

# **Strengthening Public Expenditure Management in Developing Countries**

## **Sequencing Issues**

Daniel Tommasi  
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## Introduction

Results from budget reform, and technical assistance to support these reforms, in developing countries are often disappointing<sup>1</sup>. A number of factors may explain this slow progress in strengthening public expenditure management systems, such as: the weight of informal rules, weak human resources capacity, lack of incentives to implement the reforms, lack of political commitment, poor change management, over-ambitious reforms aimed at replicating best practice models of developed countries and inadequate sequencing.

Experience shows that to be effective, budget reforms should be properly phased. As noted in the presentation of case studies on African budget reforms<sup>2</sup>: "Countries with fiscal instability that did not first address revenue unpredictability and poor spending discipline found their earlier reform efforts to improve the strategic allocation of expenditure ineffective. Similarly, improving the link between plans and budgets requires better underlying budgetary controls to be in place; poor budget execution controls detract from the incentives for proper planning. A performance orientation in budgeting is contingent on fiscal stability and sound budget planning systems". In addition, as discussed later, a budget reform is a continuous process including learning by doing processes.

This paper discusses sequencing issues related to budget reforms within the central government. It deals with management issues. It does not deal with the substance of policies. Whilst the public sector encompasses the different levels of government and public enterprises, this paper deals only with central government financial management. Sequencing the reform for sub-national governments would need to take into account fiscal federalism issues and the pace of decentralisation. Within the area of public financial management (PFM), this paper deals mainly with public expenditure management (PEM). It deals only partially with the issues related to revenue management. Discussing in depth sequencing issues for revenue management reforms would need a separate review, which should concern both revenue administration and the tax policy, the choice between tax instruments depending closely on policy issues.

Section A discusses the approach to PFM reform and sequencing issues, focusing on PEM. After presenting some general issues, it reviews the "basics first" and platforms approaches and discusses some issues related to both the starting points and the end objectives of the reform path.

Section B reviews, for each area of PFM (such as budget preparation and accounting), the possible reform blocks. Section B distinguishes basic priorities and "further steps", which may be grouped in different platforms depending on the country context and expected results.

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<sup>1</sup> For example see: Jack Diamond, Matt Davies, Pokar Khemani, Theo Thomas, and Feridoun Sarraf, "IMF technical assistance evaluation: Public Expenditure Management Reform in Selected African Countries". IMF. 2005; P. Le Houerou and R.Taliercio, "Medium Term Expenditure Frameworks: From Concept to Practice: Preliminary Lessons From Africa". World Bank, 2002; Mike Stevens, "Institutional and incentive issues in public financial management reform in poor countries". World Bank, 2004.

<sup>2</sup> Budget reform seminar. Pretoria, December 2004. Countries case studies. CABRI.

## A. The approach to reform

The starting point of a public financial management (PFM) reform should be the assessment of the performance of PFM systems against their objectives. Therefore, this section reviews briefly the objectives of PFM systems and presents the Public Expenditure and Financial Accountability (PEFA) PFM Performance Measurement Framework. Then, it discusses the approach of reform and the sequencing issues, which will be reviewed in detail for the different PFM areas in section B, focusing on public expenditure management (PEM).

### 1. Looking at PFM systems

#### a) *The objectives of PEM and revenue management systems*

##### i) Objectives of PEM

PEM is instrumental in nature. While the public expenditure policy deals with what should be done, PEM deals with the processes to implement the policies. However, a PEM system is not fully neutral because it depends partly on policy and societal choices.

Thus every budget system comprises planning, management and control processes<sup>3</sup>, but the degree of emphasis placed on each of these processes depends on the approach to budgeting and on the role assigned to the public administration. The traditional public administration model focused on the two Ps of probity and propriety, and based budgeting on a set of procedural rules and "due process", while in recent years the two Ps of policy and performance<sup>4</sup> have been emphasised. According to Schick<sup>5</sup>, the term "due process" connotes the judgement that if the procedures are sound, the outcomes are the right ones, despite the fact that good procedures may produce bad results, because of opportunist behaviour of budgetary participants and informal rules. Dissatisfaction with traditional budgeting, the fiscal stress and the political will to limit the weight of the government sector in the economy has favoured the development of policy planning and performance oriented approaches in PEM.

Thus, the recent budget literature identifies three key objectives, or level of outcomes, in public expenditure management<sup>6</sup>:

- *Aggregate fiscal discipline.* For macro-economic stability, effective control of the budget totals and management of fiscal risk, is required. These totals should be sustainable over the medium-term and beyond.
- *Resource allocation in conformity with government policy objectives.* Expenditure programming should be based on government priorities and on effectiveness of public

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<sup>3</sup> As noted by Allen Schick in "The road to PPB [Planning-Programming-Budgeting]: The stages of budget reform". Public Administration Review. December 1966.

<sup>4</sup> Stewart and Ranson "Management in the Public Domain". Public Money and Management. 1998.

<sup>5</sup> See Allen Schick "A contemporary approach to public expenditure management". WBI. 2001.

<sup>6</sup> See, J. Edgardo Campos and Sanjay Pradham in "Budgetary Institutions and Expenditure Outcomes ". Policy Research Working Paper 1646. World Bank. 1996. Allen Schick "A contemporary approach to public expenditure management" WBI. 2001. Premchand in "Public Expenditure Management" IMF 1993 refers to the SEEE paradigm (stabilisation, economy, efficiency and effectiveness), which corresponds broadly to these three objectives.

programmes. The budget system should spur reallocation from lesser to higher priorities and from less to more effective programmes.

- *Operational efficiency in public service delivery.* Agencies should produce services that both achieve efficiency gains and satisfy the objectives they were designed to meet.

Assessing progress against these objectives is crucial. In addition, the societal dimension must be taken into account. To underline the importance of probity and propriety, the Asian Development Bank (AsDB) PEM manual adds the objective "due process" to these three key objectives of PEM<sup>7</sup>. In democratic societies, the executive must be accountable to the legislature. In the same way, accountability to citizens and making the government more responsive to their needs should be sought. Therefore, this societal dimension will include due process and probity, accountability to Parliament and the citizens, and participatory processes to involve Parliament and the citizen in the decision making processes.

Of course, these requirements should be properly balanced with the three specific objectives mentioned earlier. Thus, pork barrel policies and fiscal indiscipline may emerge from Parliament debates. Addressing such risks may require adequate procedures to discipline these debates, but they should not lead to the key objectives of Parliament scrutiny and executive accountability to Parliament being abandoned.

## ii) Revenue management

Concerning revenue management the three key objectives may be formulated as follows: (i) aggregate fiscal discipline, which will require reliable revenue forecasts and effective revenue collection; (ii) revenue instruments in accord with government policies; and (iii) efficient revenue administration. Compliance with regulations, transparency and complaint procedures will specify the quality of revenue management. Accountability to Parliament is required for revenue as well as for other government financial operations.

### *b) The PFM areas*

PFM activities may be schematically represented by the financial management cycle, which involves these partly overlapping stages:

- Policy formulation, planning and budget formulation.
- Budget execution: (i) administration of budget execution; (ii) control. (iii) internal audit<sup>8</sup>.
- Accounting and reporting.

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<sup>7</sup> Salvatore Schiavo-Campo and Daniel Tommasi "Managing government expenditure". AsDB. 1999.

<sup>8</sup> Ex-post control (financial inspection) and internal audit activities are performed once the expenditure is made, but for discussing the sequencing issues they should be reviewed together with the other elements of the budget execution system.

- External audit and evaluation, for accountability and feedback to policy and budget formulation.

PFM activities should be supervised by the legislature. The "legislative cycle" includes two key stages: (i) scrutinizing and approving the draft budget prepared by the executive; and (ii) scrutinizing the end-of-year reports and accounts. In addition, Parliament may perform its oversight at other stages of the PFM cycle.

An adequate technical infrastructure is required to make the PFM cycle function, including, among others, the budget classification system, accounting systems and information management systems. The degree of development and sophistication of this technological infrastructure will depend on the country context, but some basic requirements should always be met. In the same way, an adequate legal framework must be set up. Accountability to citizens will require publishing information at different stages of the PFM cycle.

Figure 1 gathers the different elements discussed above and presents:

- the three key objectives of PFM and the societal dimension (due process, role of the Parliament in a democratic society, accountability to citizens);
- the PFM cycle;
- the PFM technological infrastructure and the legal framework;
- the legislative cycle; and
- a small picture calling for citizen information and responsiveness.

#### *c) Assessing the performance of PFM systems*

A PFM system is performant when it is able to achieve the objectives mentioned earlier in the best manner possible, taking into account the country's socio-economic context and administrative culture. The PEFA PFM Performance Measurement Framework (PEFA PFM-PMF) identifies the following dimensions of performance of PFM systems:

- For cross-cutting issues (partly the "technical infrastructure" mentioned earlier):
  - *Credibility of the budget* - The budget is realistic and is implemented as intended
  - *Comprehensiveness and transparency* - The budget and the fiscal risk oversights are comprehensive, fiscal and budget information is accessible to the public.
- For the different stages of the financial management cycle:
  - *Policy-based budgeting* - The budget is prepared with due regard to government policy.
  - *Predictability and control in budget execution* - The budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.

- *Accounting, recording and reporting* – Adequate records and information are produced, maintained and disseminated to meet decision-making controls, management and reporting purposes.
- *External scrutiny and audit* - Arrangements for scrutiny of public finances and follow up by the executive are operating.

Figure 2 shows the PEFA dimensions of performance in the PFM areas shown in figure 1.

The PEFA PFM-PMF provides a useful framework to look at PFM systems. However, it is not sufficient to assess the effectiveness of a PFM system in achieving its objectives and to prioritise a PFM reform programme.

Except the first four indicators, the PEFA PFM performance indicators deal mainly with processes, not with results. For example, the fact that the budget classification system includes a functional classification (indicator No 5) does not mean that the budget is effectively prepared on the basis of policies. The same procedures may lead to quite different outcomes depending on the country context. Taking into account the complexity of PFM systems the PEFA assessments need to be complemented by other assessments, including, among others, a broad assessment of the institutional environment and a judgemental assessment of the relationships between processes and outcomes. PFM processes are to a large extent of political nature, particularly resource allocation. This political dimension should be taken into account when looking at a budget system.

Four score levels are defined for the PEFA PFM performance indicators (A to D). A score "A" on a single process does not necessarily mean that good outcomes are achieved. Conversely, a score "D" may be interpreted differently from one country to another<sup>9</sup>. Inter-linkages between processes are important and may suggest different priorities than the performance indicators scores. The non technical factors may have a more significant impact on the PEM outcomes than the procedures.

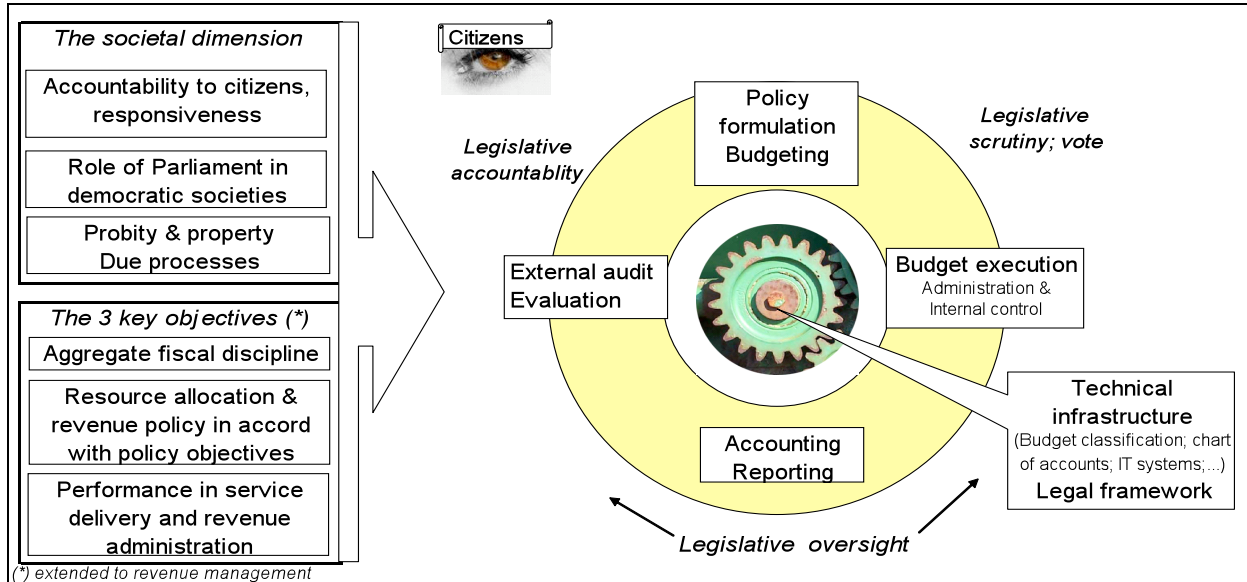
As the PEFA PFM-PMF, this paper deals mainly with processes. The priority order between reform measures suggested below in section B should not be mechanically interpreted and implemented. It should be systematically reassessed to take into account the country's specificities. There is no straightforward correspondence between the score levels for the PEFA PFM indicators and the set of actions defined in this paper as "basic priorities". Annex II shows that for some PEFA PFM-PMF indicators reaching a score B will be much more demanding than the "basic priorities" defined in this paper, while for other indicators the scores B or A, correspond to the basic priorities defined in this paper.

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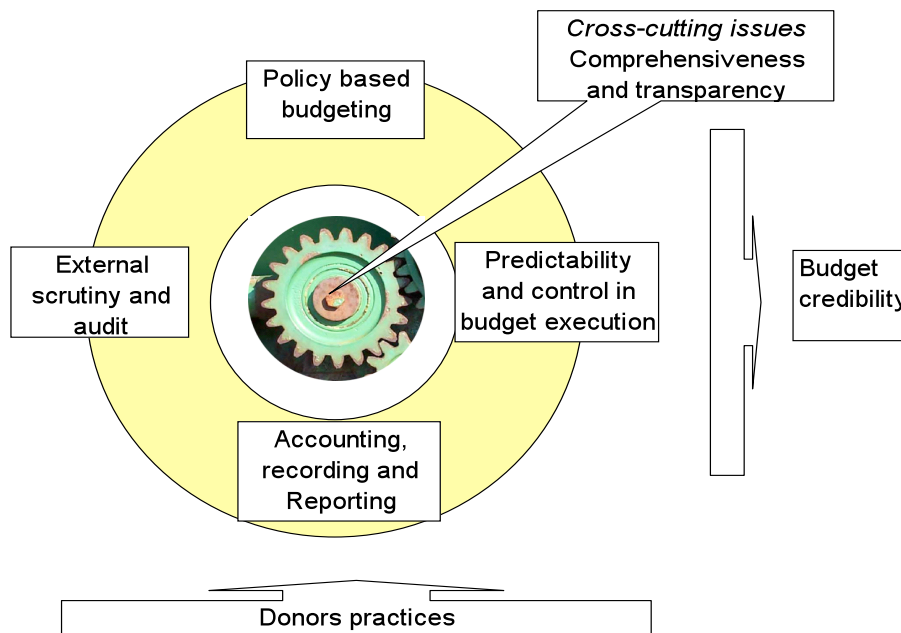
<sup>9</sup> For the performance indicator no 21 ("effectiveness of internal audit") of the PEFA PFM-FMP assessment, the scores of Norway, Kenya, Benin are respectively "D", "C"; "C+".



**Figure 1**  
**Objectives of PFM and the Expenditure Cycle**



**Figure 2**  
**The PEFA PFM Performance Measurement Framework: The 6 Dimensions of Performance**



## **2. Managing the Reform Process: General issues**

### *a) The need for a comprehensive approach to reform*

Strengthening a budget system should be aimed at improving its performance. The optimal mix of measures and instruments to achieve this objective depends on the country context, including, among other elements, human resources capacity, current strengths and weaknesses of the budget system, the administrative culture and the institutional and political context.

To undertake successful reform, it is necessary to carry out a comprehensive review of the budget system in order to determine the main weaknesses, and the changes necessary, to deal with these problems. Such a review should consist of diagnosing the problems, reviewing the different supporting systems and identifying all the interconnections and institutional weaknesses.

Linkages between the PFM systems and other systems, such as political and managerial systems, must be taken into account. Improving budget preparation processes and the information base necessary for informed decision-making is generally required. Nevertheless, it must be kept in mind that policy choice is essentially political, and strengthening decision-making requires recognition of the multitude of factors that bear on these decisions. It is, therefore, important to address issues such as: those related to governmental co-ordination mechanisms, the relationships between the executive and the legislature, and the capacity of the legislature to scrutinise the budget.

A PFM system includes a wide range of basic supporting services and subsystems, from macroeconomic forecasting to auditing and performance/policy evaluation. There are strong linkages between these subsystems. Failure of any one of them can have negative effects on the other subsystems and may undermine the effectiveness of the whole budget system. In order to target properly the reform measures and prepare their phased implementation plan, it is crucial to identify the causes of the main problems met in budget management. However, such an exercise is not straightforward. For example, what could explain unrealistic revenue forecasts? Weak technical capacity in forecasting? Unpredictable external economic developments? Or deliberate manipulation of revenue forecasts in order to postpone hard choices to the budget execution phase?

Therefore, a budget reform should generally include a set of complementary actions in several areas. Narrowly focused reforms are often disappointing. For example, it would be illusory to expect significant benefits from introducing programme budgeting or a Medium-Term Expenditure Framework (MTEF) if hard constraints are not built into the budgeting processes. Furthermore, it is important to avoid a succession of “paper reforms” that consist of implementing one measure, then moving to the next item on the agenda, without assessing the results achieved and paying attention to the other elements of the budget system.

It is necessary to define a proper mix of reform measures in order to improve the budgetary outcomes in a balanced manner. Properly balancing flexibility and restraint will be a major issue. Achieving fiscal discipline should not be made through instruments and methods that are disruptive to sound budget management, such as arbitrary cuts across the board or cash rationing. Measures to increase line agencies responsibilities in budget management are

generally desirable to improve operational performance, but they should not be implemented at the expense of fiscal discipline. Promoting performance should not lead to a forgetting of probity and the traditional value of the public administration. Although such an assessment is not shared by everyone, James Fielding Smith states that performance budgeting may be more vulnerable to threats from fraud, falsification and misinterpretation, notably because of its complexity, and therefore requires the inculcation of sound ethical standards<sup>10</sup>. The Parliament should have a key role in the budgeting processes, but it is also necessary to regulate its powers in order to avoid excessive pressure to increase expenditures.

*b) A continuous process*

The reform process is continuous. Experience shows that budget reform is in a large part a process of learning by doing. Budget systems are adversely affected by factors such as political instability, entrenched private interests, structural imbalances between existing commitments and resources and severe inflation. Defining priority areas for reform and sequencing the reform measures must take account of these realities. Moreover, the numerous interconnections between the budget system and other systems may result in unexpected outcomes when implementing reforms. A changing economic and political environment may require additional reform measures. During the reform process a systematic and regular assessment of the outcomes of the reform is needed in order to ensure that the reform programme is kept on track, and to make any necessary adjustments. When reforming a budget system, unexpected developments and potential roadblocks can arise, and the reform's ability to respond to change must be continuously tested.

*c) Importing a best practice?*

Developing a comprehensive approach to budget reform should not mean adopting a "big bang" theory of reform or importing a "best practice" model. "Best practice" models may be useful to draw up lessons from experience. But the concept of "best practice" is dangerous, when it is misinterpreted as importing budgetary models without consideration of local realities—particularly the "informal rules" that determine much of the behaviour of officials and their private sector counterparts.

Specific tools and budgetary techniques that are effective in the context of one country can be mere fossils in another country. Substance is more important than form. Thus, many concepts of the "programmatic" approaches to budgeting, such as clarifying organisational or managerial objectives or obtaining better feedback from budget execution to budget preparation through evaluation, or performance monitoring, can be implemented gradually into a "traditional" budget system. It will often be more cost effective to develop such concepts progressively, than to change the format of the budget.

In the 90s, many advocated the introduction of the new public management (NPM) model in developing countries, which had been previously introduced in New Zealand and a few other OECD countries. The NPM model injects market principles into the public service and includes, among other features, developing contractualism and managerial accountability, in which individual managers are held responsible for achieving specific tasks, under an agreed resource envelope, and are left free to determine the manner of achieving those tasks.

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<sup>10</sup> James Fielding Smith. The benefits and threats of PBB [performance based budgeting]: An assessment of modern reform". Public Budgeting and Finance. Fall 1999.

In 1998, Schick has warned against the premature development of such approaches in developing countries and has developed its "basics first" thesis discussed below, in section A4a. In practice, only a few developing countries have actually attempted to implement the New Zealand model. Generally, while some individual reform measures for "island of excellence", such as the creation of tax agencies, follow partly the NPM model, many budget reforms implemented in developing countries are non-NPM reforms. Thus reforms aimed at redressing fiscal and economic imbalances led generally to reinforced central controls, not to managerial accountability.

*d) Acknowledging the political aspects of reforms*

Political governance and budget politics affect the functioning and the reform of public financial management systems. It is not possible to separate technical budget reforms from the wider governance environment required to make them effective and from the political system in which they are embedded. Effective reforms are those that are technically sound, administratively possible, and politically feasible. Budget politics drive public budgeting and shape the rules of the budgetary game, including the ownership, timing and sequencing of reforms and the government's commitment to them<sup>11</sup>.

Budget politics offer both challenges and opportunities. Politics is not only a risk to mitigate but also an opportunity to seize. Demand for better governance and greater accountability is a key driver of change in budgetary systems. This demand emerges from both the formal institutions (parliaments or supreme audit institutions) and informal mechanisms (civil society, media and citizens).

*e) Corruption issues*

Corruption problems are widespread in many areas such as public procurement, public service delivery, customs, and taxation. Fighting corruption needs to adopt three concurrent efforts—awareness-raising, prevention, and enforcement. This requires a wide range of activities in several areas, such as justice and public administration. Enlisting civil society in shedding light on bribery problems, and building public financial accountability institutions, are essential.

Reinforcing PEM systems is necessary to fight corruption, but it is only a component of the required set of actions to fight corruption. For example, strengthening the procurement procedure may not be sufficient to fight corruption on large investment projects, which involve often the most powerful politicians.

Improving financial transparency and external accountability to Parliament and citizens is crucial to fight against corruption. In countries with poor governance and governed by informal rules, such improvements may give more effective results than refining the legal framework and multiplying control procedures. In such countries, laws and procedures may exist, but are not enforced. Formal rules are ignored by the different actors including those responsible for ensuring their enforcement. Mismanagement and misappropriation of funds are not sanctioned, except for settling political scores. Reinforcing controls may help, but

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<sup>11</sup> See "Understanding the politics of the budget: What drives change in the budget process". DFID Brief. January 2007.

government controllers may be themselves corrupted. Multiplying ex-ante controls may have the perverse effect of increasing opportunities for corruption, each controller levying tolls on the financial transactions.

### **3. Managing the reform process**

#### *a) Perquisites for change*

A high level of dissatisfaction with the current situation and the capacity of developing a shared vision are perquisites for change. The formula for change called “Gleicher's formula” provides a model to assess the factors affecting the success of organisational change programs.

According to this model, the following three factors must be present for meaningful organisational change to take place: (i) D = Dissatisfaction with how things are now; (ii) V = Vision of what is possible and; (iii) F = First, concrete steps that can be taken towards the vision. The Gleicher's formula states that change is possible, if the product of these three factors is greater than R, R measuring the resistances ( $D \times V \times F > R$ ).

Resistances must be assessed and a broad agreement should be built within the government. However, in the absence of dissatisfaction with the current situation; significant changes would be difficult to implement. The groups most dissatisfied with the current situation will be the best supporters of the reform. These groups may include groups such as civil society organisations, parliamentarians, technicians from line ministries, or managers of regional administrative divisions or end-units. Efforts should be made to identify these groups and involve them in the reform process, despite the fact that they are often not in a position to lead the process.

#### *b) Establishing a reform strategy*

Before engaging a PEM reform, a reform strategy should be prepared which will define the reform objectives, the sequence of reform activities (sequencing issues are discussed in section A4), the schedule for completing the reform measures planned over a medium-term period, the definition of responsibilities of each actor, the capacity development programme associated to the reform and the arrangements to manage the reform process.

#### *c) Capacity issues*

Capacity to perform a function such as PFM has three dimensions:

- *Institutions*—or the “rules of the game” that provide the framework of goals and incentives for PFM.
- *Organisations*—defined as groups of individuals bound by some common purpose, with clear objectives and the internal structures, processes, systems, staffing and other resources to achieve them.

- *Individuals with skills*—to analyse needs, design and implement strategies, policies, and programmes to meet those needs, and deliver services.

Institutional strengthening must be at the heart of PFM reforms, which deal with processes and rules. It consists of actions such as improving the legal frameworks, defining proper distribution of responsibilities, and providing incentives.

Special attention should be paid to the capacity of organisations to act and relate. In this area, as in others, directions for reform depend on the country context. In the 1990s, empowering the ministry of finance to better supervise budget management was the most crucial issue in transition countries, because of the fiscal stress and fragmented arrangements for managing the budget, such as extra-budgetary funds and thousands of government bank accounts. On the other hand, in many developing countries, special attention should be paid both to developing capacity of the ministry of finance to take into account sectorial policy issues and to strengthening line ministries' capacities. This may require organisational changes (e.g. organising the budget department of the MoF by sector), proper staffing and adequate processes. Enhancing dialogue between the ministry of finance and line ministries should be one of the objectives of PFM reforms.

A training programme for each component of the reform is essential for successful implementation. Training activities should cover different fields, such as basic training in specialised areas (e.g. training accountants to use new accounting procedures); high-level training in specialised areas (e.g. training of information technology specialists or macroeconomists); or general training (e.g. teaching foreign languages to the staff of the debt management office, or improving skills in the use of spreadsheets and word processors). To improve budget preparation it is necessary to increase capacity within the ministry of finance and spending agencies to define clearly the objectives of public expenditure. Developing such capacity involves both improving analytical methods and discussing sectorial policy issues.

Training will be useless if staff have no incentive to work effectively. Low salaries, and parallel private activities undertaken by staff to survive, hamper the effective implementation of reforms. Donors often try to make up for such a situation through hiring well paid local consultants or through providing in-kind support to the staff responsible for managing the reform (cars, travel expenses, etc.). Such a situation often raises frustration among the staff that do not benefit from donors' support. It is only a palliative solution that cannot last for long. Finding an appropriate solution to this problem is not easy, however. Actually, this would require both better paid civil servants and developing incentives based on perspective of promotion, and satisfaction about quality of work. Perhaps performance-related pay schemes could also be considered, but with caution because such schemes may increase problems linked to trust, corruption and patronage. It would be difficult to suggest a standard solution, but at the outset of a reform process, personnel management issues should be reviewed to ensure that incentives will be provided to encourage staff for effective implementation of the reforms.

The notion of capacity is a relative notion. The capacity problem is related to the gap between the reform objectives and the existing capacities. If this gap is excessively large, solving this problem may require redesigning the reforms. False solutions such as designing an ambitious training programme or having massive recourse to external consultants should be avoided. The reforms should be properly designed to use existing capacities as efficiently as possible. In this respect, some sophisticated reforms (e.g. over-detailed activity based budget or MTEF,

see section A5c) or some complex institutional arrangements set up at the donors' request (e.g. in some countries for managing a SWAp) pose problems. They absorb scarce resources that could be used for other tasks more efficiently. The opportunity costs of reform measures should always be assessed.

#### *d) Building a consensus*

The reform will succeed only if it has a champion or champions within the government. Financial reforms need unflagging commitment and strong leadership from the minister of finance. The top management of the ministry of finance should actively participate in the reform process.

It is crucial to build up a consensus for reform among the different participants involved in public expenditure management. To design and implement the reforms, the ministry of finance should work in close co-operation with line ministries, sub-national government authorities and other key players. Some of these stakeholders could be highly motivated for reforming the PEM system, because of their dissatisfaction with the current system. The challenge will be, however, to ensure that the different interests converge towards an agreed set of reform measures.

To increase awareness of major issues in public expenditure management and facilitate dialogue between the core ministries and line ministries, an economic and budgeting "culture" needs to be disseminated within the government. Thus, training of budget managers should not be limited to the dissemination of specific techniques and methods (e.g. how to complete the forms for budget preparation), but also be aimed at providing them with information on the objectives of PEM.

Consultations with the legislature are important. Improving the presentation and content of budgetary documents should go hand in hand with measures to improve the capacity of parliament to analyse such material. It may be useful to carry out some awareness-raising seminars with top managers of the government, members of parliament and sub-national authorities on the problems that the reform intends to address and the expected benefits.

Particular attention should be given to how to manage the process with a view to ensuring the necessary level of co-operation and participation. This requires the design of actions aimed at promoting change and communicating the changes to and through middle management, in order to gain acceptance and active co-operation from the civil service managers and operational staff. It is important at each stage of the reform process to highlight information on progress, to encourage feedback from staff, and to make necessary adjustments to the reform activities.

#### *e) Organisational arrangements*

Proper organisational arrangements should be set up to manage the reform process. These arrangements need to be tailored to the country context and the scope of the intended reform. If a wide reform is intended, they should generally include the setting up of a steering group, a core unit and working groups.

The steering group will provide general direction to the reform and overall supervision. It will consist of the top civil servants involved in the process and will normally be chaired by the

minister of finance or a deputy minister. It will be important for effectiveness to include representatives of line ministries in the steering group. A core unit, or reform secretariat, or a separately identifiable department of the ministry of finance should be made responsible for the overall management of the reform. This unit should be appropriately located, in principle within the ministry of finance. The working groups will be responsible for implementing specific reforms in particular areas.

#### 4. The sequencing issues<sup>12</sup>

Proper sequencing of reform measures is crucial. This section presents some approaches that may help in defining the reform path: the "basics first" approach developed by Schick and the platform concept.

##### *a) The Schick's basics and stages in expenditure control*

Schick argues that most developing countries should get the "basics" right first, instead of replicating the New Zealand and other NPM reforms<sup>13</sup>. According to Schick reform of public and market institutions must proceed in tandem. If market transactions are largely informal (outside the legal system, and are based more on interpersonal relations than property rights and contracts) then the public sector will also be dominated by informal institutions. Therefore, basic practices must be institutionalised before more advanced management practices are introduced.

Thus, Schick identifies a logical sequence of stages in strengthening a budget system, which corresponds to three different types of control (see box 1 and table 1). The first stage will consist of building a rule-based system including input controls exercised by the ministry of finance and other central agencies. According to Schick: *"as old-fashioned as external [to the spending agencies] controls<sup>14</sup> may seem to be, they are building blocks for a formal, rule-based, honest public sector. Operating in an externally controlled environment is an essential phase in the development process. It gives managers the skills to manage on their own, builds trust between central controllers and line managers and confidence between citizens and government, and encourages managers to internalize a public ethic of proper behaviour "*.

The second stage will consist of organising the public sector according to the principle of internal control exercised by spending departments. Managerial accountability comes only at the third stage.

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<sup>12</sup> Discussions on sequencing in this section and the following concern PEM, specific issues related to the reform of revenue administration are not reviewed.

<sup>13</sup> Allen Schick. "Why most developing countries should not try New Zealand reforms". The World Bank Research Observer. February 1998. See also the sources mentioned in box 1 and table 1.

<sup>14</sup> As shown by table 1, the expression "external controls" used by Schick refers to the controls internal to the executive, but external to the line ministries and agencies, that is typically to MoF external controls (e.g. control of virements, ex-ante controls, etc.). It does not refer to external audit.



Table 1  
**Stages of expenditure control**

Type of control	Exercised by	What is controlled	Mode of accountability
Third party (External to line agencies)	Finance Ministry and other central agencies	Inputs (individual items of expenditure)	Compliance with line budget, civil service rules and other rules
Internal	Spending Departments	Major expenditures items (total salaries, all equipment, or supplies, etc.)	Audit of systems to assure that internal controls meet government standards
Managerial accountability	Spending or responsibility unit	Global operating budget running costs and outputs	Reports and audits on outputs, costs, quality and other results

Adapted from Allen Schick. *Pathways to improving budget implementation*. 2004.  
[www1.worldbank.org/publicsector/LearningProgram/BudgetManagFinAccCourse04/Pathways.ppt](http://www1.worldbank.org/publicsector/LearningProgram/BudgetManagFinAccCourse04/Pathways.ppt)

**Box 1**

**GETTING THE BASICS RIGHT**

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

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

Source: Public Expenditure Management Handbook. World Bank. 1998.

### *b) The platform approach*

A study commissioned by the PEFA secretariat<sup>15</sup> suggests defining an approach to reform in terms of ‘platforms’ that considers an appropriate and sustainable package of measures rather than one that is focused on individual measures: *"Financial management reform should be considered as a series of realistic step changes ('platforms') defined in terms of what they enable by way of resource planning, deployment, control and accountability from which will emerge improved development outcomes as well as more effective fiduciary protection to all partners. The important thing is that each platform establishes a clear basis for launching to the next. Sequencing can be better addressed by articulating the position that these platforms are targeted to achieve (what sort of situation they enable) rather than simply setting out a timeline for individual measures. It proposes that the design and selection of short term measures be considered in terms of establishing the first of these platforms. There can then be some flexibility in the individual measures selected to achieve that platform based on local leadership, circumstances and starting points"*.

The platform concept may be useful to show the different stages of a reform process and the logical order among reform measures. However, a mechanical interpretation of the platform approach should be avoided and the platforms should not be over-designed and rigid. The definition of the different phases, or platforms, of a reform programme should be kept simple. Designing a progressive approach to PEM reform should not lead to devote excessive resources to the reform design.

As noted, the reform process is continuous. There may be few overlaps between the platforms, provided that these overlaps do not dissipate the efforts. The sequence of platforms involves a logical sequencing, but not necessarily a purely chronological one. Thus, certain reforms beyond the basics can be initiated, in parallel with more basic reforms even though they cannot be expected to have full results unless the basic reforms are actually implemented and in place.

On the other hand, it cannot be expected that the “basics” will be fully completed during the first phase of the reform path. They will have to be consolidated over a long period, through, for example, specifying some procedures, completing the legal framework, pursuing improvements to the technical infrastructure (e.g. developing information systems), or further training. Moreover, PEM systems are responsive to the economic and political environment. Backward steps cannot be excluded, after the apparent achievement of the basics. In large part, the reform process is a learning by doing process, which must take into account the evolving environment.

The platform approach is currently being developed in a few countries (e.g. Cambodia and Kenya). In Cambodia, the reform programme covers a period of around ten years and will be implemented through four successive platforms. According to Richard Allen<sup>16</sup>, such exercises reveal serious flaws, including insufficient attention paid to institutional constraints, overloading of activities, unrealistic time-horizons for implementing certain measures, poor prioritisation, and micro-management. Most of these flaws are not specific to the reform

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<sup>15</sup> Peter Brooke. "Study of measures used to address weaknesses in public financial management systems in the context of policy based support". April, 2003. PEFA secretariat.

<sup>16</sup> Richard Allen. "The Challenge of Reforming Budgetary Institutions in Developing Countries". Annual Conference of the International Consortium on Governmental Financial Management (ICGFM). December 2008.

programmes based on the platform approach. However, they may be exacerbated under such an approach, if the reform design and implementation arrangements are excessively complex.

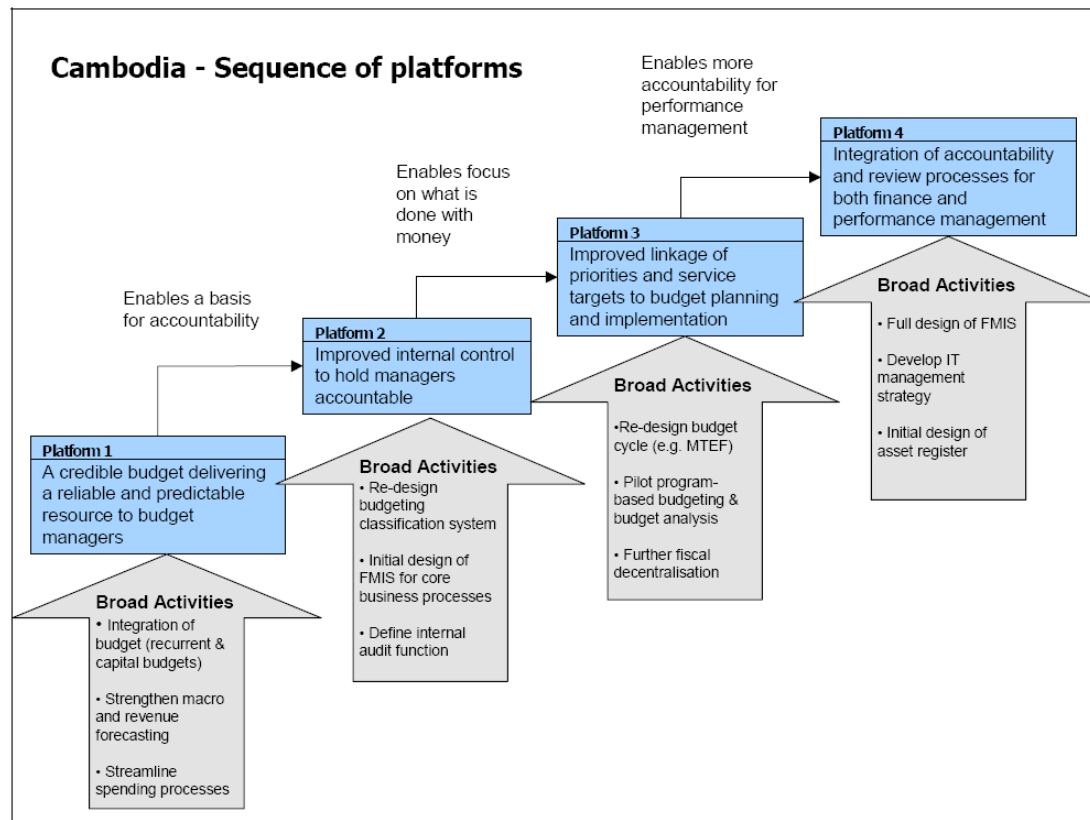
These flaws should be avoided, but identifying, over a medium or long term period, broad orientations and different phases of the reform process has the advantage of placing the reform measures in a wide perspective. Also, it is desirable to clearly distinguish the reform measures that will be implemented within the next two or three years (the first phase, or platform, of the reform programme) from measures that will be implemented later. The implementation stages of specific actions to be implemented over a long period need to be planned in detail (for example, the stages of the implementation of a government financial management information system).

Box 2 presents the Cambodia sequence of platforms and Box 3 presents the approach developed in Ethiopia, which is qualified by Peterson as being “an evolutionary approach” to reform.

## Box 2.

### Sequencing the reforms: Cambodia

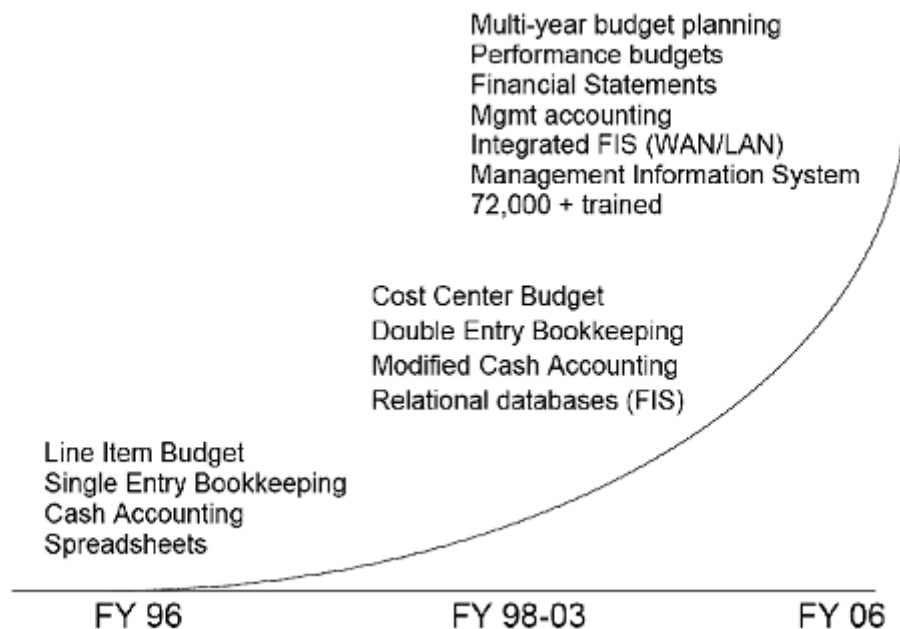
In Cambodia, a sequence consisting of four successive ‘platforms’ has been defined to frame the public financial management reform over an estimated timeframe of eight years<sup>1</sup>. These platforms are aimed at achieving the following sequence of results: (1) a credible budget delivering predictable resources; (2) improved internal controls to hold managers to account; (3) improved linkage of policy priorities to budget planning; and (4) integration of accountability and review processes for both financial and performance management.



Source: *A Platform Approach to Improving Public Financial Management*. DFID briefing. July 2005

### Box 3 Ethiopia Evolutionary approach to Reform

In Ethiopia, the Decentralisation Support Activity (DSA) project strategy of financial reform has defined a sequence that starts from building a "transaction platform" (line item budget, accounting, disbursement systems and simple supporting computer systems)<sup>1</sup> to ensure effective control. The following sequences are aimed at achieving a "policy/performance platform" (macro economic framework, budget policy and strategy, intergovernmental transfer formula; multi year budget planning; management information system); then a "legislative oversight platform" (policy development; appropriation; evaluation). The chart below illustrates the achievements under the two first platforms.



#### Sources

Stephen Peterson. *Wax and Gold A Decade of Financial Reform in Ethiopia*. John F. Kennedy School of Government. 2007.  
[www.ksg.harvard.edu/m-rcbg/papers/seminars/peterson\\_april\\_07.pdf](http://www.ksg.harvard.edu/m-rcbg/papers/seminars/peterson_april_07.pdf) -  
 DSA project brief. Project report M-52. Harvard University. 2005.

## 5. Defining a sequence

### *a) Assigning objectives to the different phases of the reform process*

The first step in preparing a PEM reform programme should consist of assessing the current degree of achievement of the PEM objectives and identifying the main concerns of the different stakeholders on this issue. This assessment will be based on the PEFA PFM PMF and other assessments, such as the IMF Reports on the Observance of Standards and Codes (ROSC) fiscal transparency module. An analysis of the external factors and informal rules, notably the political factors, should complete this assessment.

The reform path should generally consist of different phases, or platforms. The optimal mix of the expected achievements at each phase of the reform programme will be defined by analysing the results of these assessments, taking into account the country capacity and administrative culture and the priorities between the different measures (see part B of this paper). Of course, the reform path and the results that can reasonably be expected at each step of the reform process will depend on the country context.

Implementing or reinforcing the "basics", as defined below, will be, in many developing countries, the core component of the first phase/platform of the reform process. In countries with a comparatively robust PEM system, the first platform will consist of a mix of measures, including both basic elements that may be missing and more advanced measures.

### *i) The basics*

There is no straightforward definition of the "basics". This paper defines the "basics" as a system that reaches significant achievements against the following "basic objectives":

- Aggregate fiscal discipline: Without macro-fiscal control of the totals, the budget will have no meaning.
- Due process, compliance and probity at every level of budget management: Compliance at all levels of management with the budget and regulations is required to ensure fiscal discipline and to avoid wasted inputs. Enforcement of regulation and probity are important societal values.
- Basic legislative scrutiny and accountability: It will be important to start building the institutions for effective legislative oversight at an early stage of the reform process.
- Transparency: As noted, improving financial transparency and external accountability to Parliament and citizens is crucial to fight against corruption.

The instruments and procedures aimed at achieving progress along these basic objectives are presented in part B. In addition, the factors external to PEM and the informal rules should be taken into account. For example, techniques, such as developing a macroeconomic framework or reinforcing budget execution procedures, are necessary but not sufficient to ensure fiscal discipline, where the most significant budget overruns come from decisions of powerful political barons.

These basic objectives will contribute to improved operational efficiency. In many poor countries substantial progress in operational efficiency will be achieved through the basic measures such as implementing better input control and eliminating waste.

## ii) Beyond the basics

Beyond the basics, the reform measures should be aimed at achieving the second and third PEM key objectives (resource allocation in accord with government objectives and operational efficiency), and making further progress in developing accountability to Parliament and the citizens.

These objectives should be properly balanced. However, the importance paid to “policy based budgeting” suggests, for many developing countries, to emphasise first measures aimed at improving allocative efficiency. Developing beyond the basic controls a procedure aimed at improving operational efficiency, will be futile if the expenditure programmes are not prioritised and selected according to government policy objectives. In addition, operational efficiency depending on many systems (e.g. the human resources management systems) and priority actions to improve operational efficiency, are not necessarily in the PEM area.

Therefore, very schematically, once the basics are substantially implemented, the following phases could be aimed at:

- first, emphasising measures aimed at reinforcing the budget-policy link and resource allocation systems; consolidating the reforms undertaken under the first platform (including reinforcing legislative oversight and transparency). Some measures aimed at improving efficiency in management could also be introduced, but they will not be the main component of the platform;
- then, emphasising methods to improve efficiency in management and consolidating the measures implemented under the previous phases.

However, it would be questionable to delimit precisely, without reviewing the country context the phases, or platforms, beyond the basics. An inverse priority order between actions targeted to allocative or to operational efficiency may be preferred, depending on the country’s main concerns and context.

Sophisticated, but questionable, expenditure programming and budgeting techniques are sometimes advocated beyond the basics, and even sometimes before their implementation. This issue will be reviewed in section A5c below.

### *b) Some issues concerning the basics and the first phase/platform*

As noted, in many developing countries, the “basics” should be the core component of the first phase of the reform process. However, even, in such cases designing the first platform is more complex than referring only to the “basics”.

i) Specifying the first platform according to the context

The effectiveness of basic measures will depend on the country context, including the existing informal rules, the administrative culture and the nature of the existing budget system. Reforms are rarely starting from scratch and it should be taken into account that measures going beyond the basics are already implemented, at least partly. In addition, including in the first platform some elements more advanced than the basics could encourage reformers, provided that these elements suit the country context.

Attention should be paid to the informal procedures. In many developing countries the formal rules seem properly designed to ensure the basic compliance controls. However, they are often ineffective, despite successive amendments to reinforce them. Where the system is governed by informality and gaming with the rules, skills are used to find ways to overcome the rules. Implementing the basics in such contexts should not mean replicating ineffective previous budget reforms, through making further amendments to the existing formal rules. In such countries, focus should be put on measures aimed at improving transparency and external accountability mechanisms.

Approaches in strengthening internal control in Anglophone and Francophone countries will differ, due to different administrative cultures (see section B2b below)<sup>17</sup>. Thus, reinforcing the ex-ante controls of the ministry of finance would be questionable in certain Francophone countries, although a simplistic interpretation of Schick's control regime sequencing might suggest such a measure. In both systems, however, priority actions should include measures aimed at reinforcing transparency, including the comprehensiveness of fiscal reports, accounting and reporting.

Except in post-conflict countries, the first platform will not be built from scratch. Many countries have already implemented reforms going beyond the basics such as implementing some form of MTEF, or programme budgeting, or developing a contractualist approach for some semi-autonomous agencies. There are pressures from the donors to develop tools such as performance indicators, "performance assessment framework" (PAF) or MTEF within the context of budget support and SWAs.

In some countries these "advanced" reforms completely failed and can be easily forgotten. In other countries success is limited, but the reforms may have contributed to mobilise new skills and to bend lightly the budgeting approach in a few sectors. Officials and politicians that have supported the reforms might not agree on going back to the former budget systems. In such a situation, the first platform should include measures aimed at streamlining, or consolidating, the reforms already implemented. This should not mean pursuing relentless inadequate objectives. On the contrary, streamlining the reforms will often require timing-out over-ambitious reform measures, and rationalising and simplifying the reform measures already implemented.

Some argue that some elements of performance budgeting can be introduced, even if the basics are not entirely built into the budget system. Presenting the case studies of the experience of seven African countries in developing "result based budgeting", John Roberts

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<sup>17</sup> See Lienert Lienert, Ian, "A Comparison Between Two Public Expenditure Management Systems in Africa." January 2003. IMF Working Paper No. 03/2.

Daniel Tommasi "Budget execution" in Anwar Shah editor "Budgeting and budgetary institutions" WBI. World Bank. 2007.



argues that significant elements of performance budgeting can take root and be at least locally effective in countries with significant shortcomings in public financial management<sup>18</sup>. According to John Roberts: *"Informality' in the politicoadministrative culture inhibits the spread of results-accountability, but it does not prevent its emergence in islands of excellence"*<sup>19</sup>.

Matthew Andrews argues<sup>20</sup>: *"It is plausible that governments could implement performance-based reforms successfully without having basics first. Similarly, governments who do develop basics first may experience limited progress in adopting performance-based reforms"*. He notes that strong cash budgeting (rationing) and line item controls may limit the potential to ensure the budget-policy link, stifle managerial innovation, and therefore may make it difficult to move from the first stage in Schick's sequencing to the second and third stages.

Both John Roberts and Matthew Andrews acknowledge, however, that the evidence on the impact of the reviewed performance based reforms on public expenditure management is limited. In any case, their remarks may call for greater specification of the mode of sequencing and the content of the first phase in the reform process, not for throwing out the "basics first" approach.

Thus, the basic procedures should be properly defined, in order to allow further progress in public expenditure management. As noted by Schick<sup>21</sup>, *"this process [the sequencing presented in box 1], however, can bear fruit only if the controls are exercised in a fair and realistic manner... If these conditions are absent, learning will take place, but it will be pathological: how to beat the system, how to outmanoeuvre the controllers, how to get paid without really working, and so on"*. Duplicate and/or cumbersome detailed line-item controls and unpredictable cash rationing may ensure effective expenditure control. Nevertheless, except under special circumstances, such procedures should not be seen as components of the basics, because they may have a negative impact on the implementation of policies and management of line agencies.

Reforms must be attractive and favour the emergence of skilled technicians, including economists and planners, not only accountants and financial controllers. Therefore, besides control and transparency issues the first platform may include other actions, such as those aimed at reinforcing the budget policy-link, so long as they do not dissipate the efforts. Line ministries must be involved at an early stage of the reform process, in order to reach a broad consensus. Reinforcing the basics should not mean over-centralising public expenditure management in the hands of the MoF.

Building "islands of excellence" or carrying out pilot experiences may help in promoting reform measures going beyond the basics. However, to be an effective improvement in PEM,

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<sup>18</sup> John Roberts. "Managing public expenditure for development results and poverty reduction. February" 2003. ODI. John Roberts. "Results-Oriented Public Expenditure Management: Will it Reduce Poverty Faster?". ODI Briefing Paper. April 2003

<sup>19</sup> Such as semi-autonomous agencies revenue administration authority.

<sup>20</sup> Matthew Andrews. "Beyond 'best practice' and 'basics first' in adopting performance budgeting reform". Public Administration and Development. No 26, 2006.

<sup>21</sup> Allen Schick op. cit., in the World Bank Research Observer, February 1998.

these "islands" should be sustainable, not dependant on donors' support and technical assistance, and they should not lead to increased clientelism in appointments.

ii) Are there different degrees of priority among the basic measures?

There are strong linkages between these basic measures, listed in the different PFM areas. It would be questionable, for example, to focus narrowly on compliance controls in budget execution, if aggregate fiscal discipline cannot be ensured because a bad budget preparation leads to over-estimated revenues and under-estimated expenditures. The whole set of basic priorities should be in place to ensure further progress along the other objectives of PEM (resource allocation in conformity with government objectives and operational performance).

However, progress in implementing the basics in certain areas may be a condition to achieve the basics in another area. In particular, *a basic accounting and financial reporting system and clear definitions of responsibility in budgeting are necessary to build the other basic elements of a budget system*. In the few countries where the reforms start from scratch (e.g. some post-conflict countries), it may not be feasible to implement all the basic measures at short notice. The first platform should not be overloaded. It could be narrower than the whole set of basic measures presented in section B, focusing, for example, on some of the basic priorities presented in the sections B1, B2c and B5 (satisfactory budget coverage, adequate administrative and economic budget classification; clear accounting procedures and a clear definition of the responsibilities in budgeting).

c) *Questioning the relevance of some end objectives*

The relevance of some approaches in budgeting can be questioned, whether they are considered for the short or for the long term. The approaches to the control regime have been discussed earlier when presenting the Schick thesis. This section focus on issues related to planning, programming and budget formulation. Outright importation of "best practices" has been discussed and criticised earlier. Concerns expressed in this section are related to questionable interpretations of "best practices".

Umbrella themes such as reinforcing the budget policy-link and efficiency in management are often associated to specific instruments, or procedures, such as the MTEF, "performance budgeting", "programme budgeting" "budgeting by objectives", "activity based budgeting", etc. Actually, in the budgetary jargon, the precise meaning of these terms varies from one author, or from one country, to another. Box 4 presents a general definition of programme/performance budgeting, but this umbrella term may cover quite different practices. What is an MTEF, or a programme-budget, varies from one country to another. Sequencing should concern the instruments themselves (For example, sequencing MTEF implementation is discussed in section B2a). Therefore, before rejecting or promoting such budgeting methods, an analysis of their specific content is required to assess their relevance, taking into account the country context. In practice some of these methods are over-ambitious or not relevant, others are more modest and relevant, depending on the country's context.

Whatever the label, it is important to avoid inadequate approaches in formulating the annual budget or an MTEF. Such inadequate approaches include, among others: (i) attempts to establish a mechanical direct link between performance and resource allocation; (ii) attempts

to budget, or prepare an MTEF, by objectives and; (iii) excessively detailed activity costing in the budget or the MTEF.

i) What is the link between performance and resource allocation?

A performance orientation in public expenditure management is needed to encourage improvement in service delivery. However, the objective of better performance orientation should not be confused with specific tools for achieving it, which strictly depend on the country context. Sketching out a sequence of steps to introduce a performance orientation in the budget system is desirable, but, even in the distant future, it would be questionable to consider adopting, in a developing country, a budget system that will directly link budget allocations to performance.

*"Direct performance budgeting" refers to a budget system that allocates resources based on the achievement of specific, measurable outputs or outcomes, or link each increment in expenditure with an increment in output or performance<sup>22</sup>. However, as noted by Schick, implementing this concept requires that government have reliable data on the unit cost of services and that bids for resources be structured in a manner that facilitates the marginal analysis of costs and outputs. Few governments currently have this capability<sup>23</sup>, though many compile performance information.*

Although there are a few exceptions, the link between resource allocation and performance is indirect. Resources are limited. Even if a programme “performs well,” commensurate funding may not be forthcoming if it is considered a marginal function of government. Conversely, less cost-effective or “poorly-performing” programmes must continue to be funded, if these programmes are “essential” government functions— such as education. Also, if performance measures are used to mechanically adjust budget allocations, any experienced bureaucrat would be able to manipulate such a system to produce favourable results<sup>24</sup>.

Monitoring performance indicators may provide valuable feedback to budget preparation under certain conditions. As developed in the literature on performance, the performance indicators must be relevant, attributable to the concerned programmes, clear and monitored in a cost-effective manner. The number of indicators used for budget preparation and the policy dialogue should be limited. When such conditions are met performance indicators monitoring may be a part of the policy dialogue and may inform a learning by doing process for agency management. What is essential, when using performance indicators, is to build a dialogue between the different actors involved in budget management. This may take several years.

ii) Is budgeting by objectives feasible?

To ensure a better consistency between the strategies and the budget, some countries (e.g. Madagascar) have attempted to structure their budget according to the objectives of the

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<sup>22</sup> The expression "direct performance budgeting" is used by Teresa Curristine, who underlines that "this form of performance budgeting is used only in specific sectors in a limited number of OECD countries". See Teresa Curristine. Performance information in the budget process. OECD Journal on Budgeting. Volume 5. No 2. 2005.

<sup>23</sup> This remark was made for both industrialised and developing countries. A. Schick. Does budgeting have a future?. OECD Journal on budgeting. Vol. 2 No 2. 2002.

<sup>24</sup> The Goodhart's law – formulated by a former chief economist of the Bank of England - says that whatever you adopt as a target ceases to be a relevant target once you have adopted it.

strategies. Donors' recommendations to show the link between the budget and the Poverty Reduction Strategy Papers (PRSP) may have encouraged indirectly such an exercise<sup>25</sup>. Because of attribution problems, the cross-sector and cross-organisation nature of some strategic objectives and the fact that strategies do not cover non-priority sectors and routine activities, such an approach leads to an artificial and questionable grouping of expenditures. Instead of favouring the policy debate, it makes the budget documents unreadable.

Actually, there is no mechanical link between the resource envelope and the objectives, some objectives must be achieved through increased expenditures, others through institutional measures (e.g. regulations). Budgeting must take into account financial constraints. A top-down approach starting from the objective is not feasible<sup>26</sup>. Also a "budget by objective" that will attempt to overcome administrative compartmentalisation is difficult to administer and does not meet the objectives of transparency and accountability, which should govern the development of a programmatic approach in budgeting. It is generally doomed to failure.

According to some interpretations of programme-budgeting (or "full-blown programme budgeting"), a programme-budget should be organised according to cross-ministries objectives. Attempts to overcome administrative compartmentalisation explain partly the failures of many programme budgeting experiences undertaken in the 1960s. In the early 1990s, the budget of many transition countries was structured in cross-ministries programmes/functions. As a result, in several countries, the sectorial budget policies were coordinated by the branch departments of the ministry of finance, not by the line ministries.

Actually, the programme should be defined within the line ministries' budget, when it is a segment of the budget classification system<sup>27</sup>. The UN manual that promoted, in the 1960s, programme/performance budgeting in developing countries, defined the programme as *"a division of work performed by an agency, which identifies that portion of the work that produces an end product or service representative of the purposes for which the agency was established"*<sup>28</sup>. In countries such as France or Australia, which present their budget by programme ("outcome" in Australia), the programme is a division of the line ministries' budget<sup>29</sup>. As John Roberts<sup>30</sup> puts it: *"Indeed, the implication from the case studies is that full-blown programme budgeting may be unmanageable as well as unnecessary. A half-way house is preferable and more feasible in which responsibility rests with the heads of established ministries and agencies with prime responsibility for programmes for delivering programme results. This avoids the complex and unsettling need to reorganise administration around programmes"*.

Programme classification issues will be discussed below in section B1b.

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<sup>25</sup> For example, in Madagascar the 2005 PER indicated: "The key reference point for programme budgeting is a Government programme like the PRSP".

<sup>26</sup> The French ministry of finance explains the differences between budgeting by objectives and the French programme budgeting system at [http://www.finances.gouv.fr/lolf/15\\_1\\_5.htm](http://www.finances.gouv.fr/lolf/15_1_5.htm).

<sup>27</sup> This does not impede to make for special cross-sector programmes separate expenditure programming exercise, for policy inter-ministerial coordination.

<sup>28</sup> A manual for programme and performance budgeting. United Nations. 1965.

<sup>29</sup> The article 7 of the 2001 French budget organic law stipulates "the programme groups funds aimed at undertaking an action or a set of consistent actions placed under the responsibility of the *same ministry*..."

<sup>30</sup> Op. cit.

### iii) Can a budget or an MTEF be established by activities?

Some developing countries are developing what they call an "activity based budget" (e.g. Zambia), or have attempted to present detailed activity costs in an MTEF (e.g. Malawi, Ghana) or are preparing annual activity plans that detail the budget of spending units by activities (e.g. Madagascar, in some ministries). It is necessary to be aware of the advantages and limits of such approaches before launching similar exercises.

In theory, "activity based budgeting" uses activity based costing methods, which assign costs to products according to the resources they consume. The (full) costs of products include both direct costs, indirect costs (such as overheads), and depreciation of assets. Such cost accounting methods go far beyond the technical capacity of developing countries and are not widely used in the governments of developed countries. The activity costing exercises mentioned above are quite different from this theoretical "activity based budgeting".

In practice, for running costs, most governments undertake only partial costing exercises. Generally, the estimated activity costs do not include overheads and depreciation, and, in many cases, do not include the personnel, despite the fact that the personnel costs account for the larger part of the resources consumed. Such partial costing methods may be useful to estimate some potential efficiency gains or to estimate the incremental expenditures related to an increase of the level of activities. However, their importance should not be over-estimated, because the estimated costs will often correspond to a small percentage of the full costs.

Estimating the forward costs of multi-annual investment projects is required. By contrast, concerning operating activities, the cost-effectiveness of carrying out detailed activities costing exercises must be assessed before undertaking them<sup>31</sup>. Detailing the costs of each activity undertaken by a spending unit may help in preparing the budget, but monitoring these costs poses problem. Even if the overheads are not taken into account, monitoring the direct costs of each output requires setting proper accounting systems to allocate the inputs to the outputs (e.g. personnel time-sheet, ancillary books to allocate stationary expenses to each output, etc.). There are generally higher priorities in the development of the accounting and monitoring systems.

To develop a performance concern, it is desirable to monitor the delivered outputs but this does not require establishing and monitoring a budget for each individual output. In some countries, the implementation of detailed MTEF, including costing of every activity, has increased the workload of spending units without benefit. In a first stage, efforts should focus on estimating the total costs, and the annual forward costs, of investment projects above a certain size, including their recurrent costs, instead of being dissipated towards partial costing of a myriad of outputs.

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<sup>31</sup> The term "activity" is sometimes used by the governments or the donors for the activity of delivering inputs or quality inputs (e.g. school books). Of course, input costing does not pose such problems.

#### **Box 4**

##### **What is programme/performance budgeting?**

Reviewing the various definitions of programme/performance budgeting, Peter Dean says that performance budgeting would comprise five essential elements (1):

- the subdivision of the government budget into programmes and activities;
- identifying the operational aims of each programme and activity;
- budgeting and accounting so that the separate costs of each programme and activity are shown;
- measuring the outputs and performance of activities;
- using the resultant data to establish standards and norms so that costs and performance can be evaluated.

According to the Peter Dean when it is distinguished from performance budgeting, programme budgeting would comprise only the three first elements of performance budgeting, which are related to resource allocation. However, many use the terms performance budgeting and programme budgeting interchangeably, and not all performance budgets are structured in programmes.

In OECD countries, recent performance budgeting approaches have different names, depending on the country and the focus (e.g. output budgeting, outcome budgeting, accrual budgeting, activity based budgeting, output-price budgeting, etc.). There is no standard model. Key features may or may not include, depending on the country: (i) contracts between the minister and the subordinate units on agreed outputs; (ii) flexibility granted to managers against agreed outputs; (iii) performance monitoring at the programme or the agency level; (iv) accrual accounting; (v) accrual budgeting; (vi) establishing arm's length agencies; (vii) line ministries budget structured into programmes; (viii) competition between government agencies and between government agencies and the private sector; etc. The degree of implementation of these features varies considerably from one country to another. It would be quite questionable and risky to implement most of these features in developing countries (see the recommendations of Allen Schick in box 1). However, developing a performance orientation in PEM, or implementing a programme classification, suitable to the country's context does not require implementing all of them.

(1) Peter Dean "Government budgeting in developing countries. Routledge. 1989.

## B. Priorities by PFM areas

This section presents for the main PFM areas, the basic priorities in strengthening the PFM systems and the reforms that may be engaged, once the basics are substantially in place. The reviewed PFM areas include: (i) section B1: the budget coverage, budget classification and chart of accounts; (ii) section B2: the different stages of the PFM cycle<sup>32</sup>; (iii) section B3: information system issues; (iv) section B4: the legal framework; and (v) section B5: the role of the legislature and accountability to the citizens.

For each PFM area, the reform measures are grouped as follows:

- "Basic priorities" groups basic measures focusing on aggregate fiscal discipline, due process (including compliance), and minimum requirements for accountability and transparency. These measures should be properly designed to avoid hampering future progress along the other objectives of PFM.
- "Further steps" groups measures aimed at consolidating the basics, improving the effectiveness of resource allocation and promoting operational performance. When a logical sequence within the measures placed under the umbrella "further steps" can be identified, the term "subsequently" is used to separate more "advanced" reforms from "intermediate" reforms. The majority of the reform measures grouped under the heading "subsequently" deal with the development of performance oriented instruments.

A few measures aimed at creating the conditions for the development of a budgeting approach based on policies have been discussed under the heading "basic priorities", to recall that the condition for further progress must be created at an early stage of the reform process.

Theoretically, for reforms starting from scratch, the mode of grouping the reform measures in part B could give two or three platforms ("basic priorities"; "further steps"; "further steps/subsequently"). In practice, things are more complex, notably because of previous reform actions and the specificities of each country context. Dealing with previous leapfrogging in the first phase of the reform programme may be necessary. Part B presents suggestions to streamline an existing MTEF procedure or an existing programme classification.

The set of measures identified in each PFM area are not independent. Sound financial accounting and reporting procedures and a clear definition of responsibilities are preconditions for ensuring effective implementation of the reform measures of the other PFM areas. This will require implementing "basic priorities" for financial reporting and budget classification. Increased sophistication of methods for expenditure programming and budgeting will require improvements in monitoring and decision making support systems, such as budget classification. For example, it would be questionable to introduce performance indicators if they are not monitored, or to develop an MTEF if budget execution is not monitored along the same expenditure classifications as the MTEF.

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<sup>32</sup> Although this paper focuses on PEM, this sub-section deals also with some revenue administration issues, notably those covered by the PEFA-PFM-PMF.

Interconnections between processes may depend on the country context. For example, disciplined budget execution processes are necessary to make the budget credible. However, this does not necessarily suggest that the first phase of the reform programme should focus on budget execution processes. Many questionable practices in budget execution come from a poor budget preparation. Identifying the causes of poor budget credibility, as shown by a PEFA PFM-PMF assessment, calls for a detailed review of the country's institutional context, and, in particular, the informal rules.

## **1. The budget and budget classification**

### *a) The budget coverage and documentation*

#### *i) Some key issues*

Coverage of the budget. For fiscal discipline and efficient resource allocation all government expenditure programmes and revenues should be reviewed together when budgeting. Therefore, the budget of the central government and the budget execution reports should cover all central government revenues and expenditures.

Weaknesses in this area include an insufficient coverage of expenditures financed from project aid and/or proliferation of extra-budgetary funds and accounts. Such a situation is often explained by the need to by-pass cumbersome budget execution procedures or encourage performance through creating arm's length agencies or funds. Special procedures may be desirable, or required by the donors, for managing the expenditures financed by external sources and some semi-autonomous agencies, such as road funds, universities or hospitals. However, such special procedures should not hamper budget transparency or fragment decision making.

In many countries, the central government budget does not include the expenditure financed by the own revenues of spending units and presents the expenditures of semi-autonomous agencies (e.g. the hospitals) under a single line that corresponds to the transfer to the agency. Such arrangements are aimed at encouraging cost recovery and providing managers with flexibility in managing their budgets. However, for transparency, the budget documentation and reports should include all government's revenue, including agencies' own revenues, and the expenditures in gross terms (that is, not netted with agencies' own revenues).

Budget documentation. For accountability and the effective scrutiny of the legislature, annual budget documentation (the annual budget and budget supporting documents) should provide a complete picture of central government fiscal forecasts, budget proposals and out-turn of previous years, various information on the fiscal and economic policy situation and perspectives on the fiscal policy. The budget documentation should be made public. Simple documents presenting the budget policy, such as "budget in brief", should be widely disseminated.



## ii) Basic priorities

Budget coverage. Priority actions should consist of making the budget as comprehensive as possible, for both ensuring fiscal discipline and effectiveness of resource allocation. However, achieving full comprehensiveness will take time. At least in the first phase of reforms it should be shown that the country is moving in the right direction:

- A significant percentage of expenditures financed by external aid should be included in the budget documentation and the budget execution reports. They should be presented under the same headings (e.g. organisation, programmes) than other expenditures. Data concerning some grants may be difficult to collect, but all expenditures financed by external loans should be included in the budget documentation and budget execution reports.
- Own revenues and expenditures of autonomous agencies, extra-budgetary funds (including Treasury's special accounts) should be included in the budgetary documents, at least as annex to the budget, and in other fiscal reports. Such measures will face resistances. It may be difficult to reach a fully comprehensive coverage at short notice. However, it will be important to move significantly in this direction in the first stage of the reform process in order to give the right signals.
- A common economic classification (at least for the major categories) should be adopted for all government agencies (see section B1b).
- The budget of the social security funds should be transmitted to the legislature, at least for information.

Budget documentation should include information and analyses on:

- The current economic situation and the economic assumptions (e.g. expected GDP growth) for the year of the budget submitted to Parliament ("the budget year").
- The main fiscal parameters (e.g. total revenue, total expenditure and fiscal deficit/surplus), both in absolute terms and as ratios to GDP for the previous year, the current year and the budget year. The deficit should be defined according to some international standards (e.g. ESA-95<sup>33</sup>, GFSM 1986 or 2001). Preferably, these data will be presented under the format of the government consolidated financial operations table prepared, when reviewing the fiscal policy with the IMF.
- Data on financing.
- Public debt flows and stocks distinguishing government direct debt, government guarantees and non-guaranteed public debt<sup>34</sup>.

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<sup>33</sup> European System of Accounts

<sup>34</sup> In large developing countries or in medium term economies, compiling sub-national government debt and non-guaranteed debt of State-owned enterprises may take time and requires setting up adequate procedures, but transparency is required in this high risk area.

- Current year's budget and previous year's budget outturn presented in the same format than the budget.
- Various summaries to facilitate budget analysis and Parliament's scrutiny.

### iii) Further steps

There is no clear cut border between the basic priorities and further steps. Full comprehensiveness of the budget cannot be expected at short notice and improving the quality of the budget documentation is a continuous process.

Budget coverage. Further steps will consist of:

- Eliminating remaining loopholes in the budget coverage, presenting in the budget expenditures of semi-autonomous agencies in gross terms, eliminating some special funds (provided that the budget execution procedure suit the management of the expenditures of these funds).
- Including all, or nearly all, expenditures financed from external grants in the budget.

Budget documentation. In addition to the information elements mentioned in the basic priorities, and to better support the formulation of the budget policy, the budget documentation will include:

- A medium-term macro-economic framework, including a medium-term fiscal framework covering at least three years (MTFF- see section B 2a for the definition of the MTFF<sup>35</sup>).
- Analyses of policy changes, new activities and expected efficiency gains, showing their relationships with the government strategies.
- A report on tax expenditures (tax exemptions and reductions granted to achieve certain policy objectives).
- Analyses of fiscal risks (such as loans guarantees, risks related to the public sector, the banking sector or concessions).
- Reports on quasi fiscal expenditures (activities of the central bank or state-owned of enterprises that are in nature similar to fiscal actions pursued by the government, e.g. credit to commodity boards at below-market interest rates). *Subsequently*, the quasi fiscal expenditures should be either eliminated or budgeted to reimburse the entity that financed them<sup>36</sup>.

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<sup>35</sup> Preparing an MTFF is a basic priority (see section B2a). However, an interim period may be needed to ensure the process is run in properly..

<sup>36</sup> In Turkey from 2001, following a deep financial crisis, quasi fiscal expenditures ("duty losses") of State-owned banks are funded from the central government budget. The Treasury pays the subsidy monthly. At the end of the year, the Banking Regulation and Supervision Agency controls and compares actual duty losses with Treasury transfers.

- A report on the forward costs of investment projects included in the budget.
- Reports on forward revenue and expenditure estimates will be included in the budget documentation, according to the progress made in developing a multi-year approach in budgeting (see below section B2a).

## *b) Budget classification*

### *i) Some key issues*

A budget classification system is an instrument for administering the budget, policy analysis and accountability. Box 4 presents the different segment of the expenditure classification system.

To facilitate budget analysis, fiscal reporting and computerisation of clear definitions are required. The following principles should be adopted: (i) each segment of the budget classification system must be of homogeneous nature (e.g. the administrative classification should not include economic categories and vice versa); (ii) each segment of the classification system should be exhaustive and cover the whole budget (e.g. the administrative classification should cover all spending units); and (iii) redundancies should be avoided.

A "traditional" budget classification system consists of an administrative classification combined with an object (line-item) classification, which should be an economic classification. Such a system focuses on day-to-day administration of the budget and compliance control.

Economic/object classification. Countries have generally an "object"<sup>37</sup> (or line-item) classification that details the inputs, the nature of transfers (student allowances, subsidies, etc.) and the economic composition of capital expenditures (equipment, construction, etc.). Such a classification should be easily mapped into the IMF GFSM (government finance statistic manual) economic classification<sup>38</sup> to prepare fiscal reports to the IMF GFSM 2001 standards, notably the government consolidated financial operations table.

In many countries, the object classification meets this requirement<sup>39</sup>. However, in some countries, the object classification does not suit the needs for fiscal reporting, because of its heterogeneous nature (e.g. special activities are mixed with economic categories), or because different GFSM economic categories are mixed into a single object (e.g. interest and amortisation payments are grouped into a single object or some capital expenditures are

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<sup>37</sup> Detailed "*nature de la dépense*" (nature of the expenditure) in Francophone countries, at the article and/or the paragraph level.

<sup>38</sup> Excluding consumption of fixed capital (depreciation, physical deterioration, etc.), because it will be quite premature to account for such accrual elements in most developing countries, and all the more so to include them in the budget appropriations.

<sup>39</sup> For example, the West African Economic and Monetary Union (WAEMU) has established a standard economic classification and a bridge table between this classification and the government financial operation table (*Tableau des opérations financières de l'Etat -TOFE*).

classified as current expenditures, etc.)<sup>40</sup>. Such weaknesses should be addressed. Often, an immediate measure may consist of dividing the questionable objects into economically homogeneous sub-objects<sup>41</sup>. However, in the longer run, a pure economic classification should be established. For computerisation, the principle of homogeneity, as mentioned earlier, should be enforced.

In many developing countries, expenditures reported as capital expenditures are the expenditures included in the "investment budget". Actually, current expenditures may account for about 30% of the "investment budget", notably, because of the economic composition of donors' "investment" projects. As a result, capital expenditures are generally over-estimated. This is generally explained by the lack of centralised information on the actual economic composition of donors' financed expenditures. Improvements are required in this area (see section B2c).

The revenue and financing classifications must also be compatible with the GFSM standards.

Administrative classification. The administrative classification should suit the needs for accountability and budget administration. It should be properly detailed either in the budget or in budget implementation documents to identify each spending unit that benefits from budget resource allocations.

Ideally, for policy analysis and sound budget management, both the administrative structure and the budget should be organised along functional lines. However, in several countries, expenditures are managed and, therefore, presented in the budget under different administrative headings depending on their economic nature. Investment and recurrent expenditures are often classified differently. In several francophone African countries personnel expenditures are presented in the budget by ministry only, while goods and services are presented by ministry and directorate. Consequently the costs of some key functions of government cannot be assessed accurately<sup>42</sup>.

However, streamlining the administrative classification is not a mere classification issue. This will often require reorganising the distribution of responsibilities in budget management. Such reorganisation will face resistance from those who fear to lose power and control, and may have negative consequences if responsibilities in managing certain expenditure items are transferred to organisations with weak capacity.

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<sup>40</sup> For example, in the 2006 Syrian budget the item 53 mixed principal, interest and credit facilities. In Tunisia, the article corresponds to the economic nature of the expenditure for recurrent expenditures, and to the purpose for capital expenditures. In Sri Lanka, in 2003, there were two different object classifications for capital expenditures: one for donor funded projects, another for domestic funded capital expenditures. Before 2004, the South African budget classification presented many inconsistencies, according to the South African Treasury: "For example, disposable baby nappies were found to be classified as capital expenditure and major school rebuilding projects as current expenditure. This was mainly due to classification rules being inconsistently applied and limited control over their application. In addition, departments were allowed to create their own accounting codes on the systems, leading to a vast number of codes and hundreds of duplication". (source: 2004 Estimates of National Expenditure-overview)

<sup>41</sup> On the other hand, inputs are sometimes divided in sub-inputs according to some special purposes (e.g. "school books for poor regions"). It is better to consider that these special purposes are the lowest level of the administrative or the programme classification, if any, rather than to detail the object classification by purposes.

<sup>42</sup> For example, in many francophone countries (Madagascar, Morocco, etc.) the costs of primary education cannot be found in the budget and budget execution reports, because the personnel expenditures of the ministry of education are grouped together, whatever the level of education.

Functional classification. A functional classification classifies expenditure according to their socio-economic purpose. A functional classification facilitates historical and international comparisons, because it is independent from the organisation of government. The Classification of Function of Government (COFOG) is the international standard for functional classification<sup>43</sup>. Governments should be able to report according to their key functions/sub-functions (e.g. primary education, hospital services, law courts, road transport, etc.). Possible ways to meet this requirement depend on the structure of the administrative classification:

- If the administrative classification is sufficiently detailed and is, more or less, organised along functional lines, a bridge table between the administrative classification and the COFOG (eventually completed for taking into account some special concerns) can be established. Reports will be prepared using this bridge table. It will not be necessary to use the COFOG in the day-to-day budget administration and accounting activities.
- If responsibilities in budgeting depend on the economic nature of the expenditure, the accounting books and data bases should be reorganised to report properly, according to the functions and sub-functions of the government. For example, the personnel management data bases should separate primary school teachers from secondary school teachers, prison warders from judges, etc. Financial reports of donors' multi-sector projects should be organised by function/sub-function. Therefore, either the administrative classification will be streamlined, or a functional classification introduced into the classification system used for day-to-day budget administration.

Programme classification. A programme consists of a consistent set of activities to which are associated a set of policy objectives. It groups expenditures independently from their financing source and economic nature. A programme classification may be used for policy planning, decision making, performance monitoring and administering the budget, depending on the country. The notions of programme and function are near, but unlike the COFOG the programme must take into account the country administrative and policy context.

A programme classification may have three levels: (i) the programme<sup>44</sup>; (ii) the sub-programme; and (iii) the activity. If a programme/performance budgeting exercise is undertaken, outcome indicators will be set up at the programme level, while output indicators could be set up at the activity level.

Several pitfalls should be avoided in developing a programme classification, such as structuring budget according to cross-ministries objectives (see section A5a), over-detailing the programme into activities (see section A5b) or making cost accounting exercises. Box 6 suggests some principles that could diminish the risk of failure in implementing a programme classification<sup>45</sup>. However, depending on the degree of disjunction between the programme

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<sup>43</sup> Developing countries may want to detail some COFOG items. For example, the COFOG does not allow the primary health care centres to be identified and groups agriculture affairs into a single item.

<sup>44</sup> In France, the highest level is the "mission". The budget is voted by mission, but managed by the programme managers.

<sup>45</sup> Some recommendations presented in Box 6 are not shared by all descriptions of programme-budgeting. For example, Box 6 does not recommend using cost accounting techniques to allocate overheads among programmes. On the other hand, the terms of reference (ToRs) for an EC funded technical assistance project in

structure and the existing administrative structure, implementing a programme classification for budget management may be highly demanding. If the government is not organised along functional lines, setting up a programme classification for budget management will require reorganising in depth the distribution of responsibilities in budget management. As noted, such a restructuring may be difficult and face resistance. One source of resistance, met in some countries, comes from the fact that a “vertical” programmatic approach may diminish the role of central government's regional authorities (such as, the Prefect, the governor or the *wali*), which deal with several programmes.

An intermediate, and less demanding approach, consists of using the programme classification for information in policy documents annexed to the budget (such as sector MTEFs or programme-budgets), but not in the budget itself. *If* these documents are consistent with the budget and the financial constraints and *if* a bridge table is established between their programmes and the budget items, they may facilitate budget policy analysis and expenditure programming. However, because their role in budget execution management is weak or non-existent, such documents are useless in the countries where actual expenditure deviates significantly from budgeted expenditure.

Sub-national government. For the purposes of policy analysis, it is necessary to consolidate the expenditure of the different levels of government. For this purpose, sub-national and central governments should have a common functional and economic classification of expenditures, (or at least common for the main headings of these classifications).

## ii) Basic priorities

The first stage in rationalising the budget classification should be to ensure that the requirements for administering the budget and fiscal controls are met:

- Ensure that the economic classification allows reporting according to the GFSM standards<sup>46</sup>.
- Group all expenditures according to an administrative classification sufficiently detailed, for day-to-day administration of the budget and accountability.
- Ensure that all central government entities (including extra-budgetary funds, autonomous agencies, etc.) share the same economic classification (or at least, a level of their economic classification that allows reporting according to GFSM standards).

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Cameroon mention the recruitment of international experts in cost accounting to implement accounting systems at the level of programmes and sub-programmes (*Programme pour l'amélioration de la programmation des dépenses publiques*- ToRs- June 2007). Jack Diamond in "From Program to Performance Budgeting: The Challenge for Emerging Market Economies" (IMF. 2003) presents several recommendations that are similar from those presented in Box 6 (e.g. "programme mono-functional", "responsibility for implementing each particular programme should almost align by administrative unit to one chapter (or “vote”) in the budget"). However, he considers using cost-accounting techniques, which are not recommended in Box 6 for the budget programme classification.

<sup>46</sup> Excluding consumption of fixed capital.

- Ensure that all sub-national government entities may report according to GFSM economic classification standards, with the view to preparing a general government consolidated operation table.

To start developing a policy concern in budgeting, it will be desirable to prepare analytical reports according to a functional classification compatible to the COFOG, or at least the first level of the COFOG (10 functions) for all functions and to the second level of COFOG for service delivery sectors<sup>47</sup>. In decentralised countries, sub-national governments will also report according to such a functional classification. As noted, if the administrative classification is properly organised, these analytical reports will be prepared by establishing a bridge table between the administrative classification and the functional classification. Under these conditions, their preparation may be included in the first phase of the reform process. Otherwise, the budget classification system should be properly reorganised to report by functions. This may require revising the format of accounting books and the personnel databases, and goes beyond the basics. However, actions to progress in this direction must be engaged at an early stage of the reform process, at least for public service delivery sectors, such as the education and health sectors<sup>48</sup>.

The budget documentation should include summaries along the different segment of the budget classification system.

### iii) Further steps

In a second stage, proper arrangements will be set up to prepare reports according to the three levels of COFOG. They will consist of either establishing a bridge table with the administrative classification, or, if the administrative classification cannot be streamlined properly, introducing the functional classification in the expenditure classification system used for budget administration.

*Subsequently*, reforms of the budget classification could consist of grouping the expenditure into programmes to facilitate both the formulation and the implementation of sectoral policies and for accountability. However, before considering implementing a programme classification, implementation requirements and costs should be carefully assessed. Pitfalls mentioned earlier should be kept in mind. The principles suggested in Box 6 should be adopted.

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<sup>47</sup> The COFOG Classification is comprised of 10 divisions (1<sup>st</sup> level), which are in turn subdivided into 69 groups (2<sup>nd</sup> level) and 109 classes (3<sup>rd</sup> level). The COFOG groups related to public service delivery allow analysing the intra-sectoral resource allocation in sectors such as the education or the transport sectors.

<sup>48</sup> To estimate the personnel costs for some key sub-functions like primary education, some countries use various parameters such as the ratio of goods and expenditures, the average salary rate and the distribution of posts by level of education (for the programme-budgets of Benin –in 2004- and the EFA reports prepared in Madagascar –in 2007), such methods are not satisfactory and should be only transitional.

### Box 5 Budget classification system

A budget classification system is an instrument for administering the budget, policy analysis and accountability.

The expenditure classification system consists of different segments or sub-classifications, such as, the following:

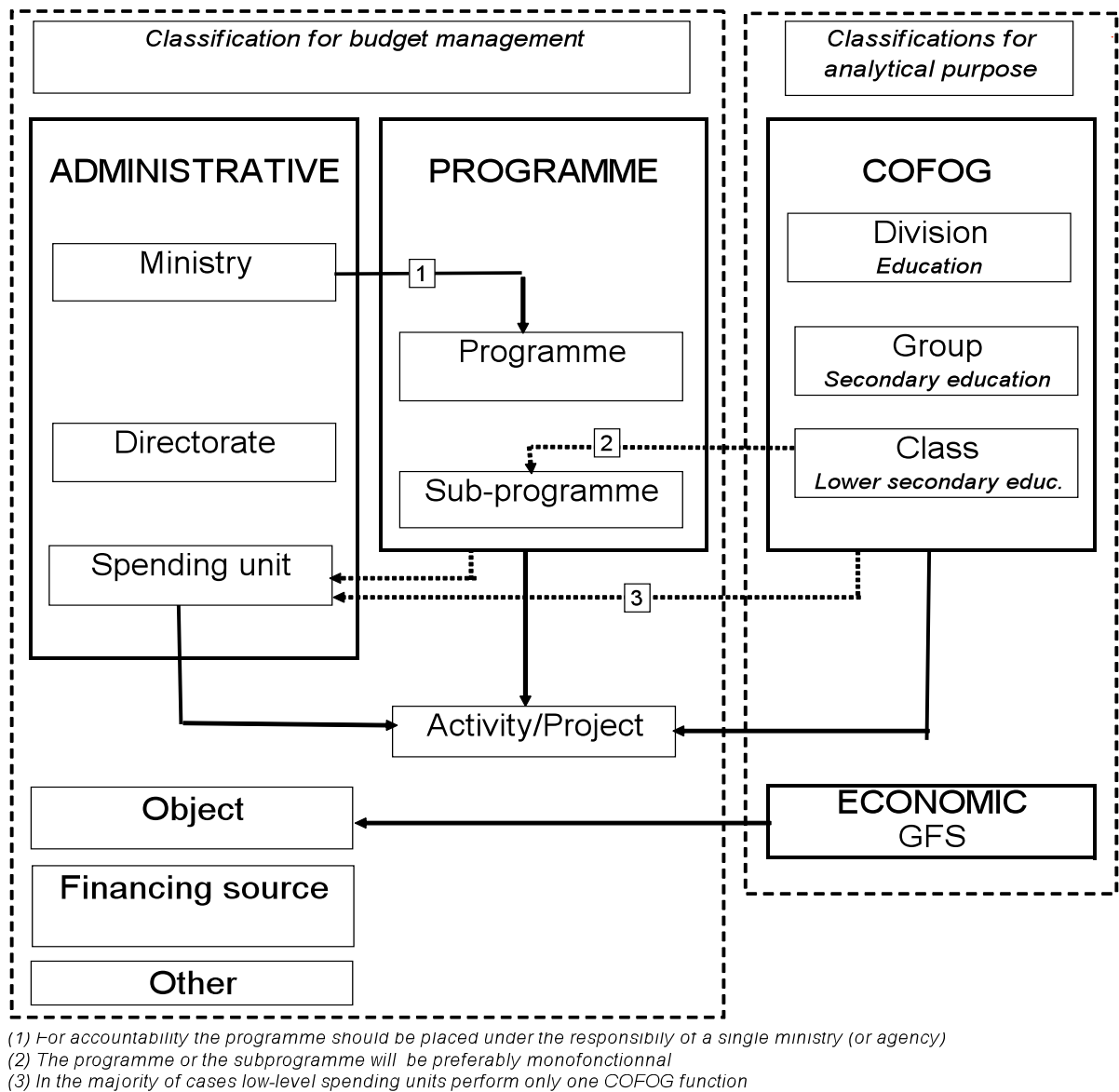
- An economic classification, for fiscal and economic analysis, and controls. The object classification used in many countries is more or less an economic classification (wages, electricity expenditures, student allowances, etc. are examples of objects). This classification should be properly designed to prepare fiscal reports, and notably the government financial operation table, according to the international standards.
- An administrative classification, for budget administration, compliance controls and accountability, which identifies the administrative divisions responsible for budget management, such as ministries, directorates and spending units.
- A functional classification, for policy analysis, historical and international comparison, and preparing the national accounts. A functional classification classifies expenditures according to their socio-economic purposes, such as defence, pre-primary and primary education and hospital services. It is generally used to prepare analytical reports, not for day-to-day budget administration. The international standard for functional classification is the COFOG.
- A programme classification, for policy analysis, budget management and accountability. A programme groups the expenditures of a line ministry according to both their objectives and the centres of responsibilities. The concepts of programme and function are near, but the programme classification depends more closely on the country policy objectives and administrative structure. The South African budget is an example of a budget structured in programmes. For example, the budget of the department of water affairs and forestry is divided into four programmes (administration, water resources management, water services, forestry), which are in turn divided into 5 to 13 sub-programmes.
- A financing source classification for budget administration, notably to separate externally financed expenditures from domestically financed expenditures.
- Any other classification that may be required for budget analysis and management (e.g. a regional classification).

The revenue classification system consists of an economic classification, which should be compatible with GFS standards for fiscal reporting and an administrative classification, at least for non-tax revenues collected by line agencies.

The financing classification consists of an economic classification, which should be compatible with GFS standards.



**Figure 2**  
**Relationships between budget classifications**



Adapted from R. Allen and D. Tommasi "Managing Public Expenditure: A reference book for transition countries". OECD, 2001.

### **Box 6**

#### **Programme classification: Bypassing some pitfalls**

A programme groups activities of a line ministry or an agency which have a common set of objectives. The programmes may be structured into sub-programmes and activities. Outcomes indicators, if any, will be defined at the programme level, while the activities are the level at which outputs are produced.

Setting up a programme classification may be time-consuming and may fail. To limit such risks, the following principles should be adopted when designing a programme classification:

- For accountability and budget administration, the programme should be placed under the responsibility of a single line ministry (or main agency). Cross-cutting issues may be dealt with in separate cross-ministries policy documents.
- Each programme should correspond to a clearly defined set of administrative units, for recurrent expenditures, transfers and investment projects. A bridge table mapping the spending units, investment projects and transfers into programmes must be established.
- Cost accounting methods and uses of distribution parameters to allocate budget lines among programmes must be banished, consequently: (i) within a ministry, the divisions responsible for coordination and administration affairs (e.g. planning division, financial affairs division, etc.) will be grouped into administrative programmes separated from the operational programmes; (ii) a staff member should be assigned to only one programme.
- The number of programmes by ministry should be limited (5 to 6 in average, depending on the size of the ministry).
- A programme should be preferably monofunctional. Examples of programmes could include, besides the administrative programme: (i) for the ministry of education, the levels of education (where the education system is centralised); (ii) for the ministry of defence, the army corps (air, navy, etc.); (iii) for the ministry of transport, the modes of transport; etc.
- To avoid in-depth revision of the accounting books and cumbersome over-detailed costing exercises, the lowest level of the programme classification (the activity) will generally correspond to the investment project or to the set of activities of the lowest level spending units. More detailed activities may be identified and their outputs may be monitored, but this does not require setting up over-detailed activity budgets that cannot be monitored.
- A programme manager responsible for coordinating the activities of the programme will be appointed, he/she will preferably be the head of the department that covers the programme activities or the larger share of the programme activities.

Such principles do not eliminate all difficulties. In particular: (i) a preliminary reorganisation of the accounting books and, in several Francophone countries, personnel data bases may be required and (ii) risks of overlaps and conflicts between the heads of administrative divisions and programme managers must be assessed; and (iii) for deconcentrated units of the central government, which manage different programmes, appropriate arrangements must be set up. In some countries the role of Prefects or Governors in budget implementation should be reviewed to make the programme approach effective.

c) *Chart of accounts and basis of accounting*

This section focuses on the accounting methods and reporting. Some additional issues on accounting are discussed in section B2d.

i) Some key issues

A chart of accounts classifies transactions and events (payments, revenues, increase/decrease in liabilities increase/decrease in assets, internal operations between agencies and treasury offices, etc.) according to their economic, legal or accounting nature. It defines the organisation of the ledgers kept by the accountants. The budget classification system reviewed in the preceding section defines the structure of the accounts or sub-accounts of the chart of accounts that are related to budgetary operations.

The degree of sophistication of the chart of accounts depends on the basis of accounting. The basis of accounting refers to the accounting principles that determine when transactions or events should be recognised for financial reporting purposes. There is a spectrum of accounting bases, ranging from cash, at one extreme, to full accrual, at the other. Full accrual accounting is similar to private sector accounting (e.g. depreciation and superannuation liabilities are accounted for). Bookkeeping refers to the way the accountants' books are organised. (See Box 7 for a definition of the bases of accounting and the modes of bookkeeping).

Debt accounting is on an accrual basis in most countries, as required for preparation of financial programmes and debt negotiations. Concerning the other transactions, the bases of accounting vary from one country to another (see Table 2).

Table 2  
**Bookkeeping and bases of accounting**

		<b>Many Anglophone developing countries</b>	<b>Most African Francophone countries</b>	<b>Many transition countries</b>
<b>Line ministries and main agencies</b>	<b>Basis of accounting Transactions reported</b>	Registration of commitments Cash accounting	Registration of commitments and payment orders	Some form of accrual accounting (not in conformity with international standards)
	<b>Bookkeeping method</b>	Single entry	Single entry	Double entry
<b>Treasury or MoF accounting department</b>	<b>Basis of accounting Transactions reported as budget expenditures</b>	Cash Payments are reported as budget expenditures	Between cash and partial accrual Payment orders are reported as budget expenditures. They may differ significantly from actual payments	Cash Payments are reported as budget expenditures
	<b>Bookkeeping method</b>	Single entry	Double entry	Double entry

Industrialised countries have implemented, or are implementing, full or partial accrual accounting systems. Certain developing countries intend to move towards (full) accrual accounting for all government operations. Actually, there are more pressing needs in strengthening the accounting systems of developing countries than accounting for items such as depreciation and superannuation liabilities. Generally, implementing full accrual accounting methods in the whole government should not be included in the reform agenda of low income developing countries<sup>49</sup>. Developing countries need to improve their asset management. Assets registers should be maintained and subjected to periodic physical inspections, but this does not require accrual accounting.

However, some aspects of accrual accounting may be considered favourably. Recognising expenditures at the verification stage (when goods and services are delivered) instead of only at the payment stage is desirable (such an accounting method is sometimes named "modified accrual"). If cash accounting is already satisfactory, implementing full accrual may be considered for some agencies involved in direct public service delivery (e.g. the hospitals), or for quasi-commercial activities (e.g. water boards).

In many developed countries the accrual method is only used for accounting. However, a few OECD countries have also implemented an "accrual budget" (e.g. New Zealand). Including accrual elements in the appropriation bill submitted to Parliament would not be transparent in countries that lack skilled accountants.

Double-entry bookkeeping is generally preferable. It facilitates controls and recording liabilities, provided that procedures are clearly defined. However, it is not a panacea. Double entry accounting systems in a few developing countries may not be transparent because the method of registering transactions in numerous third parties and suspense accounts<sup>50</sup> is unclear or understood only by the accountants.

## ii) Basic priorities

The minimum requirements for financial reporting are presented in section B2c. These requirements do not need to change the cash basis of accounting for non-interest transactions, provided that ancillary books are kept for registering commitments and outstanding liabilities. Basic priorities in reforming the accounting system should be aimed at ensuring that the basic priorities for budget formulation, control and reporting, discussed in section B2, are met. They include:

- A budget classification system that meets basic priorities discussed in the preceding section.

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<sup>49</sup> However, modernisation of the existing accrual accounting systems used by spending units, according to international standards, should be favourably considered in several transition countries, provided that cash accounting is already satisfactory.

<sup>50</sup> In several African francophone countries, the fact that the expenditures are accounted for against the budget classification at the payment order stage, while the payment transaction is the counterpart of the debit of a third party account, poses a problem in countries where the time lag between the issuance of the payment order and the actual payment can be several months.

- The capacity of the accounting and reporting systems to record and report transactions at both the commitment stage and the payment stage, and reporting unpaid expenditures.
- Debt accounting on an accrual basis.
- A wide coverage of the central government accounts, including all expenditures financed from project-loans and a large share of project-grants.

### iii) Further steps

Further strengthening of accounting will consist of:

- Developing a chart of accounts that will include accounts covering all financial assets and liabilities (except pension liabilities) and reporting accordingly (that is moving towards "modified accrual accounting"). This will generally require double entry book-keeping.
- Systematic registration and publication of contingent liabilities
- Building selective physical asset registers, focusing on categories of assets that are both valuable and "at risk" of wastage or theft, and thereafter monitoring their utilisation, including in the context of the dialogue on preparation of the next budget.

*Subsequently*, it may be considered to move towards accrual accounting in the agencies where assessment of full costs is desirable, for example for calculating user charges (e.g. water boards, large hospitals, etc.).

**Box 7**  
**Accounting: Some key definitions**

**The basis of accounting**

The basis of accounting refers to the accounting principles that determine when transactions or events should be recognised for financial reporting purposes. There is a spectrum of accounting bases that ranges from cash, at one extreme, to full accrual, at the other. In between, there are several variants of modified cash or modified accrual accounting. The accounting bases of many countries' systems are, in practice, a mixture of cash and accrual.

*"The cash basis of accounting measures the flow of cash resources. It recognizes transactions and events only when cash is received or paid" (1). Financial statements produced under the cash basis of accounting cover cash receipts, cash disbursements, and opening and closing cash balances. A cash-based financial reporting system has the advantage of being simple and comparable to monetary data. In some modification of the cash basis accounting the accounting period includes "a complementary period" (e.g. 30 days) for payments after the close of the fiscal year.*

*"The accrual basis recognizes transactions and events when they occur irrespective of when cash is paid or received. Revenues (income) reflect the amounts that fall due during the year, whether collected or not. Expenses reflect the amount of goods and services consumed during the year, whether or not they are paid for in that period. The costs of assets are deferred and recognized when the assets are used to provide services" (1). Full accrual accounting is similar to the accounting systems for private enterprises. Financial statements produced under an accrual accounting system cover revenues, expenses (including depreciation), assets (financial and physical), liabilities, and other economic flows. Because requirements to implement full accrual accounting are heavy, there are in practice many modifications of the accrual basis of accounting. For example in some countries all fixed assets are written off (i.e. fully depreciated) at the time of acquisition or construction. This method is sometimes referred to as "modified accrual accounting".*

*In Francophone systems, expenditures are recognized at the payment order stage, whether it is paid or not and the accounting period includes a complementary period for payment orders.*

**Bookkeeping**

Bookkeeping is the recording of all financial transactions. Two methods are widely in use: single-entry accounting system and double-entry bookkeeping system:

- *Simple bookkeeping system* in which transactions are recorded in a single record. An example is a checkbook showing expenditures. Single entry accounting tends to be suitable only for the cash basis of accounting or modifications of the cash basis.
- *Double-entry system* in which each flow gives rise to two equal-valued entries, a credit and a debit entry. By convention, increases in expense and asset accounts and decreases in liability are debits. Conversely, decreases in asset accounts and increases in income and liabilities are credits. In principle, double-entry accounting has the following advantages over single-entry: inclusion of assets and liabilities in the bookkeeping accounts; preparation of financial statements directly from the accounts; and easier detection of errors and fraud

(1) IFAC. Glossary of defined terms in IPSAS 1 (International Public Sector Accounting Standards) to IPSAS 18. 2002.

## 2. The expenditure management cycle

### *a) Budget preparation and expenditure planning*

#### *i) Some key issues*

The annual budget. Budget preparation is largely of political nature, but often the choices of politicians are revealed only at the budget execution phase, through a significant budget deviation. The budget preparation procedure should be aimed at revealing the policy choices before or during budget formulation, not later. Frequent weaknesses in budget preparation processes include, among others, the fact that hard choices are postponed to budget execution, an inappropriate budget calendar that leads to a hasty budget preparation, insufficient coordination between the recurrent and capital budgets, and a poor documentation base to appraise programmes and projects.

Financial constraints should be built into the budget preparation process. For this purpose, spending ceilings should be notified to line ministries at an early stage of the process. Further development of such an approach consists of organising the budget preparation process into two distinct phases:

- in the first phase, often named the "strategic phase", fiscal aggregates and sectoral resource envelopes (expenditure ceilings) are prepared, then decided at a high political level. The expenditure ceilings are notified to line ministries at the end of this phase;
- in the second phase, detailed expenditure estimates are prepared.

During the first phase macro-economic projections and government resource projections should be prepared. These projections should be realistic in order to ensure that the deficit objectives will be met without having recourse to exceptional measures such as cash rationing. Building adequate technical capacity with the ministry of finance and other central agencies involved in macro-economic management is essential. However, over-estimated revenue projections (as well as underestimated expenditure projections) often come from a weak decision-making process, which leads to the postponement of hard choices until the budget execution phase, rather than from a lack of technical capacity. Therefore, special attention must be paid to the decision making process. During this initial phase, line ministries may review the costs of on going programmes, identify new activities or savings on low priority programmes, and transmit the results of these reviews to the MoF.

Line ministries should be provided with sufficient time to prepare their budget and make intra-sectoral prioritisation within the expenditure ceilings. In the same way, the amount of transfers granted to sub-national government entities should be notified to these entities in advance in order to allow them to prepare their budget<sup>51</sup>. An indicative estimate of the grants

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<sup>51</sup> In several Anglophone countries (e.g. Sri Lanka) these transfers are estimated by a Finance Commission, which is independent from the MoF, in order to ensure stable and predictable revenues to subnational governments.

from the State budget should be communicated to semi-autonomous agencies to ensure their budget preparation will be completed before the beginning of the fiscal year<sup>52</sup>.

Medium-term frameworks. The budget should be placed within a multi-year perspective, for assessing the medium-term sustainability of fiscal policies and planning policy changes which requires generally a multi-year period, because the discretionary expenditure margin on a year-to-year basis is very small. If and only if, the processes are well disciplined, a multi-year approach in budgeting may also contribute to improved operational performance, by providing managers with greater predictability for managing their programmes.

Rolling medium-term frameworks, prepared annually, are aimed at placing the budget within a medium-term perspective (see Box 8 for the definitions of the different frameworks). Schematically, three stages may be distinguished in developing such frameworks:

- The first stage will be aimed at ensuring *aggregate fiscal discipline* and the sustainability of the budget policies, through preparing a medium-term fiscal framework (MTFF) and a medium-term macroeconomic framework (MTMF). The MTFF should be based on realistic revenue forecasts. Its preparation should involve the departments responsible for macro-economic management, budgeting and revenue management.
- The second stage will focus on *intersectoral resource allocation*, through preparing an MTEF consisting of forward expenditure estimates aggregated by sector or ministry. These basic forms of MTEF are sometimes called medium term budget framework (MTBF) or "global MTEF". They will be used to discuss the budget policy and frame the annual budget preparation.
- The third stage, which may partly overlap with the second stage, will consist of dealing also with *intrasectoral resource allocation* and providing managers with increased predictability, though developing an MTEF that will detail line ministries' multi-year expenditure projections by programme<sup>53</sup> and eventually by activity (or preparing sector/line ministry MTEF consistent with the MTFF and the MTBF).

The rolling-forward nature of the MTEF is a key feature of the MTEF. The MTEF prepared the previous year gives the baseline for MTEF-budget preparation, after being updated on technical grounds (e.g. to take into account actual inflation). The budget-MTEF preparation process focuses on policy changes compared to this baseline. Actually, in many developing countries, the MTEF and the budget are prepared without taking into account the MTEF prepared the previous year. This makes the exercise purely formal and non-credible. Various reasons explain difficulties in implementing a true rolling expenditure planning process, including, among others, uncertainty over donor funding; willingness to re-assess all expenditure programmes every year, and lack of stability within the government. The fact that this key feature of the MTEFs appears difficult to implement in many developing countries

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<sup>52</sup> In Madagascar, some semi-autonomous agencies prepare their budget three to six months after the beginning of the budget year, when they are certain about the actual amount of the State budget grant.

<sup>53</sup> Or administrative divisions of line ministries, in the countries where the government is organised along functional lines. To prepare MTEF projections, expenditures that meet the same function must be grouped together, whatever their economic nature. It will not make sense, to project over the medium-term, personnel expenditures by ministry and good and services by directorate.



questions the basis for launching such an exercise in countries with weak policy decision making and budgeting system.

Also many so-called sector MTEFs found in developing countries are more similar to a preliminary strategy costing exercise than to an MTEF. They do not comply with the MTFF and they may include financing gaps. These MTEF are not *frameworks*. More worrisome than a mere vocabulary issue, they pose problems because they are sometimes seen as being a financial commitment of the government. At best, if their costing is somewhat realistic, they may be documents to support the negotiations with the ministry of finance or for seeking new external financing. However, it should be clear that they do not provide predictability in budget management, which is one of the objectives of an MTEF. Their status and their function should not be overemphasised.

Box 10 presents two different MTEF experiences, one successful, another disappointing. Box 11 suggests some principles to limit the risks of failure in implementing an MTEF.

Investment programming. Preparing an MTEF should not lead to the abandonment of public investment programming. The systematic review of the forward costs of multi-annual investment projects, including their recurrent costs, is required to assess the sustainability of budget policies. A public investment programme (PIP) is not incompatible with the MTEF, provided that it enforces the resource envelope defined in the MTFF and the MTEF.

Dual budgeting, which consists of preparing the recurrent and the investment budget in separate processes, leads to inefficiencies in resource allocation. It may concern both procedures and responsibilities, when the two components of the budget are prepared by two different ministries or departments. Addressing the organisational issues may prove difficult. Experience shows that merging the ministry of planning and the ministry of finance is not sufficient to unify the budget processes. Depending on the country, in a first stage, it may be better to focus on the processes, rather than on organisational issues.

Strategies and plans. Medium-term frameworks are insufficient for planning policy implementation. Preparing sectoral and national strategies should be the starting point in developing a policy-based budgeting approach. Strategies in sectors such as the education, health or water sectors, or a transport plan, should cover a period of at least ten years. The budget process should take into account policies already formulated and be the main instrument for making these policies explicit and operational. However, policies will be better defined and discussed with the different stake-holders, outside the pressure of the budget process. The strategies must be realistic, but they are less closely driven by fiscal constraints than the MTEF. Before implementing fully-fledged MTEF processes, it will generally be preferable to first prepare strategies.

Figure 4 shows, schematically, the different instruments that support a policy based approach in budgeting. Upstream the budgeting and financial programming processes, sector and national strategies, as well as long term planning tools (e.g. a transport plan), should be prepared. Planning and budgeting works require a robust information base, which should be improved continuously. The expenditure components of the strategies are implemented through the annual budget. The medium-term frameworks (MTFF and MTEF) are aimed at establishing a bridge between the strategies and the budget within a realistic resource envelope. The medium-term frameworks and the budget are driven by the strategies, but they

must also take into account the recent financial and economic developments to ensure fiscal and macro-economic stability.

## ii) Basic priorities

Priority actions in strengthening budget preparation should consist of ensuring the credibility of the budget, its consistency with the macroeconomic policy and its sustainability. In parallel, various actions, such as improving the information base, should be developed to prepare the subsequent steps that will consist of strengthening the budget policy link at both the intersectoral and sectoral levels.

The following procedures, instruments or activities should be developed:

- Preparing medium-term macro-economic projections, including a medium-term fiscal framework (MTFF), which will define the macro-fiscal objectives over the medium-term (overall fiscal deficit, total expenditures, ratio revenue to GDP, etc.). The MTFF should be based on realistic revenue forecasts. Its preparation should involve the departments responsible for macro-economic management, budgeting and revenue management.
- Establishing and enforcing a clearly defined budget calendar that: (i) provides line ministries with expenditure ceilings in order to prepare the budget under hard constraints; (ii) gives line ministries enough time to prioritise their projects and programmes; and (iii) allows the budget to be tabled in the legislature in time.
- Notifying to sub-national government authorities the amount of intergovernmental transfers in time to allow them to prepare their budget on the basis of reliable resource estimates.
- Strengthening the coordination between the investment and recurrent component of the budget, by notably establishing joint reviews of the two components of the budget at each main step of the budget preparation process.
- Improving the information and technical base to support resource allocation decision. In particular, when preparing the budget, the forward costs of investment projects, including their recurrent costs after completion, should be systematically reviewed.

As discussed earlier, it will be important to involve line ministries at an early stage of the reform process. For this purpose the initial reform platform, may include starting the preparation of sector strategies, developing the information base within each sector and strengthening investment programming at the sector level.

## iii) Further steps

Further actions will be aimed at consolidating the results achieved and strengthening the budget-policy link, thorough developing a policy based budgeting approach.

*First*, these actions will include:

- Improving the methods for macro-fiscal analysis and carrying out special analysis such as debt sustainability analysis.
- Refining the budget preparation procedure with a view to preparing, during the initial ("strategic") phase of budget preparation, an MTBF (or "global MTEF"), consisting of forward expenditure estimates aggregated by sector or ministry and a budget policy paper. But its technical preparation should be based on more detailed cost estimates (e.g. review of the forward costs of ongoing investment projects). The MTBF will be reviewed at a high political level.
- Estimating the forward costs of the investment projects included in the MTBF, and publishing them, in a technical document.
- Fully unifying the processes to prepare the capital and recurrent component of the budget, by placing them under the responsibility of the ministry of finance.
- Improving the content of budget requests and budget documents to better identify the objectives and expected results.
- Pursuing the improvement of the information and technical base to support resource allocation decisions.
- Introducing multi-year commitment authorisations (at least in the francophone countries where they are stipulated in the organic budget law, but not implemented).
- Developing sector strategies for key sectors.
- Developing sector/ministry MTEFs, detailed at least by programme/sub-function. Such detailed MTEFs could be implemented progressively, beginning with the priority ministries that have prepared strategies, but they should be imperatively framed by an MTBF and the MTFF and they should be consistent with the budget.

*Subsequently*, the efforts should be aimed at both strengthening the policy based budgeting approach and increasing the performance concern. The reform measures could include:

- Generalising the preparation of sector strategies.
- Generalising the preparation of sector MTEFs.
- Using the results of the monitoring of performance indicators in the dialogue on the sector budgets and policies.
- Developing a performance monitoring system, including the introduction of selected performance indicators in the budget documentation (see also below section B2c).

#### iv) Dealing with leapfroggers

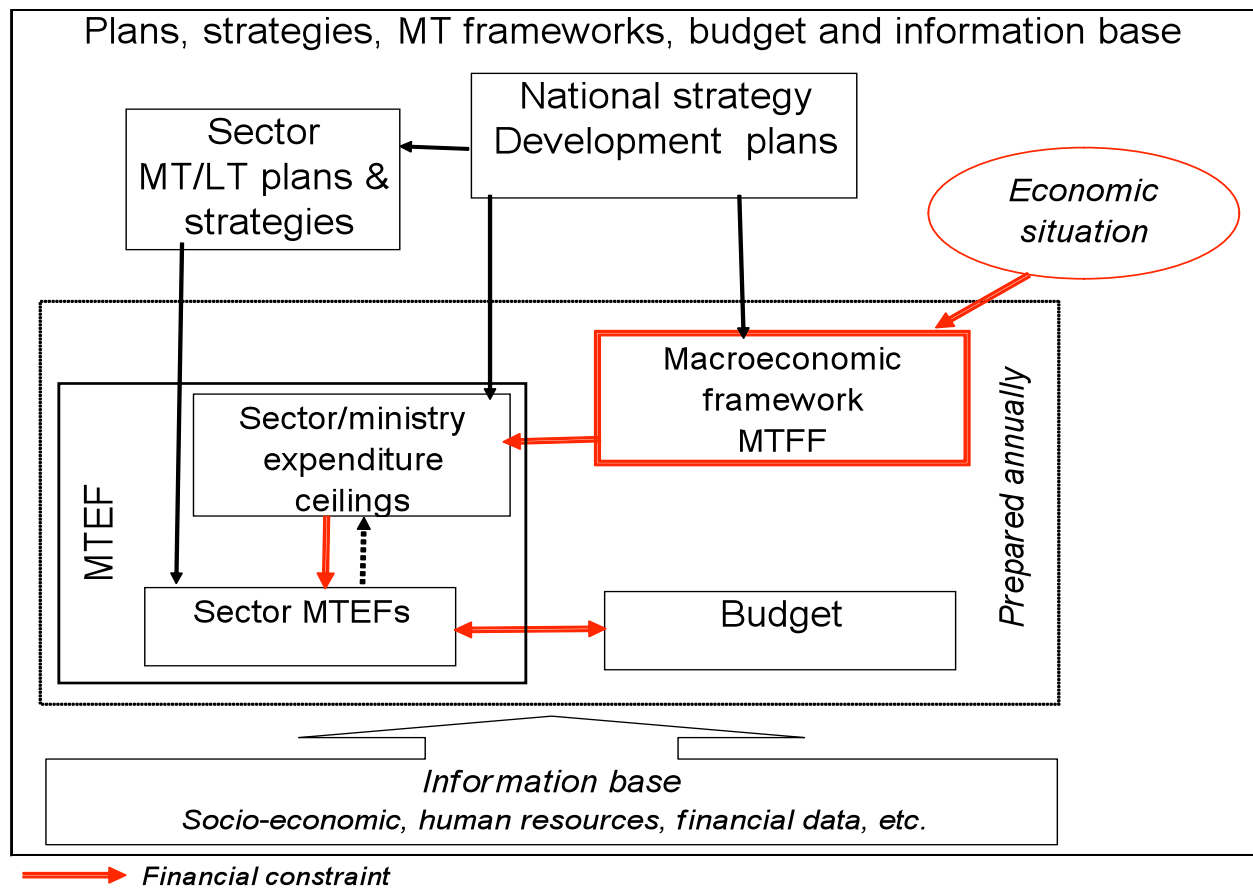
Sequencing budget reforms must take into account the ongoing reforms. In the budget preparation area, many developing countries have already implemented reforms going beyond the basic priorities. Thus, many countries have implemented or are implementing MTEFs (or programme-budgets), often with the support of donors, sometimes only to comply with the requirements or the triggers of budgetary aid, but sometimes at their own initiative.

These reforms often have limited success. However, proposing "going back to the basics only" would not be understood, in the countries where the reforms benefit from an internal support from both the technicians and the political authorities. As noted earlier, timing-out then redesigning non-satisfactory reforms will be required.

Corrective measures should be included in the first phases of a PEM reform programme. They will depend on the instruments that have already been implemented. They could include measures such as simplifying the format of the MTEF (or programme-budget) documents, revising the budget-MTEF calendar, including summaries in the budget, transforming a budget classification by objectives into a more practical programme classification, and both reducing dramatically the number of performance indicators and monitoring them more effectively (in several countries performance indicators are mushrooming, but rarely monitored).

In several countries, the sector MTEFs are mere wish lists, with a significant financing gap. Framing these MTEFs with an MTBF should have high priority. For accountability and budget management, a sector MTEF should be preferably a ministry MTEF. If these sector MTEFs cover several line ministries, line ministries MTEF should be clearly identified within the sector MTEFs.

Figure 4



## Box 8

### Taxonomy of rolling medium-term frameworks

**Medium Term Macro-economic Framework (MTMF).** The MTMF consists of the projections of the main macro-economic accounts, including the balance of payments, the real sector (GDP, consumption, gross domestic investment, import and exports), the monetary sector and the government accounts.

**Medium Term Fiscal Framework (MTFF).** The MTFF refers to the projection of the government accounts within the MTMF. It sets out aggregate fiscal targets such as total expenditures, expenditures by broad economic categories (personnel, goods and services, etc.) and fiscal deficit. It includes realistic revenue and financing forecasts. Preparing an MTFF is a basic requirement for sound budgeting.

The **Medium Term Expenditure Frameworks (MTEF)** deal with resource allocation among sectors/ministries or programmes. The MTEF covers a period of 3 to 4 years and is rolled over annually. The different types of MTEF include:

- **MTEFs focused on intersectoral resource allocation.** Such MTEFs may be named **Medium Term Budgetary Framework (MTBF)**, "global MTEF" or merely "MTEF", depending on the country. For convenience, the term MTBF is used in this note to define this type of framework. An MTBF is the most basic type of MTEF. It allocates resources to individual sectors or ministries according to the policy objectives and ensures that these allocations comply with the MTFF. It is often used for the interministerial policy dialogue and to frame budget preparation, ministries' expenditure ceilings being derived from the MTBF. The MTBF expenditure estimates are aggregated by sector/ministry, and, eventually, broad economic categories, but they should be based on more detailed technical analysis. An MTBF should include besides expenditure projections a budget policy document.
- **MTEFs dealing with both intersectoral and intrasectoral resource allocation.** The term MTEF refers frequently to this type of framework. Such MTEFs allocate resources among sector/ministry, programmes and, sometimes, activities, within the resource envelope given by the MTFF. It consists of both sectoral resource envelopes (the MTBF) and sector MTEFs. Some MTEFs have the same degree of detail than the budget. The MTEF and budget preparation procedure should be fully unified.

**Sector MTEF.** A sector MTEF deals with intrasectoral resource allocation over the medium-term. It should be the sectoral/ministerial component of the government MTEF. The sector MTEF should include besides expenditure projections statements on the sector policy. Sometimes, the sector MTEFs include performance indicators on the expected results and outputs. For accountability and budget management, a sector MTEF should be preferably a ministry MTEF. If a sector MTEF covers several ministries, each ministry MTEF must be clearly identified within the sector MTEF.

**Multi-year programme-budgets** are often similar to ministry MTEFs (e.g. in some francophone West Africa countries). They must comply with the MTFF and the MTBF. In principle, they include performance indicators on the expected results and outputs. The term programme-budget may also refer to the government budget itself when it is structured by programme.

### Box 10

#### A successful MTEF: Budget and MTEF process in South Africa

In South Africa, the MoF (the "National Treasury") started to work on a MTEF in 1994, but this experience does not last two years, because of lack of political involvement and no clear linkage with the budget process. Taking into account this initial experience, the MTEF and budget processes were merged in 1987. They include currently the following co-ordinated activities:

**Initial policy review** (May-September –the fiscal year starts April 1st), which includes various policy reviews; central and subnational government technical committees meetings; and preparation of the macro-economic and fiscal frameworks.

**Preparation of MTEF/budget submissions.** Line ministries MTEF/budget preparation starts at the beginning of the fiscal year. They submit their proposals to the MoF by mid-August. Their proposals include:

- A baseline medium term allocation. The resource envelope used to determine this base line consists of the two outer forecast years of the MTEF prepared the previous year.
- Identified savings and reprioritisation, within the baseline.
- Policy options which propose changes to the medium-term baseline allocation. These options should be related to the strategic priorities of the line ministry.
- Various documents and statements (e.g. personnel numbers, analysis of risks and contingent liabilities, etc.).

**Review of MTEF submission, MTBS, and allocation process** (August-November). At the end of October the executive presents to Parliament a Medium Term Budget Policy Statement (MTBPS); adjusted estimates for the fiscal year; data on budget execution for the first six months. The MTPBS is aimed at developing the policy debate, but it is not a binding document. It includes: (i) an economic outlook and three-year macro-economic projections.; (ii) a MTEF; (iii) a report on taxation; (iv) a "global" MTEF aggregated by broad sectors; (v) a report on the intergovernmental financial relationships.

**Finalisation.** Early November the Cabinet approves MTEF allocations to ministries. Then line ministries draft their budget. The budget is tabled in parliament in February. It includes under the same format both annual budget outlays and indicative estimates for the two following years.

*Adapted from: Medium Term Expenditure Framework Treasury Guidelines. Republic of South Africa 2004 and 2007. Operationalising the MTEF as a tool for Poverty Reduction: South Africa. Albert van Zyl. ODI. London. May 2003*

#### A Struggling MTEF: Malawi

The 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 due account local realities, ownership of reforms and political will, capacity, and sensible sequencing.

The MTEF reform commenced in 1995, include among other features the preparation of "activity based budgets" and a bottom-up approach in expenditure programming was developed. Because of the bottom approach, detailed activity costing did not take into account the overall resource envelope. Therefore, unpredictable funding undermined the credibility of the exercise. The Public Sector Investment Programme (PISP) was discontinued in 1997, under the assumption that it would be replaced by the MTEF. As a result, for several years the MoF had little information about ongoing investment projects and few of them were included in the development budget.

The MTEF II programme under implementation is aimed at strengthening the basis for "reviving the MTEF". Some improvements have been achieved. 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.

*Adapted from Dick Durevall, Mathias Erlandsson. Public Finance Management Reform in Malawi. SIDA. 2005; and Chauncy Simwakai. Chapter 3 "Malawi" in Budget Reform Seminar. 1-3 December 2004. Pretoria, South Africa.*

**Box 11**  
**MTEF: Avoiding the pitfalls**

Preparing an MTEF may contribute to strengthen the budget-policy link, but under certain conditions:

- Multi-year expenditure programming should not be a form of "escape budgeting", which will consist of over-loading the MTEF out-years of programmes and projects that cannot be financed. Unconsidered promises make the MTEF non-credible and may encourage pressures to increase expenditures. A strategy costing exercise may include variants, but an MTEF with financing gap should be banished.
- Line ministries MTEFs must be framed by an MTFF based on realistic assumption and sectoral multi-year resource envelopes, that is an MTBF or "global MTEF" (see box 9).
- The budget and MTEF preparation processes should be unified
- The "sector MTEFs" should be preferably line ministries' MTEFs. Cross-ministries expenditure planning exercises are desirable in several sectors, but the responsibilities for implementation, and therefore ministerial MTEFs, should be clearly identified, within the sector expenditure plans.
- The MTEF is structured in ministries and programmes/sub-functions (or administrative divisions if the government is organised along functional lines). The MTEF programmes should meet the principles suggested in box 6.
- The MTEF is a rolling plan. The MTEF prepared the previous years gives the baseline for the preparation of the MTEF and the budget. MTEFs prepared every year from scratch makes the exercise not credible and useless.
- The ministries MTEF should focus on key sectoral issues, the value added by over-detailed activity/output based MTEFs is unclear (see also comments in section A5c on activity costing).
- Preparing an MTEF should not lead to abandon the preparation of a public investment programme (PIP). The PIP should be seen as the investment annex to the MTEF.

Documents such as strategy costing exercises that include variants and financial gaps are sometimes named "MTEF". These documents may be useful, but they should not be seen as committing the government. They are not *frameworks* in the sense given to this term in this paper.



## *b) Budget execution procedures and control*

### *i) Some key issues*

This section deals with budget execution procedures and control. Many budget execution problems are the consequence of unrealistic budget preparation, but there are also weaknesses proper to the budget execution systems.

Commitment and other ex-ante controls. On certain aspects, reform priorities in Francophone and Anglophone developing countries differ. In many Francophone African countries, the ex-ante controls of the ministry of finance are numerous and redundant. This generates high transaction costs and inefficiencies, and has the perverse effect of encouraging special procedures aimed at bypassing the checkpoints. Streamlining the budget execution controls will require both simplifying the controls system and making them more effective. Measures to simplify the control systems will include, among others, eliminating redundant controls of payment orders by the MoF, which should only be controlled by the Treasury Department and focusing MoF ex-ante commitment financial controls on risks areas. On the other hand, special payment procedures should be eliminated, except in some special cases clearly specified (e.g. imprest account for petty expenditure of remote agencies). The Anglophone systems rely more on internal control, but those are often weak. In particular, commitments are often badly monitored.

Appropriation management rules. Appropriation management rules include, among others, rules for transfers between budget items and the annual rule which states that the authorisation to spend lapses at the end of year. A proper balance has to be found between restraint and flexibility in this area. Developing countries should not consider moving towards the managerial accountability model of some OECD countries that let the managers decide the input composition of their budget provided that they achieve the planned outputs. However, an increased flexibility in input management is desirable when input controls are excessively detailed and lead to inefficiencies in budget implementation.

Predictability of funding. To face unexpected changes in the economic environment or in the mobilisation of donor aid, or to make up for a budget badly prepared, cuts in the budget during its execution are frequent. These include the so-called "cash budgeting" procedure, which is used in several Anglophone developing countries<sup>54</sup>, appropriation freezing, and downward budget revisions. Such in-year adjustments to the budget are aimed at ensuring macro-economic stability, but they are often disruptive to public service delivery. They do not allow managers to plan their expenditures in advance. The impact of such procedures on the education and health sectors budget is sometimes eased by the fact that "pro-poor" expenditures are protected. However, such a method is not fully satisfactory. The protection may be only partial or may need to be negotiated every year. In addition the "pro-poor sectors" may be indirectly affected by in-year budget cuts made in other sectors.

In several developing countries, appropriations are allotted or cash is released to remote agencies belatedly (sometimes 5 to 6 months after the beginning of the fiscal year). Tracking surveys often show that only a small percentage of appropriated funds are transferred, or

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<sup>54</sup> Cash-budgeting is based on the principle that no cash is released to line ministries unless sufficient funds are available in the Treasury's main bank accounts to cover payments.

goods delivered, to the end users. This leads to inefficiencies in service delivery and distorts policy priorities. Measures to ensure effective cash transfer, or goods and services delivery, to the budget end-users are often required. However, often such inefficiencies come more from political factors or implicit priorities of the ministries' headquarters than from the budget execution procedures. Increased transparency in the way appropriations are allotted may help in creating pressure for changing such budget management methods.

#### Budget revisions. (see section B4).

Treasury single account. For efficient cash management, cash balances in all government bank accounts should be consolidated daily or weekly, depending on the communication infrastructure. This may be done efficiently by a treasury single account (TSA), which is an account or a set of linked accounts through which the government perform all payment transactions. TSAs are implemented in all francophone countries, in about half of Anglophone countries and in many transition countries. Implementing a TSA in countries where banking arrangements are fragmented should be favourably considered. Special cases, such as those related to remote agencies, must be taken into account to ensure smooth budget implementation.

In the African Francophone countries, the Treasury Department controls individual payment orders and, when the country faces arrears problems, prioritises the payments of outstanding invoices, sometimes on personal or political grounds and not according to the policy priorities. This calls for increased transparency of Treasury operations (see section B2c).

Personnel and payroll management. The wage bill is usually one of the biggest items of government expenditure and susceptible to weak control and corruption. The payroll is underpinned by personnel databases, which provides a list of all staff. The link between the personnel database and the payroll is a key control device, but this link is sometimes badly ensured. Special surveys to identify ghost workers are undertaken time to time, but their impact is often only temporary. Permanent procedures should be set up to ensure that these data bases are updated in a timely manner and do not include ghost workers. Audits should be undertaken regularly to identify weaknesses in the control system.

Procurement<sup>55</sup>. Significant public spending takes place through the public procurement system. While government procurement is certainly not the only possible source of corruption, it is one of the major ones, and vigilance is always necessary to minimise corruption risks, optimise the use of financial resources, and foster the growth of competition. In this respect transparency of the procurement procedures and complaints procedures are crucial. The procurement system should also benefit from the overall control environment that exists in the PFM system, including internal and external controls.

Internal audit. Internal audit is a management support function, advising the head of the agency on the soundness of internal accountability mechanisms. It differs from both the ex-ante financial control and inspection, which are aimed at detecting frauds<sup>56</sup>. In Anglophone developing countries, the management of the internal audit function is often weak. In

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<sup>55</sup> For further elements on this issue, see "Methodology for assessment of procurement systems". OECD–DAC. July 2006.

<sup>56</sup> According to Robert de Koning: "inspection is either part of managerial responsibility or involved in central investigations, it should not be involved in the independent assessment of financial management and control systems. This is the task of the internal auditor." Robert de Koning the PIFC. January 2007.

Francophone countries, there are inspectorates, but they are also weak. Where internal audit units exist, making them working effectively, should be an immediate priority. In the other countries, internal capacities should be assessed first. In several sub-Saharan African countries, it may be more cost-effective to focus first on external audit and inspections.

The EC DG budget is promoting in several EU new members and EC partner countries the public internal financial control (PIFC) model, which includes: (i) internal management and control procedures; (ii) internal audit in each line ministry or main agency; and (iii) a central harmonisation unit. Implementing this model, or a customised variant of this model, may be favourably considered in middle income countries. In many other developing countries, it can be considered only for a later phase of the reform process, because it goes beyond the administrative capacity and culture of the country.

Revenue control. Maintenance of a taxpayer's database, based on a unique taxpayer identification number, is an important element of a revenue control system. Such a system should be combined with other government registration systems that involve elements of taxable turnover and assets, such as information on government suppliers, issuance of business licenses and opening of bank accounts. The revenue administration should ensure compliance with registration requirements through occasional surveys of potential taxpayers (e.g. by selective, physical inspection of business premises and residences).

Ensuring that taxpayers comply with their procedural obligations of taxpayer registration and tax declaration is usually encouraged by penalties that may vary with the seriousness of the fault. Effectiveness of such penalties is determined by the extent to which penalties are sufficiently high to have the desired impact, and are consistently and fairly administered. Modern revenue administrations rely increasingly on self-assessment and use risk targeted auditing of taxpayers, taking into account resource constraints.

A high degree of transparency on tax procedures and legislation is required. A tax appeals systems should be built, but this may take time, and depends on progress in achieving transparency.

## ii) Basic priorities

Priority actions will generally consist of streamlining budget execution controls, with the view of both making them more effective and avoiding inefficiencies. In many countries, inputs controls are excessively detailed with cumbersome virement rules. Switching to more aggregate controls may be included in the first reform platform in several countries.

It cannot be expected that all measures aimed at achieving these objectives will be implemented over a short period. Many of them will be implemented progressively, but their implementation must generally start in the first reform platform.

## Internal controls

- *Streamlining commitment control.* In Francophone countries, redundant MoF ex-ante controls should be rationalised (e.g. the control of payment orders should be ensured only by the Treasury, some useless ex-ante commitment controls such as the control of electricity expenses or debt service payments could be eliminated). In parallel the

loopholes created by special payment procedures should be eliminated. In Anglophone countries, internal commitment controls need to be reinforced or implemented. As shown by countries' experience, this task requires a strong political commitment (see Box 12).

- *Personnel and payroll management.* Implement measures to strengthen personnel and payroll management, assure proper linkages between personnel database and the payroll; timeliness of changes to personnel records and the payroll; ensure internal controls of changes to personnel records and the payroll; and carry out payroll audits to identify control weaknesses and/or ghost workers.
- *Streamlining procurement.* In some countries, procurement laws and rules are insufficient or obsolete. A key reform priority is evidently to modernise and improve them. However, in many other countries procurement laws and formal procedures are more or less adequate, but not enforced, and de facto superseded by informal rules. It is crucial to thwart the informal rules. Transparency at each stage of the procurement cycle, well-defined and widely understood procedures for the control and audit of procurement transactions, open competition and complaints and appeal mechanisms, to ensure a control from the private sector are essential.
- *Other internal control rules and procedures.* In addition written rules should regulate various aspects of the internal management (administration of inventories, procedures for verifying deliveries, archives, control of assets and inventories, principle of dual control, etc.).

#### Cash management and payment systems

- *Developing in-year financial planning, and moving away from cash rationing.* A cash plan and, in a second stage, a commitment plan should be prepared. This cash plan should be in conformity with budget authorisations. It should take into account ongoing commitments and be based on seasonality of actual revenues and expenditures. It should be communicated in advance to line managers and should clearly identify remote agencies and regional departments. Funds should be released on a timely basis and in conformity with the cash plan. In-year financial planning requires close coordination between the entities responsible for budget execution, debt management and revenue management. In countries that can borrow on the domestic market, borrowing plans should be derived from the cash plans. In aid dependent countries, external financing must be estimated. In this respect increased predictability of aid inflows is crucial. A strong financial monitoring system is essential for in-year cash planning (see section B2c).
- *Allotment and transfer to sub-national government entities.* Budget funds should be allotted in timely manner. Transfers to sub-national entities should be made according to an agreed financial plan.
- *Payment system.* In the countries with a fragmented payment system and hundreds of line ministries bank accounts, implementing a treasury single account (TSA), which centralises cash balances, should be favourably considered. This measure may take time to be implemented. The first steps might consist of reducing the number of bank accounts, placing them under the responsibility of the Treasury and preparing monthly

consolidated reports of governments' cash balances, which should cover special accounts opened for managing investment projects and most extra-budgetary funds, and starting the conversion of line ministries bank account into zero-balance accounts.

- *Revenue collection.* Prompt transfer of revenue collections to the Treasury is essential for ensuring that the collected revenue is available for spending. Such transfers should be made daily for most tax and customs offices, the exceptions concerning only a few remote offices.

#### Control of public debt

- Procedures to control public debt, which includes direct debt, guaranteed debt and also non guaranteed public debt will depend on the major concerns over debt management, and therefore on the country context. However, some general principles should be enforced: (i) only one central government entity should be empowered to contract loans; (ii) central government borrowing and guarantees must be approved by the Parliament (either through a global ceilings or on a loan by loan basis); (iii) some form of control of sub-national governments and state owned enterprises (SOE) borrowing should be in place, which may vary from reporting requirements to banning borrowing, depending on the context.

#### Internal audit

- *Internal audit.* In countries where internal audit offices are already established, a programme to strengthen internal audits should be established. A major issue will be to ensure that audit reports are issued, distributed and actions taken on their findings. In several francophone countries, it may be better, in a first phase, to focus the efforts on strengthening external audit, making the inspectorates more effective and streamlining ex-ante financial control.

#### Revenue control

- Implement or strengthen the taxpayer databases, and introduce unique taxpayer identification numbers.
- Carry out occasional surveys of potential taxpayers.
- Undertaking a continuous programme of tax audits and fraud investigations.
- Ensure effectiveness of tax penalties and manage them fairly,
- Ensure clarity of legislation and administrative procedures, with fairly limited discretionary powers of the government entities involved;
- Ensure easy access to information on tax liabilities and administrative procedures for most major taxes

### iii) Further steps

Moving to managerial accountability should generally not be considered in developing countries, not only because of fiduciary risks, but also because it does not suit the existing administrative culture.

Therefore, further steps should be aimed at consolidating the reforms engaged in the initial phase and increasing responsibilities of line ministries in budget management. In addition to pursuing the reforms engaged in the first stage, actions may include:

- In Francophone countries pursuing the simplification of the control system, notably through developing "hierarchical" controls focusing on risks areas, and subsequently merging the functions of the financial controller and the regularity control functions of the *comptables publics* (Treasury's accountants). Such a reform is under implementation in Morocco.
- Pursuing the reinforcement of internal control procedures, including developing instruments for expenditure tracking (procedures to control the deliveries, asset registers, etc.).
- Developing internal audit. A PIFC-like approach may be considered, but it may be necessary to adapt it to the country context.
- Making the rules for transfers/virements between budget items more flexible, within the appropriations authorised by the legislature.
- Pursuing the implementation of a TSA in countries without TSA. In other countries, implementing progressively appropriate arrangements to ensure that donor sector support (SWAp) and special project accounts are included in the TSA<sup>57</sup>.

Concerning revenue management, further steps will include:

- Establishing comprehensive linkages between tax payer databases and other financial management systems (e.g. with suppliers databases);
- Reinforcing organisational arrangements. For example, creating a tax unit specialised in large companies.
- Using progressively modern tax management techniques, including self-assessments, developing and implementing tax audit plans with risk assessment criteria.

*Subsequently* other actions may include, for some special cases (e.g. the hospitals), setting up performance agreements that state the mutual obligation of the agency and its supervisory authority. However, while an explicit understanding of the key results expected will be useful, excessively detailed or straight jacketed contracts will be counter-productive.

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<sup>57</sup> The TSA may be a set of interlinked accounts.

## **Box 12. Implementing commitment control systems in African Anglophone countries(CCS)**

*Implementing internal commitment control and monitoring should be a priority task in African Anglophone countries. The experiences below show that such a reform measure requires political commitment.*

### **Uganda**

The package of measures included (i) implementing the CCS for nonwage recurrent expenditures for all central ministries and departments in July 1999; (ii) introducing the CCS for development expenditure effective October 2000; (iii) maintaining quarterly expenditure ceilings fully backed by monthly cash releases, based on improved cash management; (iv) providing adequate funds for priority and essential budget items and more realistic budget estimates; (v) creating public awareness through the media about the CCS and the responsibility of accounting officers to pay bills within 30 days; (vi) strengthening internal audit and inspection to enforce compliance and improve the quality of commitment data; and (vii) comprehensively auditing the stock of arrears by the AG and implementing a strategy for their liquidation. At the end of the first year of the implementation of the above measures, new nonwage arrears were reduced by nearly 70 percent compared with the previous financial year; and in the subsequent years the gains were maintained. However, there are still areas of concern. New arrears have been generated in 2004/05, albeit moderately (by 0.2% of GDP), if newly verified arrears from previous years are excluded (1.7% of GDP).

### **Zambia and Malawi**

There were considerable difficulties in implementing a CCS in Zambia and Malawi.

In Zambia, the CCS did not prove to be effective as it was difficult to get beyond the recording and monitoring of outstanding commitments and unpaid bills, which were needed to control commitments; and it was not combined with other supporting measures.

In Malawi, the CCS introduced was very similar to the one in Uganda. Despite some initial progress in recording and reporting expenditure commitments and audit of arrears, there was no impact on the accumulation of new arrears. The system has not progressed further due to noncompliance by the spending agencies and lack of enforcement and penalties by the MOF. Political neglect and lack of institutional capacity have also undermined reform efforts.

#### *Sources:*

*Uganda: Sixth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility. IMF country report 06/43 February 2006.*

*Selected African Countries: IMF Technical Assistance Evaluation. Public Expenditure Management Reform. IMF Country Report No. 06/67. February 2006.*

**Box 13**  
**Internal control and audit: Some definitions**

*Financial control.* Includes both ex-ante controls and ex-post controls

*Ex-ante financial control* (named merely *financial control* in several countries). Ex-ante financial control is usually carried out by a *financial controller*, who must approve control draft financial decisions, such as commitments, tender procedures, contracts, decisions on personnel, etc. In francophone systems the financial controller is appointed by a central agency (generally the ministry of finance, but sometimes the prime minister office), in other systems the financial controllers report to the line ministries.

*Financial Inspection.* Financial inspection consists of ex-post financial controls at the level of beneficiaries of public funds to ensure the correct use of these funds in accordance with relevant rules and regulations. Financial inspections are transactions or complaint oriented, while audit is system oriented. In Francophone systems, inspections are carried out by various corpses such as the state inspectorate, the ministry of Finance financial inspectorate and line ministries' inspectorates. In other countries, anti-fraud committee may play a similar role.

*Internal control.* The whole system of managerial, financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its governance. In the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition internal control relates to the following categories: control environment; risk assessment; information and communication; control activities and monitoring of controls.

*Internal audit.* The Institute of Internal Audit definition is "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes." The Chartered Institute of Public Finance and Accountancy (CIPFA) definition is "Internal Audit is an assurance function that primarily provides an independent and objective opinion to the organization on the control environment comprising risk management, control and governance by evaluating its effectiveness in achieving the organizations objectives. It objectively examines, evaluates and reports on the adequacy of the internal control environment as a contribution to the proper, economic, efficient and effective use of resources.' Internal audit is not widespread in Francophone countries. In African Anglophone countries there are generally internal audit offices, but, sometimes, they do not work according to the international standards.

*The Public Internal Financial Control (PIFC)* concept covers: (i) systems and principles for financial control (separation of duties, manuals, audit trail, accounting, archiving, ex-ante financial control, ex-post controls, etc.); (ii) internal audit based on international standards (see above); and (iii) central harmonisation for harmonisation and co-ordination, on-the-spot verification, networking and publications, etc.

Sources: Robert de Koning Public Internal Financial Control. January 2007; Robert de Koning. PIFC Advantages and challenges. [http://pifc.mfin.hr/en/doc\\_en/Mr\\_Koning\\_speech\\_ENG.pdf](http://pifc.mfin.hr/en/doc_en/Mr_Koning_speech_ENG.pdf); Alain Gérard Cohen. Contrôle interne et audit publics. LGDJ. Paris.2005; Richard Allen and Daniel Tommasi: "Managing Public Expenditure: a Reference Book for Transition countries". OECD. 2001.



c) *Accounting, monitoring, reporting*

i) Some key issues

Reliability of financial data. Whatever the accounting and bookkeeping methods, the financial data must be reliable. Reconciliations with bank accounts should be regularly undertaken. This is particularly crucial in the countries where there are hundreds or thousands of government bank accounts. In francophone countries data on payments orders issued by the authorising officer (*ordonnateur*) differ often from Treasury's data on payment orders. This issue should be addressed.

Some payment transactions may be made through special procedures, and recorded in suspense accounts or special registers (e.g. extra-budgetary, "urgent" expenditures, expenditures made in remote regions, some imprest advances, etc.). In such cases, adjusting entries should be passed at least every quarter, not only at the end of the fiscal year.

Concepts must be clearly defined. For example, what constitutes a "commitment" in the budgetary jargon varies from one country to another, and within a country according to the nature of the expenditure. Sometimes the commitment in the budgetary sense corresponds to the legal commitment (contract or purchase order), sometimes to the liability and sometimes to a mere reservation or allotment of appropriation. Therefore, it is important to explain clearly in the financial reports the exact nature of the transactions named "commitments".

Financial reporting. Accountability and sound budget management require timely and reliable accounting and financial reporting. In many countries financial reporting systems are weak, reports are not produced in a timely fashion and their coverage may be insufficient both in organisation terms and in transactions terms.

In particular, transactions financed by project aid are not systematically included in the financial report. Special management procedures for donor financed projects should not impede accounting for project aid, or at least the larger share of project aid. Some grants, notably the grants disbursed from donors' headquarters, are difficult to monitor. However, the debt management offices monitor and account for the disbursements from project loans, several grants are managed locally by a national authorising officer, and a projects manager should monitor expenditures made under their projects<sup>58</sup>. There are difficulties due to different bases of accounting but procedures to compare data may be set up, and the accounting method should be specified in footnotes to the financial reports.

Aggregate reporting on tax assessments, collections, arrears and transfers to (and receipts by) the Treasury must take place regularly and be reconciled, where appropriate, in order to

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<sup>58</sup> Difficulties in monitoring and accounting externally financed expenditures are significant for projects financed by some bilateral donors and UN agencies. However, in other cases these difficulties are more related to the accounting procedure and the administrative culture than to the lack of data. In some Francophone countries, the Head of the Treasury Department opposes the registration of expenditures made from project aid, even when data is available, because he/she would be (in theory) personally and financially responsible in case of irregularity for transactions recorded in its books, according to the francophone financial regulations. In another country, project aid disbursements are partially recorded in the Treasury accounts, but with several months in late, because the paperwork to prepare "regularisation" payments orders. In some Anglophone countries, objections come from the fact that project aid is not channelled through the consolidated fund. In such cases amending the financial regulations should be considered.

ensure that the collection system functions as intended, that tax arrears are monitored and the revenue float is minimised.

Aggregate fiscal control requires comprehensive financial monitoring of public entities. Section B1a suggests the inclusion of reports on public debt flows and stocks and on fiscal risks (including among others guaranteed and non guaranteed debt from state owned enterprises), in the budget documentation. This will require setting up adequate mechanism to centralise data on the possible fiscal risks. In addition all SoEs, central government's autonomous entities, and sub-national governments should submit to the ministry of finance their audited end-of-year accounts. Procedures to control public sector indebtedness are discussed briefly in section B2 b.

Progress in decentralisation calls for strengthening reporting requirements from sub-national government. The government financial operation table, which shows fiscal aggregates, should cover both the central government and sub-national governments. Consolidated expenditure reports on an economic and functional basis should be prepared at least annually.

Other reports. Besides financial reports, reports on the physical progress of investment projects, various reports from spending units, and a line ministries' annual report on their annual performance, may be produced.

Quarterly or six-monthly reports on the physical progress of investment projects help in identifying implementation problems.

Taking into account concerns over resources being effectively available for public service delivery units, special tracking surveys are undertaken, often at the donor requests. This should only be a transitional procedure. Permanent procedures should be set up, which include assets and inventory registers, personnel files, financial and physical reports.

"Performance reports" may be prepared either for every ministry or for only a few key programmes. Their format and content will have to be tailored to the country capacity. They may include: (i) statements on the objectives; (ii) results achieved, including performance indicators; (iii) descriptions of the activities carried out; (iv) budget financial execution; and (v) review of problems and identification of corrective measures.

Such performance reports should become an element of the budget process, with the view to providing feedback to decision making. Progressively they will monitor performance indicators. In many developing countries, several performance indicator monitoring systems have been set up, most of them at the request of the donors. Producing such reports may help in streamlining these scattered performance monitoring systems.

However, caution is required before defining an additional reporting system. Currently, several reports prepared with the support of the donors present some similarities with performance reports (e.g. certain PER, the reports for the Education for All initiative, sectoral monitoring and evaluation reports, etc.). This calls for rationalising the reporting system, before defining the format of new reports.

## ii) Basic priorities

The basic priorities should be aimed at ensuring the basic requirements for financial reporting:

- Production of budget execution reports. These reports should show along the budget classification: (i) initial appropriation, appropriation after budget revision and transfers/virements; (ii) commitments; (iii) payments<sup>59</sup>; and (iv) outstanding liabilities. In countries that monitor only payments, a commitment register and an ancillary book for outstanding payments should be implemented. Budget execution reports should be produced monthly for domestically financed expenditure, and at least quarterly for externally financed expenditures.
- Central government accounts should be produced at least quarterly, according to the chart of accounts.
- The operations of extra budgetary funds should be consolidated, and all government entities should be required to follow the same standards for expenditure and revenue classifications.
- The larger share of project aid transactions must be included in the accounts.
- Reconciliation procedures should be set up including for expenditures: (i) monthly reconciliation of accounting data, held in the government's books, with government bank account; (ii) clearing and reconciliation of suspense accounts and advance at least quarterly and (iii) in francophone systems, monthly reconciliation of data from the Treasury with data from the authorising officer (*ordonnateur*).
- Complete reconciliation of tax assessments, collections, arrears and transfers to the Treasury takes place, preferably, monthly within one month of end of month, or at least quarterly within six weeks of end of quarter.
- Preliminary end-of-year accounts for FY t-1 should be available within about 2 months after the end of the fiscal year, with the view to providing information for year t+1 budget preparation.
- End-of-year accounts should be prepared and transmitted to the Supreme Audit Institution within 5 months after the end of the fiscal year, in order to ensure that the audited accounts for FY t-1 will be transmitted to Parliament before or at the same time than the budget bill for FY t+1.
- Statements on stock and flows of arrears and a report on financial assets should be produced.

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<sup>59</sup> In the African Francophone systems the budget execution report gives the payment orders along the budget classification, but not the actual payments, because the budgetary expenditure is recognised at the payment order stage and in the double entry bookkeeping system the payment is the counterpart of the debit of third party accounts. In countries that face delays in paying suppliers, it will be desirable to report along the budget classification both the payment orders and the actual payments. This may be done easily if Treasury's transactions are computerised. Otherwise ancillary books should be kept.

- Reports on debt should be prepared regularly (at least, every 6 months). Loan guarantees, should be individually recorded, and statements prepared and published, including amounts and beneficiaries. Debt records should be updated monthly for direct debt, at least quarterly for indirect debt.
- Autonomous government agencies and SoEs should submit to the ministry of finance central, and to their supervisory authorities, financial reports and audited end of year accounts at least annually.
- The government consolidated financial operations table should be updated regularly (e.g. quarterly). It should cover most sub-national government entities in countries where expenditures from these entities exceed 3 to 5 % of general government expenditures.
- For the general government (including sub-national governments), consolidated expenditure reports on economic and functional bases (at least the first level of COFOG) should be prepared annually within six months after the end of the fiscal year, in the countries where sub-national expenditures exceed 3 to 5 % of general government expenditures.
- The government should publish basic financial statements in a form accessible to the public or at least the media.

### iii) Further steps

Further strengthening of accounting and reporting will include the following measures:

- Improving the periodicity of reports mentioned above.
- Accounting for all financial assets and most liabilities (except pension liabilities), that is moving towards modified accrual accounting (see section B1c).
- Building selective physical asset registers (see section B1c).
- Producing an annual consolidated report on fiscal risks.
- Producing an annual report on tax expenditures.
- Producing reports on quasi fiscal expenditures<sup>60</sup>. Then, in a further step, such expenditures should either be eliminated or replaced with direct spending.
- The government consolidated financial operations table and consolidated expenditure reports on economic and functional (at least the first level of COFOG) bases should cover nearly all sub-national government entities.

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<sup>60</sup> Activities of the central bank or possibly other state-owned entities that are in nature similar to fiscal actions pursued by the government, but not included in the government's budget. Examples include, among others, credit to farmers at below-market interest rates and central bank expenditures on the bailout of failing banks.

- Ensure that permanent procedures are in place to provide reliable information on all types of resources received in cash and in kind by the spending units involved in public service delivery in key sectors, including at the sub-national government level.
- To provide feedback to decision making, line ministry performance reports will be prepared for a few priority ministries.

*Subsequently*, the following activities may be considered:

- Moving towards accrual accounting in the agencies where assessing full costs is desirable (see section B1c).
- Generalisation of line ministries reports and performance indicators monitoring in key sectors.

#### *d) External Audit and Evaluation.*

##### *i) Some key issues*

External audit provides reports on the use of public funds for the legislature and the public. External audit is performed by the Supreme Audit Institution (SAI), which reports to Parliament in most Anglophone countries and is part of the judicial power in francophone countries (either Court of Accounts or Chamber of the Supreme Court). External audit standards are defined by the International Organisation of Supreme Audit Institutions (INTOSAI). Effective audit requires the independence of the SAI, professional skills and that the audit standards conform with international norms.

The main characteristics of independence of the SAI are the following<sup>61</sup>:

- Freedom to decide what work it will do.
- A mandate to review all matters affecting the internal control systems and recommend improvements.
- Discretion to limit the audit of individual transactions when system audits deemed sufficient.
- Ability to publish its reports to Parliament and the public.
- Ability to determine its budgetary and human resources needs subject only to Parliament approval.
- Freedom to recruit staff on the basis of professional merit alone

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<sup>61</sup> Drawn up from Larry O'Toole "Questionnaire on PEM systems-Annex I" in Richard Allen and Daniel Tommasi: "Managing Public Expenditure: a Reference Book for Transition countries". OECD, 2001.

There are different types of audit (see Box 14): (i) compliance audits, which consist of reviewing compliance with financial laws and regulation; (ii) financial audits, which consist of providing an opinion on the fairness of the information presented in government financial statements; and (iii) performance (or value for money) audits. In a country with poor governance, priority actions should focus on strengthening SAI capacity to carry out compliance and financial audit.

Evaluation studies are carried out by the executive. They provide valuable feedback to decision making, but they are time and resource consuming.

#### ii) Basic priorities

Basic priorities should include:

- Ensuring that an SAI is effectively in place.
- Ensuring the independence of the SAI and that the scope of its activities covers all government transactions and money.
- Developing a programme to train the auditors, defining audit standards in conformity with INTOSAI standards, setting up and enforcing a code of conduct for SAI staff.
- Ensuring that compliance audits are effectively carried out. The end-of-year accounts should be forwarded by the executive to the supreme audit institution within about 5 months after the end of the year. They should be audited within about 4 months, in order to be published and transmitted to the Parliament before the budget bill for the following year is tabled in Parliament, or at least at the same time.
- Ensuring that SAI reports are made public.
- Ensuring that the SAI recommendations are followed up and that the executive respond publicly to SAI recommendations.
- Ensuring that a Parliament committee reviews the SAI reports.

#### iii) Further steps

The following stages in the reform process will consist of improving financial audit methods, further training of the staff, co-ordinating with internal audit units to avoid duplication of effort and progressively implementing performance audits.

Commissioning selected sectors or programme evaluation studies could be also considered.

### **Box 14**

#### **Audit definitions**

The scope of audits includes:

- *compliance or regularity audits*, which examine legal and administrative compliance, the probity and propriety of administration, financial systems and systems of management control;
- *financial audits*, covering the examination and reporting on financial statements, and the examination of the accounting systems upon which those statements are based;
- *performance audit/value for money audits*, which assess the management and operational performance (economy, efficiency and effectiveness) of public programmes, particular ministries and agencies in using financial, staffing and other resources in meeting their objectives

Source: Effects of European Union Accession, Part 1: Budgeting and Financial Control, OECD SIGMA Paper No. 19, March 1998

### **3. IT issues**

#### *a) Some key issues*

##### *i) What is an IFMIS?*

In principle, an integrated financial management information system (IFMIS) is a computerised system covering the main public financial management activities, linking the ministry of finance, line ministries and spending agencies, and providing information in real time. Integrated systems are not monolithic. For practical system implementation, it is essential that system elements be developed in a modular way. Modules are integrated in the sense that they can exchange data and that there is a single secure point of entry for commonly used data.

Benefits from a well-functioning IFMIS includes greater fiscal transparency, rapid processing of transactions, improved efficiency of financial control, improved checks and balances and consistency of information, support to financial analysis and decision making. Addressing a budget reform in the context of the introduction of an IFMIS may provide incentives for change or to facilitate the implementation of reforms,

While an IFMIS must interface with other information systems on other government activities, it does need to encompass all those activities. At least, it includes the following modules:

- a core accounting system, which will provide data exchange standards with other systems;
- a budget execution system for appropriation management, including allotment of appropriation, distribution of cash and commitment, periodic in-year limits to spending units, control of commitment and payment against appropriation and cash and commitment periodic limits.

For effective expenditure monitoring, both accounting and budget execution must be covered. In several African francophone countries computerisation focused initially on commitment controls and regular payment order issuance, but it did not cover the Treasury transactions. As a result cash payments made from Treasury extra-budgetary accounts were not monitored, and it was not possible to monitor the actual cash payments against the budget classification. This issue is being addressed in several countries, but not all. On the other hand, in several Anglophone countries computerisation had focused on cash accounting, with the commitments not being registered in the computerised database. As a result the computerised systems were insufficient for budget management.

Besides the core accounting and budget execution systems, government financial management systems include, among other systems, revenue administration systems, debt management systems, budget preparation system, payroll and personnel systems. Revenue, debt and payroll management systems periodically post summaries in the accounting system.

In practice, these systems are often implemented before the core systems. This does not pose a problem, if the linkages between the different systems may be established through a common chart of accounts and compatible hardware and software. Cost-effectiveness issues must be taken into account. They may suggest starting information systems development with a payroll and personnel management system, not with an IFMIS<sup>62</sup>. In most developing countries, the larger share of domestically financed payment transactions concerns the monthly payroll, both in terms of number of transaction and in money terms<sup>63</sup>. Risk of errors in payroll calculation and fraud are higher in a manual context than in an automated context.

## ii) Off-the-shelf software or application development?

The software development strategy may consist of: (i) either developing an application, using a DMBS (data base management system) and development tools; or (ii) customising an off-the-shelf ERP (enterprise resource planning) system. Application development should be commissioned to a consulting firm, in-house development for large software application being always problematic.

Off-the-shelf software packages were originally designed for the corporate environment, but they are increasingly used in the government sector. They are capable of filling many of the financial management needs of government. They require, however, to be customised to suit

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<sup>62</sup> At least in countries where the payroll is centrally administered by the MoF or line ministries headquarters level. In other situations, computerizing the payroll is also desirable, but may take time and face significant resistances.

<sup>63</sup> In a poor country, where the number of transactions on non-personnel expenditures items is comparatively limited a payroll system processes 10 to 20 times more transactions than a budget and core accounting system, including payroll calculations..



the needs of the country. They are initially more expensive than application development because of their high license costs. However, it is often argued that their adoption could result in significant savings in the long run, because they offer good documentation, continuing software support, and generally less risks than application development. Many ERP integrators argue that the budgetary procedures should be adapted to the off-the-shelf software design, in order to minimise the customisation costs.

On the other hand, application development has lower initial costs, is more easily tailored to the country needs and more suitable to a progressive approach than an ERP. Computerisation should not drive the budgetary reform, arguing that the budgetary procedures should be adapted to the off-the-shelf software design is quite questionable. Launching a full business process reengineering may be disruptive for budget management.<sup>64</sup> Of course, this does not mean computerising questionable procedures and practices, but the modernisation of procedures should be based on analysis of the existing system, not on the pre-established functional design of an off-the-shelf software. Customisation of an ERP may be resource consuming and documentation and maintenance problems may be met with a customised ERP, not only with software development<sup>65</sup>.

Therefore, defining the software development strategy will require reviewing carefully the different variants, assessing whether they suit the country needs and estimating their costs. Whether software development, off-the-shelf software, or a mixture of both,<sup>66</sup> is the most cost-effective variant will depend on the country context.

### iii) Condition for success

Results from IFMIS are often disappointing:

- First, there are sometimes over-expectations on what an IFMIS may achieve. In theory, an IFMIS can lead to better expenditure control and better decision making and management. However, it will not be able to change an environment characterised by informal rules and non-compliance with existing regulations. It cannot substitute internal controls. In countries with poor governance, a large part of the expenditures risk being committed outside the computerised system. An IFMIS cannot assist decision making if the budget classification is inadequate or if the coverage of the budget is not sufficiently comprehensive.

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<sup>64</sup> Stephen Peterson opposes process change, which evolves existing procedures using information technology in a supportive role to process innovation which involves a radical and comprehensive restructuring of procedures. He argues that IFMISs may fail or underperform in developing countries when they involve a high risk strategy of process innovation. Stephen Peterson. Automating Public Financial Management in Developing Countries. Stephen Peterson "Automating Public Financial Management in Developing Countries" in Anwar Shah editor, Budgeting and Budgetary Institutions. World Bank. 2007.

<sup>65</sup> For example, in Croatia SAP, which is one of the most performing ERP, is implemented. However, several years after its implementation, because bad customisation and poor maintenance, the MoF staff had still to transfer data manually to a spreadsheet for preparing the cash plan and the system is not able to manage in-year cash or commitment limits for a period of more than one month.

<sup>66</sup> For example, an off-the-shelf software for the core accounting system and application development for the budget execution modules, because the budget execution modules of off-the-shelf softwares require often substantial customisation.

- Second, the costs, the time and the capacity development actions needed to implement an IFMIS are often under-estimated. A review of thirty four IFMIS projects financed by the World Bank<sup>67</sup> shows that it takes on average 7 years for completing an IFMIS and costs are high (US\$ 12.3 million), while it is difficult to assess whether these IFMIS are sustainable. Self assessments of sustainability made by the task managers said that 25% of projects were unsustainable and 69% "likely" to be sustainable. Similarly, an IMF review of IFMIS in six African countries shows that only one country (Tanzania) has achieved satisfactory results<sup>68</sup>. The Tanzania example is presented in Box 15.

For effective IFMIS implementation, the following conditions should be generally met:

- The implementation of an IFMIS should be regarded as a component of a wider reform process, addressing the weaknesses of the PEM systems. The IFMIS will not make up for poor budget execution or accounting procedure. In many cases the manual procedures must be reformed before IFMS implementation.
- Sufficient manpower, financial resources, and capacity development are required for implementing an IFMIS. The government must be able to supervise closely the software developers or the ERP integrator.
- A long implementation period should be planned. Country authorities should be prepared for a long implementation path, and one that involves significant challenges. Donors should avoid pushing for quick implementation, because of the closing date of an IT project or a questionable disbursement condition included in a budget support agreement.
- A phased implementation strategy should be defined both in terms of functionality and number of entities. It must be taken into account that implementing an IFMIS over a whole country will take time. Both manual and automated procedures will coexist during the IFMIS implementation period. If new budget management procedures are set up, they should be able to work in both a manual and an automated environment. It will be necessary to maintain interim arrangements to avoid weakening financial control and reporting where the IFMIS is not yet implemented.

#### *b) Defining the implementation approach*

The "basics" are a robust manual system, a satisfactory chart of accounts (including a sound budget classification system) and clearly defined budget procedures.

Beyond these basics, sequencing the implementation of an IFMIS is country specific. It will require first reviewing the sequence of budget reforms, country existing information systems, country capacity in terms of maintaining the information system (are there qualified local consulting firms and integrators?), and country technical communications infrastructure. The number of transactions must be estimated for each organisation and area of public expenditure

<sup>67</sup> William Dorotinsky. Implementing Integrated Financial Management Information Systems: World Bank Experience. World Bank.2003

<http://info.worldbank.org/etools/Bspan/PresentationView.asp?PID=1014&EID=502#RM>

<sup>68</sup> Jack Diamond and Pokar Khemini. Introducing Financial Management Information Systems in Developing Countries. IMF Working Paper. October 2005.

management. The technical approach to computerisation will largely depend on this parameter.

Once the context is reviewed, it will be necessary to define, for each phase of IFMIS development, the public financial management areas and organisations covered, the technical issues and the project management and change management issues. An implementation plan should be established.

PFM areas covered. A logical sequencing suggests starting with the core accounting system that will give the data exchange standard with other financial management systems, then, or at the same time, developing the budget execution system.

However, some practical and cost-effectiveness issues must be taken into account. There are areas where the automation may precede the implementation of full fledged core accounting and budget execution systems, provided that a chart of accounts is implemented to ensure future linkages with the core accounting system. Before the implementation of full-fledged core accounting and budget execution systems, that will include secure procedures and a wide set of functionalities, a "light" interim accounting system may be implemented for accounting and reporting (using software such as Access).

Therefore, starting with a "light" accounting system and personnel and payroll management systems may be favourably considered in many countries. Also a simple budget preparation system may be implemented, without waiting for a full-fledged accounting and budget system. For debt management, systems such as DMFAS and CS-DRMS are already implemented in many developing countries, as well as ASYCUDA for customs administration<sup>69</sup>.

Institutional and geographical coverage. It will be difficult to cover the whole country at short notice. The implementation should start in the areas where the number of transactions is the highest.

Technical issues. There are many technical variants: (i) for software, from very simple systems, based on software such as Access, to off-the-shelf ERP software and (ii) from stand alone computers to countrywide networks. To choose among variants, different factors must be taken into account, such as the existing technological infrastructure, the software development and equipment costs, the available human resources to manage the IFMS, and appropriation issues. Each technological variant has pros and cons.

Project management. Application development or off-the-shelf software customisation should generally be externalised. However, a close supervision of the preparation of the GFMIS, then of its operations is required. Internal capacity for ensuring these tasks must be taken into account in the implementation approach.

Issues related to change management. A comprehensive training programme must be carried out for computer and budget specialists and end-users. It will also be necessary to properly address the concerns of persons that fear losing their job or their function in the computerised environment.

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<sup>69</sup> UNCTAD- Debt Management Financial and Analysis System (DMFAS); Commonwealth Secretariat's Debt Recording and Management System (CS-DRMS); UNCTAD - Automated SYstem for CUsoms Data (ASYCUDA).

### **Box 15**

#### **Implementing an IFMS in Tanzania**

One of the first steps the government took to ameliorate weaknesses in public expenditure management was to close the accounts of a multitude of ministries, departments and agencies, and to centralize the government's payments system through the introduction of a Treasury Single Account (TSA).

Shortly thereafter, in 1998/99, the government introduced the Integrated Financial Management System (IFMS) to support TSA operations. This involved significant capacity-building efforts and the documentation of new processes. The initiative also required enabling legislation to be enacted. To this end, the Public Finance Act (PFA) of 2001 was passed, and associated regulations were formulated. The milestones achieved include operationalisation of the IFMS in 47 ministries/departments, in 20 regional sub-treasuries, in 20 regional administrative secretariats and in 32 local government authorities (LGAs).

Over 800 personnel have been trained. Three years of accounts are online, as are four years of budgets based on the Medium Term Expenditure Framework (MTEF), and final government accounts can now be produced within three months of year-end. The accounting is automated, and reports based on international financial standards are in place. Altogether, this has resulted in a major reduction in domestic arrears and better control over funds.

*Drawn up from: Budget Reform Seminar. Collaborative Africa Budget Reform Initiative (CABRI). December 2004*

## **4. The role of the legislature and accountability to the citizens**

### *a) The Parliament*

As illustrated by Figure 1, the Parliament should intervene at different phases of the public financial management cycle. Its most crucial tasks consist of approving the budget and budget revisions and reviewing the end-of-year accounts. Issues related to the end-of-year accounts have been discussed in sections B2c and B2d.

Timely submission of the budget to Parliament is required to allow its proper scrutiny and the completion of budgetary debates, before the beginning of the fiscal year. Late submission of the budget to Parliament often comes from a poorly disciplined budget process. However, in some countries (e.g. some Anglophone countries and China), the legal framework<sup>70</sup> stipulates that the budget may be tabled in Parliament after the beginning of the fiscal year. Such a procedure weakens the role of Parliament, which approves a budget under implementation. In these countries the legal framework should be revised to allow the Parliament to scrutinise

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<sup>70</sup> For example, the Article 117 of the Zambian constitution stipulates "the Minister responsible for finance shall cause to be prepared and shall lay before the National Assembly *within three months after the commencement of each financial year* estimates of the revenues and expenditure of the Republic for that financial year". In China, "the most recent time table of the budgetary process, as prescribed by the Ministry of Finance in 2005, still runs from July to the end of April of the next years, *four months after the start of the fiscal year*" (Yilin Hou "Choice of the Fiscal Year and Functions of the Budget - A Policy Recommendation for China's Budget Reform". Paper for International Symposium on Institutional Reform and Public Financial Management. Beijing 2006).

and vote on the budget before the beginning of the fiscal year. However, implementing such changes may take time, taking into account the administrative and political culture and the existing legal framework.

A number of countries present to Parliament a mid-term budget review, which may include budget execution reports, budget policy statements, medium term fiscal projections, and supplementary estimates (see the South African example in Box 10). Such a review favours the policy debate and provides a useful feedback to budget preparation.

Depending on the country, it may be necessary to include in the legal framework provisions that regulate the power of Parliament to amend the budget<sup>71</sup> or the adoption of laws with fiscal impact outside the budget or the budget revision enactment procedure.

#### i) Basic priorities<sup>72</sup>

Basic priorities will consist of establishing an effective scrutiny of the budget and the budget policy by the legislature, and establish adequate relationships between the executive and legislative branch of government. This includes:

- Budget bill tabled in Parliament in time, to be voted before the beginning of the fiscal year, except under special circumstances. As noted, in some countries, because of the legal framework, this measure will need time to be implemented. It will be considered only in a second stage of the reform process, despite its importance.
- End of year accounts audited and presented to Parliament before the budget bill is tabled in Parliament, or at least at the same time.
- Regulations that limit the freedom of the executive to make shifts between appropriations, without Parliament's approval, in order to ensure that the policies stated in the budget will be effectively implanted.

#### ii) Further steps

Actions to reinforce the role and the capacity of the legislature in scrutinising the budget and its implementation should be carried out. They may include, among others:

- presenting a mid-term review of the budget to Parliament (including budget execution report, budget policy statements, medium-term fiscal projections, and supplementary estimates);
- improved budget documentation,
- increased capacity of Parliament's commission.

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<sup>71</sup> E.g. by stipulating in the legal framework that any amendment that increase expenditure or decrease revenue should be balanced by savings or revenue increases proposals.

<sup>72</sup> Detailed requirements for the legal framework may be found in William Allen "Public Expenditure Management and Budget Law: Toward a Framework for a Budget Law for Economies in Transition". IMF 1994.

- procedures that will facilitate feedback from the legislature during budget preparation<sup>73</sup>.

For reinforcing fiscal discipline, a two-step procedure for voting on the budget should be adopted, consisting of approving the fiscal aggregates before individual appropriations.

#### *b) Accountability to the citizens*

Elements of budgetary information to which public access is essential include, among others: (i) annual budget documentation. A complete set of documents should be available to the public through appropriate means when it is submitted to the legislature, then the approved budget should be published; (ii) in-year budget execution reports; (iii) year-end financial statements; and (iv) external audit reports.

Transparency will depend on whether information on fiscal plans, positions and performance of the government is easily accessible to the public. Reports should be easy to understand and should permit information to be captured quickly and communicated easily. They should include explanations and interpretations for those who are not familiar with budgetary concepts.

Publishing resources available to primary service units (such as elementary schools or primary health clinics) is generally seen as a means to better ensure that they will be effectively available as planned. As noted, in section B2b transparency on procurement and tax legislation is crucial.

Civil society should be involved in the preparation of strategies. Some suggest also the participation of civil society in budget formulation. This would risk delaying budget preparation. The participation of civil society is better sought upstream of budget preparation when policies are formulated.

Improving the volume and the quality of information to citizens is a continuous process, which should take into account the country context (e.g. easy access or not to the Web). Priority actions will consist of making public the budget, the end-of-year accounts and the external auditor report. Further involvement of citizens, will consist of developing actions such as associating civil society groups in the preparation of strategies, disseminating the draft budget at the same time it is tabled in Parliament, and making public information on various fiscal issues (e.g. tax expenditures, quasi-fiscal expenditures, etc.)

## **5. The legal framework**

### **i) Some key issues**

The legal framework consists of several levels, namely the constitution, the organic budget law<sup>74</sup> (OBL), other statute laws (such as audit law, local government finance law, etc.), and financial regulations and instructions. Box 16 shows the main elements of an organic budget law.

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<sup>74</sup> Named also, depending on the country, budget framework law, budget code, etc.

**Box 16**  
**Main elements of an organic budget law (OBL)**

Concepts and definitions  
Principles of good budgeting  
Scope of the budget  
Accounting and classification principles  
Appropriation, vote  
Budget calendar  
Execution and revision of the budget  
Debt and contingent liabilities  
Financial reporting and end-of-year accounts  
Banking and financial assets  
Roles and responsibilities  
Relationships with sub-national governments  
External audit  
Sanctions

In a few post-conflict countries the legal framework must be built from scratch. The immediate measures will include: (i) defining clearly the distribution of responsibilities in budgeting, notably to empower sufficiently the ministry of finance for budget control; (ii) establishing basic rules for expenditure control by this ministry.

In other developing countries, the legislative and regulatory framework, which dates from the time of independence, often meets the basic requirements for expenditure control. Nevertheless, in several countries compliance is weak. The system does not sanction, or does not sanction in a fair and correct manner. If they are lacking, provisions for sanctions should be included in the legal framework, but this will not be sufficient in a system governed by informalities. Priority actions should include increasing transparency and legislature's control.

In several countries, the legal framework may need to be updated, however. Provisions for fiscal reporting and legislature's control may need to be strengthened. The legal framework should ensure the independence of the external auditor. The financial regulations drawn up from the legal framework of the former colonial power may not take into account some specificities of budget management in developing countries (for example, the management of expenditures financed from external aids). The legal framework may sometimes be muddled because it consists of different layers, prepared in different periods, by different persons.

Concerning sub-national government, a special law separated from the organic budget law, is generally desirable, because the decentralisation policy may evolve at its own pace. Detailed provisions concerning the budget process and financial management procedures at the various levels of sub-national government, and the often complex fiscal relationships between the central and sub-national levels, need to be defined in separate legislation. However, the OBL should include provisions on: (i) The basic principles of financial management, control and external audit, and of revenue sharing arrangements, if any; (ii) restrictions on borrowing; and

(iii) budget accounting methodologies and classifications so that these are coherent and common to all levels of government.

Whatever the degree of decentralisation, fiscal and revenue-sharing arrangements between the central and local governments should be stable and predictable. Rules must be clear. They may be amended from time to time, but renewed bargaining each year should be avoided.

A single government body, generally the minister of finance, should be authorised for contacting loans or granting guarantees. A ceiling for loans and guarantees should be voted and agreed on by the Parliament at the same time as the budget.

Other amendments to the legal framework should go hand in hand with the reforms that will be implemented. In Anglophone countries, there is a recent tendency to develop fiscal accountability-type legislation, as introduced in the OECD Anglo-Saxon countries. While some Francophone countries are considering replicating the new French OBL. Such approaches may be suitable to the developing countries, with a comparatively robust budget system, but in most developing countries there are more pressing needs.

## ii) Basic priorities<sup>75</sup>

The OBL and other legislation must include provisions to balance the fiscal powers between the legislative and the executive branches, and to ensure consistency with fiscal democracy and transparency principles. Where relevant, they should include provisions to ensure that basic priorities developed in the other sections of this paper are effectively implemented.

The legal framework should include, among others, the following provisions:

- Timely submission of the budget to Parliament to allow its proper scrutiny and the completion of budgetary debates, before the beginning of the fiscal year.
- Comprehensiveness of the budget (see section B1a)
- Enhanced data presentation in the budget documents (cf. section B1a).
- Appropriation management rules that limit the freedom of the executive to make shifts between appropriations, without Parliament's approval, in order to ensure that the policies stated in the budget will be effectively implanted.
- Authority to contract loans and grants guaranteed. Procedure to submit them to Parliament for approval.
- Prohibition of the initiation of unbudgeted expenditures by the executive branch in the course of budget execution, except through supplementary appropriations.
- Requirements for financial and fiscal reporting.

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<sup>75</sup> Detailed requirements for the legal framework may be found in William Allen "Public Expenditure Management and Budget Law: Toward a Framework for a Budget Law for Economies in Transition". IMF 1994.



- Timely submission of the end-of-year accounts.
- Independence of the external auditor (see section B2d).
- Transparent and rules based systems for intergovernmental transfers, revenue sharing arrangements and expenditure assignments between the different levels of government.

### iii) Further steps

Further steps in developing the legal framework should be coordinated with the implementation of reform measures.

Besides regulations for budget management, the regulatory framework for policy formulation may need to be reviewed, to enable coordination and cohesion in decision making, and to keep political decisions at the right political level.

## ANNEXES

## **Annex 1. Basic priorities and beyond the basics**

This annex sum up: (i) the basic priorities; and (ii) the further steps identified in this paper.

Starting from scratch the basic priorities will be the first platform while the further steps will consist of one or several following platforms. Sequencing the "further steps" would need to take into account each country context.

When a logical sequence within the measures placed under the umbrella "further steps" can be identified, the term "subsequently" is used to separate more "advanced" reforms (possibly included in a third platform) from intermediate reforms (possibly included in the second platform). In many cases, the "intermediate" reforms deal with policy based budgeting and consolidating the basics while the "advanced" reforms deal with operational performance elements. However, there may be overlaps between these elements.