reliable operation have been consistently and badly underestimated in Africa. When incorrectly introduced, ICT systems have caused serious damage rather than improvements. A first warning in that direction was sounded by the IMF (see Diamond and Khemani, 2005). The readers interested in the advantages and pitfalls of FMIS introduction are strongly encouraged to read the excellent and comprehensive review of experience published recently by the World Bank (see Dener, Watkins and Dorotinsky, 2011.)

Training: Still at the center of the issue
While capacity development is more than training, there can be no capacity development without appropriate formation of human capital. Skill formation and maintenance are essential to permit the implementation of improved institutional rules, stronger organizational architectures, and easier information flows. The best designed structures, norms and systems avail nothing in the absence of human beings with the incentives and skills to manage them.

But all good training is a two-way street. The African Development Institute (ADI) recognizes that it is essential for its training programs not only to be conceptually sound and tailored to country needs, but also to evolve and continuously improve in keeping with the feedback received from the participants. Thus, training in PFM should be designed to achieve the most constructive possible interaction between trainers and participants, and among the participants themselves, to take advantage of the valuable experiences in countries other than their own—the successes as well as the mistakes and the missed opportunities. This book will serve as the platform for ADI training activities in public financial governance.

A concluding word
The most general lesson of international experience in budget reform in low-income developing countries, including African countries, is that long-term sustainability of institutional reform always demands genuine local ownership, political buy-in, and a degree of comfort among those responsible for implementing the reform. Without support from the top political leadership, and the active cooperation of budget managers and key staff members in both the core ministries and the line ministries, budget reforms have remained a paper exercise to satisfy donor demands—the equivalent of pushing on a string. Thus, the sequencing and time period of the reform process should be very carefully considered, to make sure that it will fit the absorptive capacity of the system over time and not cause reform fatigue.

Moreover, just as ex-post evaluation is necessary for good budgeting, periodic reassessments of the actual costs and benefits of specific PFM reforms and midcourse adjustments are necessary for sustainable reform. It is advisable therefore to provide for “digestion and consolidation” periods, to make sure that the budget managers and staffs have understood, internalized, and learned how to use the changes, and to give them a temporary respite from further change and the concomitant uncertainty. Accordingly, it appears wise to call a reform timeout from time to time. Without halting the reform momentum or interfering with any progress already under way, such reform timeouts permit adjusting the course or speed of specific reforms; give a fresh look at the marginal opportunity cost (including the transaction cost on the government officials) of building on certain improvements as opposed to others; carry out reality checks of the various claims of reform success; and allow skills to catch up, through learning-by-doing and various forms of training.

Introducing budget reforms in African countries has always been very easy; indeed, the cemeteries of PFM are full of stillborn reforms. Implementing budget reforms successfully has always been very difficult. The objective, of course, is not just to introduce changes but to help achieve permanent improvements in expenditure control, strategic resource allocation, operational effectiveness, inclusiveness, and quality of public services for the long-term benefit of the people of Africa. It is hoped that this book makes a significant contribution toward this critical objective.
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A. Bibliographical note and acknowledgements

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- The tax administration section in chapter 3 is summarized largely from Bird, 2010.
- The section on extractive resources in chapter 3 is based in part on the IEG evaluation of the Africa Action Plan (World Bank, 2011).
- Chapter 7 on multiyear expenditure perspectives is based in large part on the author’s “Of Mountains and Molehills: The Medium-Term Expenditure Framework,” paper presented at the Conference on Sustainability and Efficiency in Managing Public Expenditures, East-West Center and Korea Development Institute, Honolulu, July 2008.
- The discussion on fiduciary risk in Chapter 10 is drawn from Allen, Schiavo-Campo and Garrity (2004).
- The section on management controls in Chapter 12 is partly based on Harry Haven’s chapter in Schiavo-Campo and Tommasi, 1999.
- The section of subnational expenditure management in Chapter 13 draws largely on an unpublished paper co-authored with A. Premchand in 2004 and originally presented at an IMF-World Bank workshop on subnational fiscal reform held in Washington in 2004.
- The section on decentralization in Chapter 13 is based largely on Boex, 2009; Gonzales, Rosenblatt and Webb, 2002; Shah, 2004 and 2010; and World Bank, 2008. The last study assessed World Bank group efforts at supporting decentralization in developing countries, including African countries.
- Chapter 14 is based partly on Sorbo et al, 1998 (Guatemala, Mali, Mozambique, Sudan, Rwanda, and Burundi); Schiavo-Campo, 2003, and 2006; and various World Bank studies on postconflict reconstruction in Bosnia, Mozambique, Uganda, West Bank and Gaza and other countries. For a general analysis of the genesis of conflict, from the now extensive literature on conflict and reconstruction, see Collier and Hoefllier, 1998.
- Chapter 15 on performance is based in part on Schiavo-Campo, 1999.
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