Managing Public Expenditure
A Reference Book for Transition Countries

Edited by Richard Allen and Daniel Tommasi

THE SIGMA PROGRAMME

SIGMA — Support for Improvement in Governance and Management in Central and Eastern European Countries — is a joint initiative of the OECD and the European Union, principally financed by the EU's Phare Programme. The Organisation for Economic Co-operation and Development is an intergovernmental organisation of 30 democracies with advanced market economies. Its Centre for Co-operation with Non-Members channels the Organisation's advice and assistance over a wide range of economic issues to reforming countries in Central and Eastern Europe and the former Soviet Union. Phare provides grant financing to support its partner countries in Central and Eastern Europe to the stage where they are ready to assume the obligations of membership of the European Union.

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FOREWORD

This book fills an important gap in the literature on public expenditure management both in terms of its depth and breadth of coverage and its specific orientation towards the needs of countries in transition, especially in Central and Eastern Europe. Even after ten years of transition, many fundamental reforms remain to be completed in these countries, and past reforms are being rethought. The hurdles facing countries in transition that strive to achieve an acceptable standard of performance in budgeting, accounting and auditing become ever higher, as OECD countries modernise their own systems, building on one another's experience and good practices, and as new international standards are developed. We hope that this book will be useful as a basic reference text for policy-makers and budget practitioners, or as part of training programmes or distance learning courses.

The book covers all aspects of public expenditure management from the preparation of the budget to the execution, control and audit stages. It is intended to be a practical, operational guide to help countries that are designing and implementing new laws and procedures relating to public expenditure management, and to improve the transparency of budgetary procedures and information. Beyond its immediate target audience in Central and Eastern Europe, we believe that the book will be of interest to developing countries and countries in transition - and developed countries also - in all parts of the world. Good budgeting systems rest on certain classic principles and practices of administration, wherever these systems are to be found.

Background

In April 1998, SIGMA and the Asian Development Bank (ADB) agreed to co-operate in the preparation and publication of a reference book on public expenditure management that was to address particular problems of developing countries and countries in transition. Two versions of the book were to be prepared: one for countries in South East Asia and another for countries in Central and Eastern Europe, particularly those participating in the SIGMA Programme.

The two books include a significant amount of common material because they deal with the basics of a budget system. However, there are also substantial differences between Asia and Central and Eastern Europe. The background of central and eastern European countries is that of the distinctive Soviet institutions and culture overlaid, in many cases, with elements of the systems of public administration and budgeting drawn from Western Europe, especially France, Germany, Austria and, in the case of the Baltic States, the Scandinavian countries.

Moreover, most countries in Central and Eastern Europe are candidates for membership of the European Union and are likely to become Member States from 2002 or 2003 and onwards. Ministries of finance, government control offices, supreme audit institutions, national statistics offices and other budgetary/financial institutions in these countries are already heavily engaged in adapting their systems and procedures to the requirements of EU membership; adopting the body of European legislation, the

acquis communautaire, where this is necessary; and bringing procedures of budgeting, financial control and audit into line with western standards. Practices and procedures used in Members States are particularly important "models" in this respect.

ADB and the OECD, as copyright holder of SIGMA publications, signed an agreement enabling the two organisations to use and adapt each other's material freely in preparing the two versions of the book. Work on preparing the Asian version, *Managing Government Expenditure*, started in summer 1998 and the book was published in April 1999 (Schiavo-Campo and Tommasi, 1999). SIGMA and the OECD's Public Management Service (PUMA) contributed material to that book and participated in a technical workshop in November 1998 organised to review a preliminary draft of the book.

Work by SIGMA on adapting ADB's *Managing Government Expenditure* to the European context started in summer 1999. Daniel Tommasi, co-author of the ADB book, was hired as a principal editor/author in order to provide the required continuity. This involved both commissioning entirely new materials (e.g. on the EU budget and procedures for managing and controlling EU pre-accession funds), expanding existing material in certain areas (e.g. financial control and audit) and rewriting case studies and examples to give them a European flavour. The structure of the book has also been redesigned, some annexes added and others removed, the glossary completed and an index inserted.

How to use this book

Many advisers can be found in consulting firms or donor organisations (multilateral or bilateral) around the world who advocate an approach based on the importation of "best practice" techniques into the repertoire of countries engaged in designing new approaches to budgeting or public administration more widely. However, such an approach rarely works in practice. There are a number of reasons for this: the presence of both "formal" and "informal" rules that affect the behaviour of public servants; and the wider economic and cultural factors that determine these informal rules of behaviour.

In many developing and transition countries (and in developed countries also), these informal rules are dominant. As a result, public administration systems are slow to change. There is little advantage, for example, in introducing swathes of new rules and regulations if compliance is poor. Similarly, it is difficult to change a system from an internally controlled culture to an externally controlled culture, or vice versa. Nevertheless, change can occur in the right circumstances and environment, with the right champions, and with the right internal and external incentives. Change needs to "fit" with the environment of economic and cultural behaviour, and the informal rules. This, in broad terms, is the approach to public administration reform that SIGMA has been pursuing since the programme began.

This book as a whole is designed primarily for technicians and practitioners working, for example, in the budget department of the ministry of finance or a line ministry, or the budget committee of parliament, or in a supreme audit institution or government control office, or the technical services of the European Commission. It is not necessarily intended to be read as a whole but used whenever there is a specific need to review the operation of a particular part of the budgetary "machine", e.g. the medium-term budget framework, the treasury system, the accounting conventions, internal (management) control systems, etc.

Readers who wish to obtain a rapid overview of the main issues involved are encouraged to read the Executive Summary, the introductory chapter, the four summary end-parts, the questionnaire in Annex I and the glossary. Then, if desired, they can delve into the detailed treatment, chapter by chapter. Such readers

could include senior officials in the prime minister's office or university professors or journalists with an interest, general or specific, in fiscal policy, budgetary issues or European integration.

Acknowledgements

I would like to acknowledge the debt I owe to all the contributors to ADB's *Managing Government Expenditure*: its author-editors Salvatore Schiavo-Campo and Daniel Tommasi and the great number of experts from the IMF, OECD, UNDP, World Bank, and other organisations, who contributed to it.

So far as this book is concerned, I would like to express special thanks in particular to Bob Bonwitt, Head of the SIGMA Programme, for supporting this idea and work, and inspiring and helping in numerous ways; and to my co-editor, and the author of several chapters, Daniel Tommasi. Special thanks are also due to the authors of new or extensively revised chapters of the book, in particular Chapters 3, 10, and 14, and Annexes I, II and III: Benoit Chevauchez, Alan Pratley, Harry Havens, Bettina Rafaelsen and Larry O'Toole; and my SIGMA colleagues, especially Brian Finn, Kjell Larsson, Stephen MacLeod, Johannes Stenbaek-Madsen and Nick Treen.

Other experts and colleagues who made substantial contributions to the book include Jean-Pierre Baché, David Darby, Rolf Eidem, Jan Kinst, Alain Morisset, Michael Spackman, Harry Wilkinson, and Eduardo Zapico- Goñi. The book has also benefited from interactions, too numerous to mention, between SIGMA and our colleagues and partners in the budget offices, control offices and supreme audit institutions of the countries with whom we are privileged to work; and with officials in the European Commission, IMF, OECD, US Treasury Department, World Bank and other organisations working in similar enterprises and activities.

Last, but not least, I am indebted to Belinda Hopkinson for piloting the book through all its final editorial stages; to Halima Benlatrèche for her bibliographic work; to Gilles Plante for advice on the index; to Catherine Candea and Véronique Chamart of the OECD Public Affairs and Communications Directorate for their support; to Vif-Argent for preparing the book in camera ready form; and to my assistant, Michelle Gillespie, who bore the brunt of the administration and typing of the project.

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Richard Allen
SIGMA, Paris

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LIST OF ABBREVIATIONS

ABC	activity-based costing
ADB	Asian Development Bank
BOT	build, operate and transfer
CBA	cost-benefit analysis
CEEC	central and eastern European country
CIS	Commonwealth of Independent States
COFOG	Classification of Functions of the Government
COREPER	Committee of Permanent Representatives
DG	Directorate-General (European Commission)
EAGGF	European Agricultural Guidance and Guarantee Fund
EBF	extrabudgetary fund
EBRD	European Bank for Reconstruction and Development
EC	European Commission *or* European Community *or* European Council (depending on context)
ECA	European Court of Auditors
ECOFIN	Economic and Financial Council
ECSC	European Coal and Steel Community
EEC	European Economic Community
EIB	European Investment Bank
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
ESA	European System of Accounts
ESF	European Social Fund
ETF	European Training Foundation
EU	European Union
EUROSAI	European Organisation of Supreme Audit Institutions
EUROSTAT	European Community Statistical Office
FMIS	Financial Management Information Systems
FSU	Former Soviet Union
GAAP	generally accepted accounting principles
GDP	gross domestic product
GFS	Government Finance Statistics
GNP	gross national product
GPA	Government Procurement Agreement
IASC	International Accounting Standards Committee
IBRD	International Bank for Reconstruction and Development
IFAC	International Federation of Accountants
IFC	International Finance Corporation
IIA	Institute of Internal Auditors
IFI	international financial institution
ILO	International Labour Organization

IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
IRR	internal rate of return
ISPA	Instrument for Structural Policies for Pre-Accession
MTBF	medium-term budget framework
MTEF	medium-term expenditure framework
MTFF	medium-term fiscal/financial framework
NPV	net present value
OBL	organic budget law
OECD	Organisation for Economic Co-operation and Development
OLAF	European Anti-Fraud Office
PEM	public expenditure management
Phare	Poland and Hungary Assistance to the Reconstruction of the Economy (European Commission)
PIFCS	Public Internal Financial Control Systems
PIP	Public Investment Programme
PPBS	planning, programming, budgeting system
PPO	public procurement office/organisation
PUMA	OECD Public Management Service
R&D	research and development
SAI	supreme audit institution
SAPARD	Special Accession Programme for Agriculture and Rural Development
SIGMA	Support for Improvement in Governance and Management in Central and Eastern European Countries (European Union and OECD)
SNA	Systems of National Accounts
TACIS	Technical Assistance to the Commonwealth of Independent States (European Commission)
TSA	treasury single account
UCLAF	European Commission's Co-ordination of Fraud Prevention Task Force
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization
ZBB	zero-based budgeting

EXECUTIVE SUMMARY

The national budget is the single most important policy vehicle for giving effect to a country's economic and social priorities within the scarce resources that are available to government for public expenditure. It is through the budget process that competing policy objectives are reconciled and implemented in concrete terms.

This book provides a comprehensive and in-depth analysis of all aspects of public expenditure management from the preparation of the budget to the execution, control and audit stages. It is intended to be a practical, operational guide that will assist countries in designing and implementing new laws and procedures in this field, and in improving the transparency of budgetary procedures and information. The book will be of general interest but is focused particularly on the requirements of countries in transition, especially those in Central and Eastern Europe that have the objective of being members of the European Union. These countries, like many others around the world, are modernising their budget systems and procedures in line with international standards.

This book is organised into four parts; at the end of each part is a summary containing key points and directions for reform.

The opening chapter is an *Introduction*. It summarises the three core objectives of PEM systems: fiscal sustainability, efficient resource allocation and operational efficiency. Transparency is another key objective, pushed into recent prominence by the IMF's *Code of Good Practices on Fiscal Transparency*. The chapter emphasises the importance of the historic legacy of the former communist regimes in central and eastern European countries which still acts as a constraint on reforming PEM procedures and strengthening the institutional role of the ministry of finance. This chapter then sets out a "baseline" of criteria against which countries can assess the extent to which their PEM systems meet international standards, including (where appropriate) the specific requirements of EU membership.

The opening chapter ends with a section that describes the methods that transition countries might consider using in order to manage the change process effectively. Effective communications, co-operation and co-ordination of activities are essential to successful reform of PEM systems, as they are in other areas of public administration. Building commitment to reform within the ministry of finance and other ministries and organisations directly affected by change is of key importance.

Part I covers the budget and the institutional context.

Chapter 1 reviews the basic concepts and definitions of the budget, the need to have the broadest possible coverage in order to achieve the three core objectives, and the use of special arrangements such as extra-budgetary funds and off-budget expenditures. The chapter also analyses other forms of government activity with a fiscal impact such as quasi-fiscal activities, government liabilities and contingent liabilities, loan guarantees and tax expenditures.

Chapter 2 describes the importance of having a sound legislative base for the budget through the constitution and an "organic budget law". Theses should provide a balanced division of responsibilities between the main actors in the budget process — the executive and the parliament — and, within the executive, between the council of ministers, the ministry of finance, and the line ministries and other spending units. The chapter lays out the main elements that should be found in an organic budget law. It also reviews the distribution of fiscal responsibilities between central and subnational (state and local) government entities — the "fiscal federalism" issue.

Chapter 3 describes the key features of the EU budget, the main elements of expenditure and revenue, the role of the Commission, Council of Ministers and European Parliament, and the procedures followed in preparing the annual budget and executing the budget. The chapter also reviews the implications of the EU budget for the national budgets and fiscal policies of Member States and candidate countries. The Stability Pact, and the access of candidate countries to pre-accession funds, imposes requirements on these countries to tighten up budgetary discipline, bring their national accounts and public finance statistics into line with European standards, establish multi-annual budgetary frameworks and introduce rigorous monitoring, control and reporting procedures.

Part II deals with issues relating to the allocation of resources, policy formulation and budget programming.

Chapter 4 describes the presentation of expenditure information in the budget and the importance of efficient, modern systems of budget classification by function (COFOG), economic classification (GFS) and administrative units. The chapter also reviews the strengths and limitations of techniques of performance and programme budgeting.

Chapter 5 describes the main steps and procedures used in preparing the budget. This starts with the government setting the macroeconomic and fiscal policy framework, including key fiscal targets and objectives for the medium-term. The chapter reviews different approaches to setting the budget, e.g. top-down and bottom-up; the important role of the ministry of finance in defining the main assumptions and parameters for the budget through guidelines and circulars; the budget timetable; the negotiation process; and the distribution of responsibilities in annual budget preparation.

Chapter 6 explains the medium-term budget framework (MTBF) and the main issues arising in this field — setting the policy basis, planning new policies and programmes and linking annual budgeting and multi-year budgeting. The chapter also reviews the relationship between capital investment programming and the MTBF, the role of the public investment programme (PIP) and the need for an integrated approach between budgeting for operational and capital expenditures.

Part III covers budget execution and its management, including internal (management) control and internal audit.

Chapter 7 describes the broad objectives of budget execution and the main issues arising. These include a clear working definition of the commitment and verification stages, operational rules for the release of funds, compliance controls and special issues relating to multi-year commitments. The chapter also discusses budget appropriation management rules (e.g. transfers between budget items), issues of overspending and underspending, and the monitoring of budget execution.

Chapter 8 reviews three important areas of budget execution: managing payables and arrears, budgeting and control of personnel costs, and managing the procurement process. All these areas are potential

sources of misuse and mismanagement of public funds where stronger management from the centre of government is required. In the European context, Member States are required to bring their national laws and procedures into line with the EC Procurement Directives and wider Treaty obligations. This chapter also includes a discussion of the advantages and disadvantages of contracting out the delivery of public services to private sector suppliers.

Chapter 9 reviews the cash management and treasury function. The basic objective is to centralise cash balances within a single treasury account so as to minimise costs and increase the efficiency of payments and revenue collection. Efficient financial planning and forecasting techniques are required. The chapter also reviews issues related to the management of public debt and government assets.

Chapter 10 concerns the implementation of effective internal (management) control and internal audit procedures. These are essential if the risks of mismanagement or misuse of public funds, fraud and error or unsatisfactory accounting records are to be minimised. There are two main "models" of internal (management) control: one is characterised by a centralised approach (e.g. controls carried out by officials designated by the ministry of finance) and the other by a decentralised approach. This chapter also includes a section on the financial management of EU funds in candidate countries, through the so-called National Fund system, where specific EC regulations apply.

Part IV deals with issues relating to accounting, financial reporting, information systems, audit, performance measurement and evaluation.

Chapter 11 describes the accounting frameworks that lie at the heart of a good budgeting system. The advantages and disadvantages of cash accounting and accrual accounting, and variants of these two approaches, are presented. In general, the book argues that transition countries should focus on the requirement of achieving an effective cash accounting system before moving to an accrual basis. This chapter also discusses special issues relating to accrual budgeting, generational accounting, cost measurement and capital charging.

Chapter 12 reviews issues related to preparing reports on the execution of the budget and the scope and coverage of financial reporting within government, including reporting on projects and programmes financed from external sources such as EU pre-accession aid. Proper external scrutiny of these reports, through parliament and the external audit process, is essential.

Chapter 13 describes the architecture of integrated information systems for government financial management. This includes systems related to budget preparation and execution, debt management, cash planning, payment implementation, revenue collection and accounting and reporting.

Chapter 14 concerns the external audit function. Different types of audit are characterised (ex ante, ex post, compliance, attestation, performance) and pre-requisites for effective auditing (independence, audit coverage, professional skills) are defined. The chapter also reviews the reporting of external audit results and the limitations of the audit process.

Chapter 15 describes the performance measurement and programme evaluation process. Performance measurement requires careful design and implementation. It is a resource-intensive activity and, if not used carefully, the costs can outweigh the benefits. Programme evaluation techniques can also be useful but have similar limitations, especially in transition countries.

The book includes four annexes:

- *Annex I* is a questionnaire designed for countries engaged in PEM reform in order to assess the strengths and weaknesses of their systems in areas such as budget preparation, cash management or internal audit, and to measure improvements in these systems over time. It also allows countries to compare their performance with those of other countries.

- *Annex II* is a checklist of the main issues relevant to the establishment of an effective system for managing EU funds through the so-called National Fund.

- *Annex III* is a list of the main EC regulations concerning budget, financial control and audit.

- *Annex IV* reproduces the IMF's *Code of Good Practices on Fiscal Transparency*.

A list of abbreviations, a glossary, a bibliography, a short list of selected Internet sites, and an index complete the book.

INTRODUCTION — REFORMING PUBLIC EXPENDITURE: AN OVERVIEW

A. Definitions, Goals and Objectives

1. The meaning and role of public expenditure management

In order to perform the roles assigned to it by its people, the government needs, among other things, to: (i) collect resources from the economy, in a sufficient and appropriate manner; and (ii) allocate and use those resources responsively, efficiently and effectively. The national budget[1] is the main instrument through which these transactions are planned and carried out. Public expenditure management (PEM)[2] pertains only to item (ii). It is thus only one instrument, albeit a key instrument, of government policy. Hence, although this book focuses on PEM, readers are advised to always keep in mind the integral relationship between revenue and expenditure — i.e. between the money collected directly or indirectly from the people, and the use of that money in a manner that reflects most closely the people's preferences. Also, close co-operation between tax and budget officials is essential for areas such as macroeconomic and budgetary analysis and forecasting, and the analysis of policy trade-offs between proposals for increasing public expenditure or reducing taxation.

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

2. The objectives of public expenditure management

a. Three basic objectives[3]

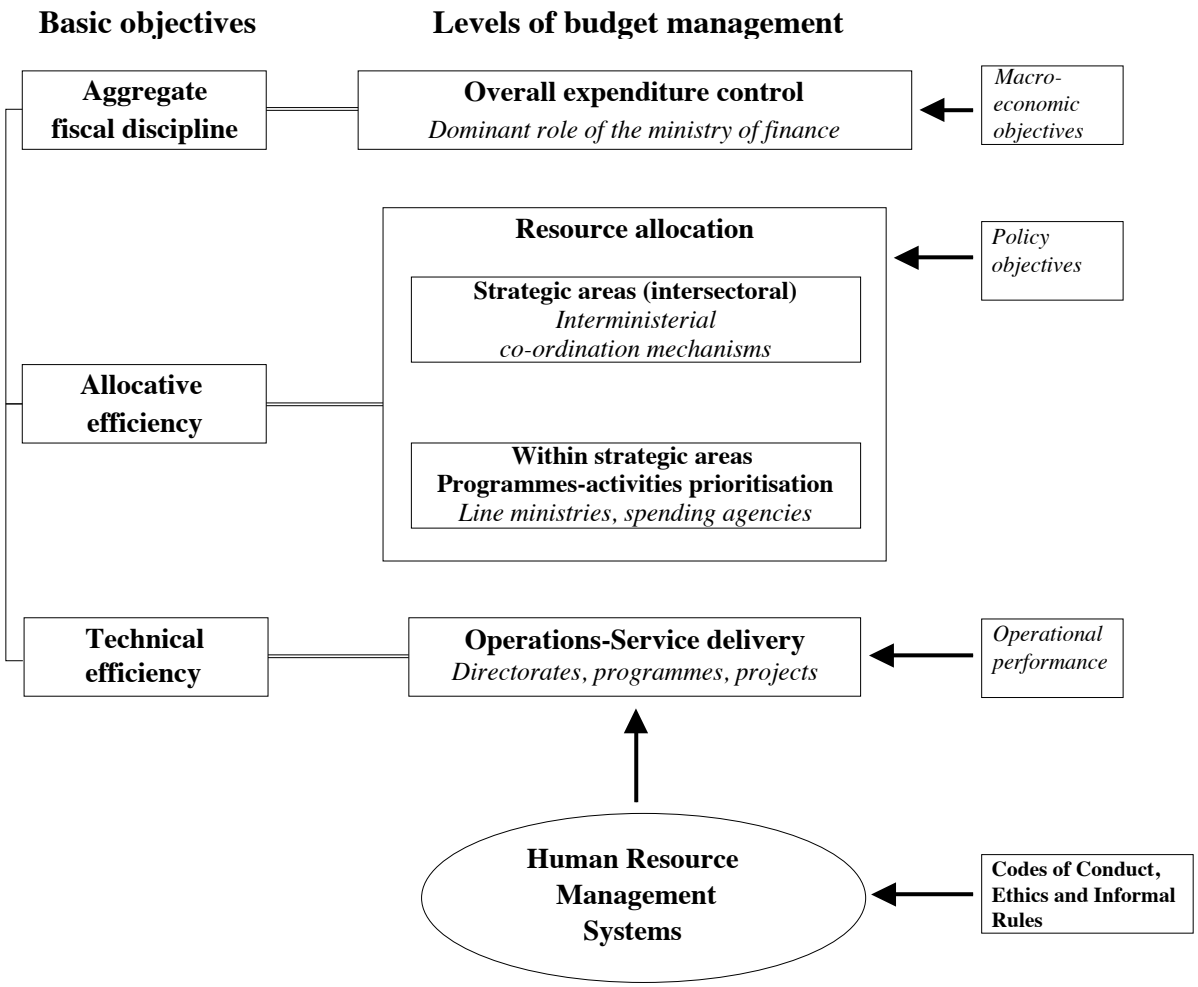
It is generally accepted that all budget systems need to achieve the following three basic objectives:

- *To maintain aggregate fiscal discipline*. Fiscal discipline pertains to effective control of the budget totals, by setting ceilings on expenditure that are binding both at the aggregate level and on individual spending entities. An effective budget system is one that has disciplined (in contrast to accommodating) totals. Control of the totals is the first purpose of every budget system. There would be no need for budgeting if the totals were permitted to float upward to satisfy all demands.

- *To allocate resources in accord with government priorities*. Allocative efficiency is the capacity to establish priorities within the budget, to distribute resources on the basis of the government's priorities and the programme's effectiveness and to shift resources from old priorities to new ones, or from less to more productive activities, in correspondence with the government's objectives. Effectiveness, which refers to the extent to which the objectives of the policy, the programme or the activity are met, depends closely on resource allocation decisions.

- *To promote the efficient delivery of services*. Technical or operational efficiency in the use of budgeted resources refers to the capacity to implement programmes and deliver services at the lowest cost (e.g. minimising costs per unit of output).

Figure 0.1. **BASIC OBJECTIVES OF PEM AND BUDGET MANAGEMENT**



These three objectives are complementary and interdependent. Without fiscal discipline, it is impossible to achieve effective prioritisation and implementation of policy priorities and programmes. Improving the internal management systems to achieve efficiency without a hard constraint is not credible. But mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. If a top-down expenditure limit is imposed in isolation and without any attention to the internal workings of the public expenditure system, the outcome may well be to underfund many worthwhile activities and distort policy priorities. Difficult situations that require special measures to ensure fiscal

discipline call for increased allocative and technical efficiency, not for arbitrary cuts across-the-board. None of these three basic objectives should be pursued in isolation from the others.

When reforming a budget system, the three basic objectives of PEM provide a framework to assess progress in improving performance of the budget system. The optimal mix of measures that is required in order to make progress according to these three basic objectives depends on the country context. Improvements in one or another area can and should go forward as and when circumstances permit. But a coherent vision of the entire reform process is needed to prevent "progress" against any one objective from getting so far out of line as to compromise progress against the other two objectives.

b. Implications for budget processes

Schematically, the main links between the three basic objectives of PEM and budget processes are as follows (see Figure 0.1):

- *Aggregate fiscal discipline* requires overall expenditure control, with expenditure estimates based on realistic revenue forecasts, and the capacity to set up fiscal targets and enforce them. As discussed in Part II of this book, the preparation of a macroeconomic and fiscal framework must be the starting point of budget formulation. To achieve aggregate fiscal discipline, the role of the ministry of finance is crucial.

- *Allocative efficiency* operates at different levels within the government. The allocation of resources among "strategic areas" and/or line ministries entails appropriate arrangements at ministerial level, and between ministries, to formulate policies and decide on sectoral financial envelopes. The allocation of resources among programmes, projects, and activities within these strategic areas requires both appropriate arrangements within line ministries for sector policy formulation and adequate technical capacities within spending agencies to select the most cost-effective programmes, projects and activities.

- *Technical efficiency* mainly concerns the operational level, and is dependent on arrangements to implement programmes within spending units[4] on the basis of efficient and effective management systems.

Operational performance in programme implementation and service delivery calls for both efficiency and effectiveness in use of resources. Effectiveness in service delivery is closely related to resource allocation decisions and allocative efficiency. But achieving improved efficiency and effectiveness at the operational level also depends on many factors not directly related to the budget system (e.g. the application of EC regulations, and, in the education sector, to policies relating to school curricula).

c. Political aspects

Aggregate fiscal discipline and the efficient allocation of resources are often impeded by the so-called "tragedy of the commons". There are many claimants to the budget, e.g. interest groups, legislators, line ministries. Each has preferences over the manner in which the budget should be allocated. The sum of these individual preferences puts pressure on increased expenditures. The allocation of resources is the more challenging of the three key objectives because it is dominated by political factors. As Petrei (1998) puts it:

"Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population's preference. The allocation of funds results from a series of

forces that converge at different points of the decision-making process, with an arbitrator who rules according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want."

As discussed below, rules and procedures to discipline policy debates are required, but the political dimension of the budget system is inescapable. Strategic policy choices should be in the hands of decision-makers that are accountable to parliament and society.

This book focuses mainly on the technical aspects of PEM, but it must be kept in mind that success in reforming a budget system to improve fiscal discipline and allocative efficiency depends fundamentally on the political commitment to achieve these objectives.

3. Institutional arrangements

Colloquially, the term "institution" is used as a synonym for "organisation". However, institutions are best understood as rules, and are thus distinct from the organisations that function under them (see, among others, North, 1990). To use a sports analogy, the game of football (soccer) is played better or worse depending on the players, but all players must adapt to the same rules; the "institution" of football does not change unless the basic rules are changed (e.g. by allowing the use of hands). Budgetary outcomes are profoundly influenced by institutions, which comprise both formal and informal rules.

Comprehensiveness of the budget is fundamental for both fiscal discipline and strategic prioritisation. As reviewed in Chapter 2, the legal framework must include the basic principles of integrity and universality of the budget.

Transparency and accountability mechanisms are needed to impose implicit costs and, when relevant, explicit sanctions on politicians and bureaucrats for violating budgetary rules. Accountability means that politicians and public officials (i) have to respond periodically to questions concerning their activities; and (ii) must be held responsible for the exercise of the authority provided to them. Accountability is essential but does not become operational until one defines accountability "of whom", "for what", and "to whom". Accountability requires clarity in the definition of responsibilities. Being held responsible should lead to consequences that can include rewards or sanctions, as in the case of misuses of public funds. But accountability can also be considered part of a learning-by-doing process that does not necessarily call for rewards or sanctions.

Accountability is required for a variety of areas from policy commitments made by politicians to operational activities. There are various forms of accountability: some are "internal" to the executive branch of government, others affect the relationship between the executive and the other branches of government, or the external world. Accountability to parliament is essential, and one of the basic conditions for sound budgeting. It should be supplemented by accountability to citizens, notably through making public policy commitments and publishing reports on government activities and results achieved. With the development of information and communication technology (ICT), external accountability through feedback from service users and citizens will be obtained at low cost and for a great variety of government activities. Internal accountability contributes to increased efficiency in the implementation of government policies and programmes, but managers and staff can be held responsible only for the exercise of the authority provided to them. However, officials are not always responsible for failures of such policies. Without predictability and clear lines of responsibility, results-oriented management systems can result in civil servants being made scapegoats for the failures of their political masters.

Transparency underpins accountability. Fiscal and financial information, made available on a full, regular and timely basis, is an important ingredient of an informed executive, legislature, and public. Competent legislative staff and independent public media are essential to processing and disseminating this information. It is important not only that such information be provided, but that it be in a relevant and understandable form. In 1998, the IMF assembled a *Code of Good Practices on Fiscal Transparency* (see Box 0.1 and Annex IV) that emphasises the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. This Code identifies good practices that constitute a minimum standard that should be implemented by all transition countries.

Predictability is important for operational performance. Lack of predictability of financial resources undermines strategic prioritisation and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for poor performance). Predictability of government expenditure in the aggregate and in the various sectors also provides important signals to the private sector in making its own production, marketing and investment decisions. However, assuring predictability does not mean making unconsidered promises, which would weaken fiscal discipline. Predictability is a relative notion, the challenging task being to deal with uncertainty in the most suitable manner, taking into account a country's economic and fiscal context.

In general, flexibility in decision-making is important in order to achieve efficient and effective operational performance. At the policy level, ministers should be given authority to make decisions relating to their particular sector, provided that they fit the strategic policy objectives of the government. Similarly, at the operational level, managers should have authority to take decisions with their defined area of competence. However, such flexibilities need to be balanced by appropriate rules and standards of conduct, proper arrangements for accountability, and control mechanisms.

Appropriate participation by concerned public officials and employees and by other stakeholders is required for the sound formulation of expenditure programmes; participation by external entities, for the monitoring of operational efficiency; and feedback by users of public services, for the monitoring of access to and quality of the services provided. However, it is evidently impossible to provide for participation

Box 0.1. MAIN REQUIREMENTS FOR FISCAL TRANSPARENCY

Clarity of Roles and Responsibilities

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

(cont'd)

Box 0.1. **MAIN REQUIREMENTS FOR FISCAL TRANSPARENCY** *(cont'd)*

Public Availability of Information

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

Open Budget Preparation, Execution, and Reporting

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

Independent Assurances of Integrity

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

Source: IMF (1999).

by all shareholders at all stages in the expenditure cycle, and unwise to use participation as an excuse to avoid taking tough but necessary decisions.

4. Governance aspects

Beyond the three basic objectives, a sound system of public expenditure management needs to take into account the wider values and requirements of society. Accountability, transparency, predictability and participation are important instruments for sound budget management, but also have an intrinsic value, and are generally seen as the four pillars of good governance.

If budget managers do not comply with parliament's authorisations, or if public funds are used for private purposes, it is doubtful whether either aggregate fiscal discipline or efficient resource allocation, or both, will be achieved. The requirements of compliance with parliament's authorisations and accountability to parliament come essentially from the role assigned to the parliament in a democratic society. In modern societies, citizens expect probity from the people in charge of government activities. Due norms and processes are essential for enforcing the citizen's rights, as well as for developing a client orientation in public service delivery.

Corruption, which is the misuse of public or private office for direct or indirect personal gain, poses moral and legal problems and is a major source of inefficiency in PEM. Certainly, one effective route to strengthening PEM is to reduce the opportunities for corruption and punish corruption when it occurs.[5] The reverse is also true: a major way to curb corruption is to strengthen public expenditure management systems. Corruption in government is often identified with large procurement transactions and major public works projects (see, for example, Tanzi, 1993). Effective systems of procurement, internal (management) control and audit are required to limit opportunities for corruption. Often in transition countries, the traditional inspectorates focus on relatively minor irregularities, while the more serious cases of corruption are not investigated and remain unpunished. Such cases are often found in the "hidden" part of the annual budget (such as contingent liabilities, off-budget expenditures, and multi-year expenditure commitments). Moreover, the expenditure budget is not the only source of potential corruption. Weak systems of tax administration, debt management, customs administration, privatisation, etc., are equally prone to corrupt and fraudulent activities. Fiscal transparency and accountability, and appropriate audit systems, are essential to fighting corruption in all these areas.

5. Administrative and cultural context

There is no automatic relationship between a particular instrument or institutional arrangement and the budget outcomes. The relevance and effectiveness of institutional arrangements and budget management systems depend on the country context. Hence, any instrument for public expenditure management originating from another country must be carefully analysed in the light of the local context and rejected, adopted, or adapted as needed. There are, however, some basic principles that every budget system should enforce (such as comprehensiveness), and as argued by Schick (1999), when reforming a budget system, the priority actions should be aimed at getting the basics right first (see Box 0.2).

Particularly important for improving PEM is an evaluation of the country's institutional framework. The rules of procedure are always more complex than what appears at first sight. Informal rules are equally as important as formal rules such as regulations, decrees and operating manuals issued by the government or by government agencies. If budget reforms are designed without taking key informal rules into account, they are likely to fail. Budget organisations can be restructured, recombined and created, and sophisticated instruments implemented, but no change in behaviour (and hence in budgetary outcomes) will result unless the basic rules, procedures, and incentives change as well. One way to improve the overall institutional

Box 0.2. **TEN BASIC PRINCIPLES OF BUDGETARY REFORM**

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

Source: Schick (1999).

framework is to make the informal rules more visible. But, in any case, durable institutional changes in general, and public budgeting in particular, take a long time to be implemented successfully — a result of what North (1990) called "path dependence".

B. Public Finance in the Command Society

As noted, public expenditure management is country specific and rooted within a country's administration culture. To modernise the budget system in transition countries, it is important to understand the legacy of the command societies from which they originated.

1. The function of the budget

In command societies, the chief functions of the government were to organise overall planning and production of goods and services. In many of these countries, the most important document in terms of the creation of incomes and welfare was "the plan". Although there were many functions to be carried out by means of state budget resources that derived directly from this plan — such as "social-cultural",

"defence" and "administration" expenditures — the role of the budget was less important than that in market economies. For example, income distribution was essentially determined as part of the overall plan and little was left for the state budget to adjust.

It is not quite clear on what basis resource allocation decisions between categories such as production, investment, social payments and defence were taken in command societies. Such decisions seem to have been largely the result of the "directive power" of the party. The resource allocation system was founded neither on competitive voting nor on decentralised competition among state firms. Instead, it usually involved negotiations among political leaders to determine a state budget that would safeguard the perceived interests of the state and the political positions of the negotiators. Therefore, to a large extent, the real objectives of the state budget were to secure the political survival of the top leadership, provide political information of sorts, and give the surrounding world an impression that the national ideology worked.

2. The budget in the context of the plan

The organisational structure supporting the planning and budgeting activities in most command societies was a typically hierarchical structure, where all formal information travelled vertically. An enormous amount of information was handled through this structure, first as part of the planning process and second as part of the actual production process. There was a myriad of technical input-output interdependencies in the plan, which was vulnerable to unexpected real-life events. In order to ensure that budget executors complied fully with the requirements of the political leaders, the plan document was normally promulgated into law.

The role of the ministry of finance in the former command societies was chiefly to provide a source of finance both for physical production and social transfer flows, whose directions and volumes were decided elsewhere. The state budget proper was, of course, the responsibility of the ministry of finance, but this was not enough to raise that ministry's hierarchical role above that of most of the line ministries. Compiling the state budget itself was a relatively minor job, compared with "monetising" the whole of the overall production plan. This "honourless" and enfeebled position of the ministry of finance meant that there was little if no incentive for innovative thinking among the leading staff.

The budget law was accompanied by a huge quantity of detailed administrative instructions that left little room for individual initiatives to change working methods or influence policy priorities. The interpretation of laws was a matter for the dominating party and its members, rather than for the courts. This is one of the features of the former command economies that is the most difficult to grasp. Everywhere in society there was a sort of secondary (if not primary) "judicial" system, whose chief impact (probably negative rather than positive for the development of national welfare) lay in blocking new initiatives that were perceived to be damaging to the party.

3. The budget process

The budget process was basically a negotiated procedure, in which the underlying "directive power" of the monopoly party determined the outcome of the negotiations at all levels.

In the Former Soviet Union, for example, starting at the level of the municipalities, requests in terms of physical resources and/or money were put forward by administrative bodies and production organisations to the regional capitals. Representatives of these municipality level interests went in large numbers to the regional capitals in order to defend their plan proposals against all competing proposals. A similar procedure then took place at the national level, when regional representatives presented their plans to the co-ordinators of the overall national plan, i.e. the Gosplan and the ministry of finance. The prospects for

any production unit in the coming year in large measure depended on the plan document handed down from above and the instructions contained therein about what should be produced and the resources required to put the plan into effect.

The objective of this process was to produce two plan documents: one containing the production plan of the whole country[6], the other, containing the state budget. After lengthy negotiations to achieve broad consistency across these plans, they were finalised in more detail before being presented towards the end of the year to the Supreme Soviet for formal recognition. Behind this process was a parallel political process through which the communist party made sure that the plan was in line with its political and social objectives by exerting its so-called "directive power".

Audit, in the sense of an external, independent checking of the financial records of government organisations or production units in order to make statements on their veracity, was never practised systematically in the former command societies. Controls consisted largely of internal checking of whether all instructions had been followed in administrative decision-making and bookkeeping. Such checks were made under the auspices of a control and revision unit in the ministry of finance, and similar procedures were followed in the line ministries. This was more an inspection system than an internal audit system (in the western sense), since it had nothing to do with organisational development. In addition, in the Soviet Union, there were the so-called "people's control commissions", whose members were called upon by the party to make investigations into alleged misuse of powers by persons, unsatisfactory bookkeeping, etc. However, these commissions were not skilled in audit work and seem to have had little impact on improving the functioning of the system.

C. Improving Public Expenditure Management in Transition Countries

1. The current context

Transition countries recognise the importance of effectively managing government expenditure and are undertaking many important reforms in this area. Nevertheless, they are still burdened, to an extent that varies from country to country, by their inheritance from the previous regimes.

In many transition countries, the tendency to impose decisions from the top, without adequate consultation and co-ordination, still creates inefficiencies in policy development and implementation. Moreover, the distribution of budgetary responsibilities between the ministry of finance and line ministries is often not clearly defined, and the ministry of finance remains insufficiently empowered to ensure adequate scrutiny of budget proposals. Budget fragmentation — e.g. through use of numerous extra-budgetary funds and separate capital and expenditure budgeting and programming procedures — reduces allocative efficiency. Little progress has been made to strengthen the policy-making function and create the necessary links with budgeting. Parliaments are inexperienced and are generally unable to perform their control tasks effectively. Accounting and reporting standards, and systems for financial control and audit, need to be developed further and brought into line with European Union requirements. The development of procurement law and systems is uneven.

Meeting the standards reached by EU Member States in PEM thus remains a challenging task for countries in the region that aspire to be members. In fact, the European Commission does not prescribe any particular model of public expenditure management on Member States. Indeed, there are few explicit requirements in this area except in the fields of aggregate fiscal discipline, the management of EU own resources and financial control. However, in countries of central and eastern Europe, the allocation and

efficient use of EU funds and the necessity for maintaining fiscal discipline call for undertaking PEM reforms in several major areas. These reforms should be aimed initially at implementing essential elements of good practice in budgeting systems and also meeting specific EU requirements for Member States.

With this objective in mind, we present below a set of "baseline" criteria that set out the essential requirements of a well-functioning public management system covering both EU funds and national resources provided through the budget. A strategy for implementing these baseline measures and bringing public expenditure management systems into line with western European standards, is discussed in Sections D and E below.

2. The baseline measures

a. Institutional framework

Clearly defined principles should be set out in a country's constitution, the organic budget law and related laws. The regulatory framework should provide a sound balance between the legislative and the executive powers. Parliament must be enabled to properly scrutinise the budget, and debate and review fiscal policies. For good macroeconomic management and efficient allocation of resources, the budget should cover all revenues and expenditures. Extra-budgetary funds and sources of external finance (e.g. EU funds) should be integrated into the national budget.

b. Medium-term fiscal framework

Future EU Member States should be able to provide budgetary information within a medium-term framework, and set medium-term fiscal objectives. Once they become EU members, either within or outside the European Monetary Union, they will have to submit either stability or convergence programmes. Both programmes will have to specify the main elements of a medium-term fiscal framework that complies with certain methodological principles and standards (e.g. national accounts statistics should conform with SNA93[7] and ESA95[8]).

c. Budget preparation process

There should be a well-defined and widely understood sequence of steps in the budget preparation process, allowing sufficient time for each step to be implemented efficiently. Procedures used for preparing the budget for operational and capital investment expenditures should be integrated. Hard budget constraints should be included. The draft budget should be presented to parliament in an appropriate format to allow parliament to scrutinise it properly. It should specify the government's fiscal policy objectives, the macroeconomic framework, the budget policies and identifiable major fiscal risks. Budget information should be presented to the public in a clear and accessible form.

d. Budget execution and monitoring

The line ministries should enforce spending limits stipulated by parliament, and the ministry of finance should be able to supervise these limits. The ministry of finance should monitor and control the flow of expenditures during the year on the basis of a unified system of financial accounts. Systems for monitoring and controlling personnel expenditures should be as robust as for other areas of the budget. Line ministries should make regular reports to the ministry of finance that compare actual spending with monthly forecasts based on the budget appropriations. Parliament and the council of ministers should have appropriate responsibilities for reviewing periodic reports on financial performance relative to the budget

and for revising targets and/or policies as required by changed economic or financial circumstances. The cash management (or treasury) function should be strictly managed through a treasury single account under the control of the ministry of finance.

e. Accounting and reporting

Budget and accounting categories at the national level should have a common system of classification that facilitates policy analysis and promotes accountability. Accounting concepts need to be made compatible with concepts related to the disbursements of EU funds (commitments, payments, eligible expenditures, etc.) and the definition of "deficit" and "government" aligned with the ESA95 standards. Fiscal reporting should be timely, comprehensive, reliable and identify deviations from the budget. Procedures for evaluating the efficiency and the effectiveness of expenditure policies and programmes, including those funded from EU sources, should be established.

f. Financial control

A coherent and comprehensive statutory base defining the systems, principles and functioning of management control, or internal control, is required. The following systems and procedures are essential for sound internal (management) control: (i) standards and regulations for financial reporting; (ii) a modern accounting system conforming with international standards; (iii) a defined audit trail, which for the management of EU funds should clearly define the roles and the responsibilities of the different national entities involved, including the National Fund, Paying Agencies and Implementing Agencies (as defined in EC regulations); (iv) ex ante controls of commitments and payments; (v) public procurement procedures that comply with EC regulations and are effectively implemented; and (vi) control of state revenues.

An efficient internal audit/inspectorate mechanism should be put in place. It should meet the following criteria: (i) be functionally independent; (ii) have an adequate audit mandate; and (iii) use internationally recognised auditing standards. Systems should be in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence.

g. Procurement systems

Achieving a properly functioning market is one of the priority tasks of the European Union. One of the key ways of achieving this goal, and other related and essential elements of good governance, is to have an efficient procurement system in which competition is encouraged for contracts awarded by public sector bodies. Sound procurement policies and practice can reduce costs of public expenditure; produce timely results; stimulate the development of the private sector; and reduce waste, delays, corruption and government inefficiency.

Measures to improve procurement procedures include: sound public procurement legislation; the establishment of a central public procurement organisation with overall responsibility for the design and implementation of public procurement policy and national training programmes; the development of the capacity of spending units in efficient procurement procedures; and the establishment of effective control and complaints review procedures.

h. Budget management of EU Funds

The European Commission expects that candidate countries for EU membership will prepare themselves for managing the pre-accession funds (Phare/ISPA/SAPARD) so that, when they join the EU, they have

the required budget and control instruments in place. In order to comply with this, governments should have the capacity to present multi-annual programmes involving careful co-ordination between partners at different levels of government, well-designed co-financing procedures and sound technical and economic appraisal of such programmes.

D. Approaches to Managing Change

Streamlining a public expenditure management system requires setting up a strategy for reform and managing the change properly. This section draws together the main messages and lessons of this book and presents some general and practical considerations for developing a strategy and managing the change process. The starting point of the preparation of a strategy for reform should be a comprehensive assessment of the strengths and weaknesses of the budget system currently in place. For this purpose a questionnaire to assess the strengths and weaknesses of a budget system is presented in Annex I.

1. The approach to reforming budget systems

a. The need for a comprehensiveness

A public expenditure management 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 plan the phasing of their implementation, 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 explains unrealistic revenue forecasts? Weak technical capacity in forecasting? External developments beyond the scope of the forecasters to predict? Or deliberate manipulation of revenue forecasts in order to delay hard choices on the expenditure side?

To undertake successful reform, it is necessary, first, to define what the objectives of the reform are; and, second, to undertake 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. A budget reform should generally include a set of complementary actions in several areas. Narrowly focused reforms are often disappointing. For example, it will be illusory to expect significant benefits from introducing programme budgeting or multi-year budgeting procedures if hard constraints are not built into the budget process. 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 also necessary to achieve a proper mix of reform measures in order to meet the three basic objectives of budgeting — fiscal discipline, effective resource allocation and operational efficiency — in a balanced manner, taking into account the country's context. For example, implementing a treasury system contributes to increase fiscal discipline and should be favourably considered in transition countries. However, the implementation of a treasury system should not exempt spending agencies from their accounting obligations and should not impede the efficient management of government expenditure programmes. Incentives to strengthen accounting and management systems within line ministries should therefore generally accompany the implementation of a new treasury system. Moreover, improvements in the procedures for budget preparation should go hand in hand with measures to manage cash transactions more effectively.

Linkages between the public expenditure management system and other systems, such as political and managerial systems, must be taken into account. For example, to reinforce expenditure control at the spending agency level, improvements in public procurement and human resources management systems are as important as reforms of the budgetary procedures themselves. Improving budget preparation processes and the information systems that are necessary for informal 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, also 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.

b. Institutions and organisations

Improving public expenditure management requires both institutional (regulatory and procedural) reform and organisational development. Improvements in the budget system are largely a function of institutional change, in the contemporary sense of the basic rules that govern the behaviour of organisations and individuals. The distinction between "institution" and "organisation"—and the interplay between the two—is key to understanding the challenge of improving the management of public expenditure in transition countries. Budgeting organisations can be improved but economic, social and political behaviour will not change unless the rules and procedures change as well. However, the reverse is also: rule modification by itself is unlikely to produce beneficial results unless organisational improvements proceed in parallel. Improving public expenditure management requires both institutional reform and organisational development.

In many transition countries, the legal framework needs to be streamlined and rules to enforce it need to be established. Processes for budget preparation and execution need to be regulated. However, understanding of a country's culture of "informal rules" – namely those unstated rules that define how people, including politicians and government officials, actually behave — is essential in order to design reform measures, enhance formal rules and make them effective. Thus, a country may have an exemplary set of formal rules, but these are meaningless if they cannot be enforced because of the more powerful informal rules. Comparing systematically what actually happens with what should happen according to the formal rules helps to reveal the informal rules. Many informal rules have perverse effects on the budget system, such as those that lead to corruption and patronage. This requires carefully balancing flexibility and restraint, increasing transparency to make these rules more visible, and exercising extreme caution before considering results-oriented management techniques, since a system of performance-based incentives can easily be misused. On the other hand, some informal rules and processes can benefit the budget system (e.g. in a number of countries, the informal working of the network of civil servants can anticipate potential conflicts in budget preparation). Governments should make sure that such benefits are retained when designing a budget reform.

Fragmented organisational arrangements and weak interdepartmental co-ordination impede effective co-ordination of budgeting activities in a number of transition countries. As stressed in this book, the budget processes must be unified and the ministry of finance sufficiently empowered. The ministry of finance should be organised according to functional lines. The budget department should be fully responsible for the preparation of the budget, including: (i) the capital investment budget; and (ii) the review of sectoral budget submissions, which is in some transition countries is made by "branch departments" that are separate from the budget department itself. A department (or unit) for macroeconomic and fiscal forecasting should be established within the ministry of finance. In some countries, the distribution of responsibilities between the treasury department and the budget department needs to be clarified and co-ordination

between these two departments should be reinforced, notably for preparing the budget implementation plan and the cash plans. The debt management department, which is sometimes split into two distinct units, should be unified. A close co-ordination between the department responsible for debt management and the department responsible for preparing the budget implementation and cash plans is required. In most transition countries, co-ordination between the tax administration and the other departments responsible for preparing the annual tax forecasts, and updating them during budget execution, is weak and should be reinforced. Interministerial co-operation also needs strengthening, at the political and operational level, in many transition countries, e.g. between the ministry of finance, the ministry of economy, and the national statistics office.

c. Managing reforms within the government

Specific actions at the sectoral level are required to make effective the reforms established at the central level. For example, improving investment budgeting depends in a large part on the effectiveness of procedures to screen and select projects within the ministries and agencies concerned. Similarly, dealing with the problem of arrears generation requires an efficient internal (management) control within line ministries.

In many areas, the ministry of finance should prepare the general framework for reform and provide appropriate incentives and guidelines. However, the reform measures themselves must be defined and implemented by the line ministries. In reality, a two-pronged approach to reform may be necessary. This might involve parallel reforms at the central level, focusing on measures to improve fiscal discipline and the strategic allocation of resources, and reforms at the sector level, focusing on the allocation of resources within the sector and measures to improve internal (management) control and technical efficiency. The desirable degree of integration of these two parallel sets of actions depends on the nature of the actions, but conflicts between them must be avoided. For example, special programming instruments, such as the establishment of programme budgets, can be developed in some sectors, without requiring a government-wide exercise. Nevertheless, such sectoral exercises must comply with the overall budget ceilings that need to be established at the central level.

In many transition economies, the absence of systematic lines of interagency communication and the lack of incentives to share information result in fragmented policy formulation and atomised decision-making. This presents a major problem for the implementation of reforms. The challenge is how to improve communications and reduce the cost of information within the public sector. The guiding operational criterion for sustainable improvement in public expenditure management systems should therefore be to strengthen the linkages between the components of the overall budget formulation and execution systems, between ministries and agencies, and between central government and subnational entities. Even when supporting the reinforcement of a specific budgetary procedure, it is essential to encourage positive interaction with other government agencies. Such encouragement must not be limited to rhetoric, but should entail specific incentives for greater information exchange, training and co-operation. Special attention should be given to the linkages between the central government and the subnational governments. An increased degree of devolution requires improved circulation of information and increased awareness of fiscal problems at the level of subnational governmental authorities.

d. The pace of reform

Developing a comprehensive approach to budget reform does not necessarily mean adopting a "big bang" theory of reform or importing the model of more "advanced" countries in all its aspects. "Best practice" models are useful to draw up lessons from experience. But the concept of "best practice" is dangerous,

when it is misinterpreted as importing budgetary models without hard-nosed consideration of local realities—particularly the "informal rules" that determine much of the behaviour of officials and their private sector counterparts. Formal rules can be imported fairly easily, informal ones much less so. Replicating foreign institutional practices should be considered only when these practices have a high component of formal rules. This is the case, for example, in the more "technical" areas of public expenditure management, such as accounting procedures or financial control (though even in such areas caution is recommended). By contrast, when the nature of the reform entails a high component of informal rules, such as in "governance" areas or where institutional incentives are affected, the reforms will normally need to be homegrown or, if imported, will require substantial adaptation. There are, for example, many potential pitfalls in attempting to replicate in transition countries aspects of the so-called "New Public Management" approach recently adopted by some OECD countries (see, for example, Verheijen, 1996, and Allen, 1999).

Specific tools and budgetary techniques that can be effectively used 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 is more important to develop such concepts than to change the format of the budget.

It is sometimes debated, often by reference to some budgeting paradigm, whether a big-bang approach or a gradualist, but often piecemeal, approach should be adopted to reforming a budget system. There is an aura of unreality in this debate when it is posed in general terms. The pace of reform should be defined according to each country's context and priorities, and depends on the objectives established for a given set of measures. In transition countries, and more particularly in countries that are candidates for EU membership, the pace of the budget reforms should be determined primarily by the following two concerns:

- Reforms must be aimed at getting the basics right and implementing the measures required to meet the minimum standards of developed countries. Strategic attention should therefore focus on implementing the baseline measures summarised earlier on in the chapter. In some areas, especially financial control and public procurement, these measures include specific requirements that are part of the *acquis communautaire*, i.e. the formal framework of EC rules and regulations. For this purpose, the questionnaire included in this book (Annex I) provides a valuable tool to assess the strengths and weaknesses of the public expenditure management system and determine in which areas priority actions should be undertaken.

- 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. The phasing of reforms and the definition of the priority areas for reform must take account of these realities. Moreover, the numerous interconnections between the budget system and other systems can result in unexpected outcomes when implementing reforms. A changing economic and political environment can 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, making any adjustments that are necessary. When reforming a budget system, unexpected developments and potential roadblocks can arise, and how well the reform responds to change must be continuously tested.

2. Preparing and monitoring an action plan

Once the key reform measures have been identified, on the basis of the assessment of the budget system, a phased action plan can be prepared. This plan should include the following elements:

- The *overall goal* of the reform and the *specific objectives* of each of its component parts.
- A list of the *components* (e.g. streamlining the budget preparation process, preparing a new organic budget law, etc.).
- A list of *activities* for preparing and implementing the reforms (e.g. pilot studies, user surveys, training courses); the deadlines for completing these activities; and milestones for accomplishing key tasks.
- *Indicators* to monitor progress achieved.
- The *organisational arrangements* to prepare the reform and supervise its implementation.
- The *resources* that will be devoted to the reform in order to purchase the required inputs of technical assistance, equipment and computer software, training of staff, etc.

It is important to phase and articulate properly the different components of the reform. For example, before undertaking the detailed design of an information system for budget preparation and execution, it is generally necessary to review the budgetary procedures, the budget classification system and the chart of accounts.

The action plan should include appropriate indicators to assess progress against the reform objectives and provide feedback to correct or complete the reform process. These indicators should measure:

- *Progress achieved in the preparation and the implementation of the reform*. To manage the reform programme, it is necessary to monitor: (i) the inputs devoted to reform (e.g. staff hours, equipment acquired, training activities, consulting services, etc.); and (ii) the outputs of the reform process (e.g. laws drafted, laws adopted, circulars issued and effectively implemented, operational manuals drafted, training courses implemented).
- *Effectiveness of the reform*. This requires an evaluation of whether the reform has contributed to improved performance of the budget system on the basis of the three essential criteria (fiscal discipline, allocative efficiency, technical efficiency). To make such an evaluation, quantitative or qualitative measures of (i) the processes and the outputs of the budget system (e.g. production of the annual budget law in a timely manner), and (ii) its outcomes (e.g. a decreased budget deficit) need to be established.

Setting up outcome indicators for measuring the performance of a budget system is a difficult issue since the interconnections between the budget system, other systems and changes in the economic environment pose an attribution problem. Nevertheless, it is important to make progress in this area for several reasons. First, to gain acceptance of the reforms from decision-makers, it is necessary to indicate what are the expected results. Second, as discussed earlier, the reform process is continuous. Perhaps poor outcomes will not necessarily mean that the reforms were badly designed, but they will provide nevertheless a powerful message: "reforms are not completed and additional measures must be taken to strengthen the budget system or in related areas".

The following are examples of indicators that can be used to assess the overall effectiveness of a budget system:

- *Fiscal discipline*: Are the deficit targets met? Are revenue forecasts realistic (what is the ratio revenue collected/revenue forecast)? Is there a reduction in overcommitments? Is there a reduction in the stock of arrears?

- *Allocative efficiency*. Does the actual composition of the budget match policy objectives? What is the degree of correspondence between planned and actual composition of expenditures by sector? Does the investment programme focus on the most cost-effective projects or are funds still inefficiently distributed among a variety of uncompleted projects? What is the average time to complete projects included in the budget? What are the total costs of the annual tranche of these projects compared to the balance of expenditure necessary to complete work on the projects?

- *Technical efficiency*. Has the efficiency of the tax administration improved (e.g. a diminished volume of tax arrears, an increased ratio of tax receipts to GDP , after netting out the impact of any new tax measures)? Did measures to strengthen cash management contribute to diminished borrowing costs? Are procurement tendering procedures sufficiently competitive?

Such indicators provide useful feedback, where necessary, to amend and adapt the reform process to unexpected developments. However, it is important not to put too much weight on favourable developments in few indicators. Such developments may, in reality, be attributable to factors external to the reform itself, and the improvements may not be sustained.

E. Managing the Reform Process

1. Building a commitment to reform

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. Reforms prepared outside this ministry, or by a reform committee or by consultants working in isolation, often attempt to copy so-called best practice solutions from another country or to focus on technical issues without considering the specific institutional character and culture of the country concerned.

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, subnational government authorities and other key players.

Consultations with the legislature are very important, particularly when the reform will affect its activities or the legal framework. For example, the legislature must be involved at an early stage in the preparation of new budgeting laws. Parliament's committees should be consulted about any substantial changes that are proposed in the format of the budgetary documents or of the financial reports communicated to parliament. Improving the presentation and content of budgetary documents should go in hand with measures to improve the capacity of parliament to analyse such material. For example, presenting accrual accounting information in the budgetary documents will be useful only if the parliament is fully aware of the meaning of the data provided and can find in the budgetary documents the information that it needs.

To reach a consensus for reform within the government, it is essential to clarify precisely the objectives assigned to the reform and the expected benefits. For this purpose, it may be useful to carry out some awareness-raising seminars with top managers of the government, members of parliament and subnational authorities on the problems that the reform intends to address and the expected benefits.

Disseminating the information on the proposed reform among the members of parliament and the public, and reaching a wide agreement on the reform, is also important to ensure its sustainability. The reform must be sustained after the main change agents give way to a second generation. This generally requires a period of at least five to ten years.

Rationalising organisational structures, modernising procedures and processes and/or implementing a new computerisation programme can easily be derailed if operational staff do not understand and support the change. 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.

Such actions, which might include workshops and wide dissemination of documents, should be aimed at:

- Making sure that senior officials within the government are fully informed about and supportive of aims and objectives of the proposed reform and the measures required to implement it; and are aware of the need for appropriate internal communications and the potential social impact of the changes.

- Creating a culture of "ownership" in the reform by ensuring that middle management levels participate in an appropriate way in the reform activities and that these managers explain the purpose of the reforms to their colleagues.

Reform should not be viewed as either a "one-off" event or an additional burden on managers and staff that must be imposed by necessity, but instead as a way to strengthen the civil service profession, both individually and collectively. It is important at each stage of the reform process to highlight information on progress made in an appropriate, widely circulated newsletter, to encourage feedback from all staff, and to make necessary adjustments to the reform activities.

When some departments are subject to organisational changes, as part of the proposed reform, it is desirable to:

- Designate the manager who will be in charge of proposing, promoting, co-ordinating and supporting colleagues in explaining the reforms, and providing information on developments and results.

- Organise a series of interactive seminars for middle managers on the objectives, content, phasing and consequences of the reform project.

- Organise a similar series of seminars for staff at the operational level who will be directly affected by the reforms.

- Announce at the same time measures that will be taken to cushion the impact of phasing out certain activities. Accompanying measures to promote the redeployment of staff to other activities, and staff retraining, should be devised in advance to minimise uncertainty.

• Conduct a regular evaluation of staff attitudes to the reform.

2. Organisational arrangements

Organisational and human capacity is essential to administer the reform and enforce the new framework. Proper organisational arrangements should be made 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, organised as follows:

- *Steering Group*. 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 in this steering group the heads of the key departments of the ministry of finance and representatives of line ministries and other organisations participating in the reform (e.g. representatives of subnational governments). One of the aims of setting up a steering group is to ensure that the objectives of reform will be shared by high-ranking officials with a stake in the process.

- *"Core unit"*. A core unit or a separately identifiable department 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 core team needs to have a very clear vision regarding the goals and objectives that should be reached. It needs to be appropriately staffed with persons who are competent, motivated and efficient. It should be given the authority to spread new institutional and organisational practices thorough the government by organising training activities, seminars or workshops. This unit, assisted by the working groups, will be responsible for identifying external consultancy needs and preparing the terms of reference for these consulting assignments, which should include: (i) the objectives of the assignment; (ii) the activities of the consultant; (iii) the time frame for this work; (iv) the expected outputs; and (v) the arrangements under which the consultant makes regular reports to the project manager.

- *Working groups*. The working groups will be responsible for implementing specific reforms in particular area (e.g. a financial management information system). In many cases, formal arrangements will need to be put in place to manage these working groups, including: (i) project planning; (ii) accounting; and (iii) a system for progress monitoring and reporting.

3. Training

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 increase awareness of major issues in public expenditure management and facilitate the 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 context of modern budgeting systems and increasing their awareness of macroeconomic and EU financing issues.

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 and make informal choices among competitive programmes. Developing such capacity involves both improving analytical methods and discussing sectoral policy issues. This generally requires incorporating into training activities some "learning by doing" activities, such as undertaking a sectoral review with an external team of specialist consultants.

The training programmes must be prepared in advance and require a detailed review of existing skills and training needs. Training needs in the field of public expenditure management are diverse, and the major line ministries should have their own capacity for undertaking or commissioning training. The ministry of finance should ensure that these activities fit the common framework dictated by budgetary laws and procedures. For this purpose, the trainers should be well informed of the existing system, and the intended reforms, and should co-ordinate their activities with the unit responsible for overall management of the reforms.

NOTES

1. Throughout the book we generally use the term "national budget" or simply "budget" to refer to the budget of the central government and the term "subnational budget" to refer to the budget of subnational authorities such as regions, counties or municipalities. The term "state budget" is used occasionally and refers to the budget systems and processes of the centrally planned societies – see for example Section B in this chapter.

2. In this book, the term "public expenditure management", which is commonly used, covers the management of government expenditure, but not the activities of public enterprises, which are essentially commercial enterprises, nor the activities of financial institutions owned by the state. The book generally focuses on central governement, but much of the analysis and recommendations apply also to other levels of government.

3. Adapted from the basic objectives proposed by Campos and Pradham (1996) and the presentation of the basic tasks given by Allen Schick in OECD (1997c). In relation to these basic objectives, the *Public Expenditure Management Handbook* of the World Bank (1998) develops the concept of three levels of budgetary outcomes: (1) aggregate fiscal discipline; (2) strategic prioritisation; and (3) efficiency and effectiveness of programme and service delivery.

4. "Spending unit" is used throughout this book and covers all entities that have the authority to spend money through the budget, e.g. line ministers, subordinated agencies, and other government organisations.

5. A convergence of actions and policies aimed at fighting corruption has occurred recently. The OECD succeeded in negotiating in December 1997 a landmark convention against bribe-giving, which entered into force at the end of 1998. See http://www.oecd.org.

6. Subdivided, of course, into production plans at national (federal), regional (state) and local levels.

7. The System of National Accounts established in 1993 by the EC, IMF, OECD, UN and World Bank.

8. EU Member States use a common framework and methodology of national accounts (ESA95), which is a specification of the SNA93 standards in the European context.

PART I

THE BUDGET AND THE INSTITUTIONAL CONTEXT

CHAPTER 1

THE BUDGET AND ITS COVERAGE

This chapter presents some basic definitions, reviews the nature of legislative authorisations, and discusses the coverage of the budget and some key issues related to fiscal instruments other than direct spending. Government policy objectives can be achieved through a variety of instruments: direct spending, indirect spending (such as tax expenditures, contingent liabilities and loans), and tax policy measures. To be an effective instrument for implementing government policies, the budget documents must not only cover all government revenue and expenditure, but also disclose in the more transparent manner all policy commitments and decisions that have an immediate or future fiscal impact.

A. Basic Definitions

1. What is the "budget"?

The word budget comes from "budjet", a Middle English word which means king's bag containing the money necessary for public expenditure.[1] Budgets evolved in two directions. At first, parliaments fought to take control of the budget and make governments accountable for the use of resources. In democratic societies, for instance, approval of the budget (the "power of the purse") is the main form of parliamentary control of the executive. The budget authorises the executive to spend and collect revenues. In later years, the scope of government activities expanded considerably, and the role of the government budget became more complex. Today, government expenditure is aimed at a variety of objectives, including economic development, and social goals, or redistribution objectives. Hence, governments need sound fiscal policies, i.e. policies concerning government revenues, expenditures and borrowing, in order to achieve macroeconomic stability and the other policy objectives.

The scope of the budget depends on the field of activities of the government, but must also be in a form to allow government policies to be appropriately scrutinised by the legislature and the public. As noted, this book does not deal in substantive terms with the revenue side of the budget. However, it is important to note that, from the macroeconomic point of view, it is crucial to review revenues and expenditures together. In a number of countries, draft laws on public expenditure proposals and tax changes are presented to parliament separately. This presents many problems in relation to the coherence of policy-making and policy proposals, and in relation to parliamentary scrutiny of the budget. Assessing the soundness and the realism of tax forecasts should be an important preliminary step in analysing a budget. Since fiscal stabilisation, and policy objectives concerning income or wealth distribution, or the allocation of resources, can be achieved either through changes in either tax policy or public expenditure policy, or both, common issues need to be reviewed together. Accordingly, it is necessary during the budget formulation process to co-ordinate the preparation of the expenditure and the revenue portions of the budget and consolidate them into a single document at the time of presentation to parliament.

2. What is the "government"?

The government may be defined as a group of entities or units that, in addition to fulfilling their political responsibilities and their role in economic and social regulation, deliver public services for individual or collective consumption, and redistribute income and wealth. A defining characteristic of government is the ability to impose, directly or indirectly, taxes and other compulsory levies for which there is no direct quid pro quo on other sectors of the economy. "General government" is a term used to describe all government entities at whatever level, central, regional or local.

The systems of national accounts (SNA93 and ESA95) classify the government into four categories which may be defined as follows:[2]

- *Central Government*. The national government in federal and unitary countries. In general, central government is responsible for those functions that affect the country as a whole: for example, national defence, conduct of relations with other countries and international organisations, establishment of legislative, executive and judicial functions that cover the entire country, and delivery of public services such as healthcare and education. Non-market, non-profit institutions controlled and mainly financed by central government are included in the central government.

- *Local Government*. Local government is a collection of public bodies with authority over a subdivision of a significant area of a country's territory. It is either the third tier in federal countries or the second and third tiers in unitary countries (regions, counties, municipalities, etc.) To exist as a separate entity, a local government body must have the authority to exercise powers independently from other levels of general government.

- *State Governments*. State government has independent authority for certain functions in a significant part of a country's territory. This intermediate level of government exists in all countries with a federal constitution (for example, the *Länder* in Germany). Regional government authorities have similar characteristics in terms of territorial jurisdiction but are generally found in countries that do not have federal constitutions.

- *Social Security Funds*. Funds that provide social benefits to the community through a social insurance scheme that generally involves compulsory contributions by participants. In most countries, such funds are separately organised from the other government activities, have their own budget, and hold their assets and liabilities separately. Social security systems that do not hold their assets and liabilities separately are not called social security funds. In the GFS, the preferred treatment of social security funds is to classify them as a part of the level of government at which they operate. An alternative treatment is to group all social security funds into a separate subsector. Funded government employee pension plans are not social security funds. They are financial corporations and are excluded from the general government sector.

In relation to field offices and autonomous agencies, the legal authority under which they operate and the nature of their functions constitute the proper criteria to assess at which level of the government they should be incorporated (e.g. a hospital managed by the ministry of health, wherever it is located, is part of the central government). Their classification should reflect the difference between "decentralisation", which is the transfer of responsibility to democratically independent lower levels of government, and "deconcentration", by which the authority of the centre is exercised more effectively through local or regional entities, or offices acting as agents of the central government.

Each level of government should have its own budget that covers its respective fields of responsibility and activity. Most countries have arrangements in place that determine the required allocation of responsibilities and, where appropriate, arrangements for sharing revenues, or transferring them from one level to another. However, in some transition economies, the organisation of the budget system and the mode of negotiation of tax sharing arrangements, based on political bargaining, do not ensure a clear assignment of responsibilities in budgeting. In these cases, one of the first steps in public expenditure reform should be to clarify the distribution of responsibilities among the different levels of the government and to put in place stable and transparent arrangements for organising the relationships within and between these levels.

3. What is the "public sector"?

In addition to the government itself, the public sector includes non-financial and financial corporations and quasi-corporations owned or controlled by the government. A quasi-corporation is a government establishment engaged in activities that: (i) charges prices for its outputs; (ii) is operated and managed in a similar way to a private sector company; and (iii) has a set of accounts that enable its operating surpluses, savings, assets and liabilities to be separately identified and measured.

In market economies, public enterprises[3] should be commercially oriented and, wherever possible, should aim to make a profit. For this purpose, they must have autonomy in management and be given a corporate structure. Thus, their expenditures and revenues cannot be submitted to the same scrutiny and approval mechanisms as the national budget, which should cover only the enterprises' financial transactions with the government and not their transactions with the rest of the economy.[4]

However, a system for monitoring and reporting financial information for the public sector as a whole must also be developed. Thus, the budget documents can show in an analytical table, presented for information only, the consolidated account of the public sector (called sometimes "consolidated budget", although it has not the legal status of the national budget).

For reasons of accountability and transparency, the government should report on the performance and the financial situation of all entities that it controls. In practice, the definition of the government reporting entity varies from one jurisdiction to another.

B. Nature of Legislative Authorisations

1. Basis of appropriations

The nature of the spending authorisations granted by the legislature depends both on the budget system and on the nature of the expenditure. Although there are exceptions, these authorisations are generally granted through "appropriations", which are authorisations enabling the government and its agencies to spend money for a specific purpose.

Some countries (e.g. the United Kingdom) present to parliament an appropriation bill distinct from the budget. In many countries, however, there is no separate appropriation act. The appropriation is defined implicitly through a set of rules set out in the organic budget law, which determines the degree of freedom of the executive in using budgeted resources and making transfers (virements) between "chapters". These two different approaches are equivalent, as regard to the role of parliament.

Appropriations may be grouped into the following broad categories:

- *Obligation-based appropriations* give rights to make commitments and make cash payments according to these commitments, *without a predetermined time limit*. Such appropriations have their own life cycle and are not limited to one year. This system is no longer used for all expenditures, but may be used for special programmes (e.g. in the US).

- *Cash-based appropriations* give authority to make cash payments *over a limited period of time*, generally corresponding to the fiscal year. This system is the most widespread. In principle, appropriations define cash limits that cannot be exceeded, but there are exceptions. They cover the *payments due*.

- *Accrual-based appropriations* cover the full cost of the operations of a ministry or agency, and increases in liabilities or decreases in assets (such as pension superannuation liabilities, depreciation of fixed assets, etc.). "Full costs" are the goods and services actually used or consumed (as opposed to acquired) over a period. Therefore, the depreciation of physical assets, variations in inventories and variations in liabilities are added to actual payments to calculate the full costs of a programme. Moreover, for goods and services, there may be differences between the points of time at which they are acquired, paid for and used/consumed. For central government entities, accrual-based appropriations are currently used only in a very few countries (New Zealand, Australia and, from 2002, the United Kingdom). When appropriations are accrual-based, special mechanisms for controlling cash must be put in place.

Budget systems can be classified schematically according to the basis of appropriations, into obligation-based, cash-based and accrual-based budgets. Most budget systems at the present time are cash-based.

As discussed in Chapter 11, the basis of appropriations, which concerns the nature of authorisations of parliament, should not be confused with the basis of accounting. Accrual accounting does not require abandoning the presentation of cash-based appropriations to parliament. In many transition countries, spending agencies keep books on an "accrual" basis. Nevertheless, these countries have given priority to reinforcing the cash-budget system in their recent budgetary reforms.

A cash-based budget system fits well the needs for compliance and expenditure control. Payments are controlled on the basis of the authorisations of the parliament. Macroeconomic objectives, such as the cash deficit are directly linked to the appropriations. All transition countries need to enhance their system of accountability to parliament and their macroeconomic control. Presenting cash appropriations to parliament serves both purposes. Whatever their accounting system, transition economies should present cash-based appropriations to parliament.

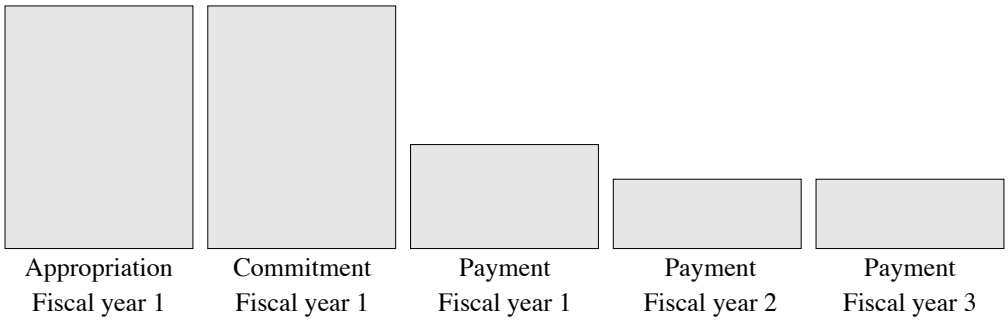
Figure 1.1 shows three different types of appropriations. In addition, some countries and the EC have a procedure for making multi-year commitments.

2. Gross terms

To formulate and assess correctly government policies and activities (including its business activities) expenditures and revenues should be shown in the budget in gross terms, even if the authorisation of the parliament and the budget execution controls concern only netted appropriations (i.e. expenditures that exceed commercial revenues).

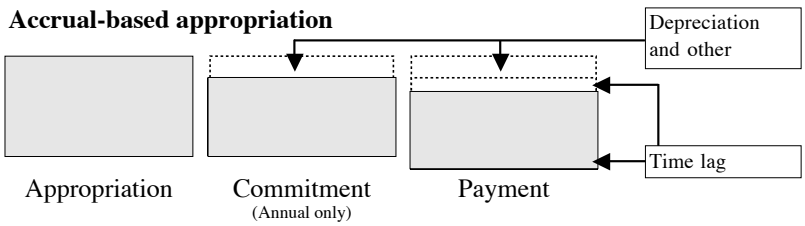
Figure 1.1. **TYPES OF APPROPRIATION…**
For running costs

Obligation-based appropriation

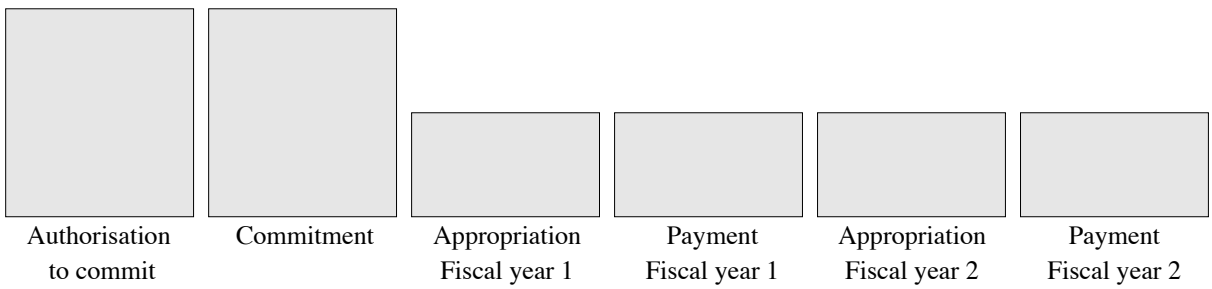


Cash-based appropriation

Accrual-based appropriation



…AND COMMITMENT APPROPRIATION



3. Annual nature of the budget

Budgets are almost always annual (the "fiscal year" can be the calendar year or some other 12-month period). A shorter period would be disruptive for management; a longer period could make budgetary planning and implementation subject to considerable uncertainty. Because many other relevant statistics (e.g. international trade) are published on a calendar year basis, a 1 January — 31 December fiscal year is the most convenient for analytical and reporting purposes, and most countries conform to this cycle.

As noted earlier, except in obligation-based and accrual-based budget systems, annual appropriations are cash limits for most goods and services and capital expenditures. They lapse at the end of the fiscal year. This annual rule assists effective control of cash. It can, however, induce distortions in management, particularly for capital expenditures and "end-year spending surges", that are an inefficient use of budget funds. A number of countries therefore adjust the annual rule by authorising carry-over of some portion of any appropriation that is unused at the end of the year. The pros and cons of carry-over provisions are discussed in Chapter 7. If authorised, carry-over must be strictly regulated.

4. Budgetary treatment of entitlement programmes

Even in a stable economic environment, entitlement programmes (sometimes referred to as "demand-led programmes") depend on various economic and demographic parameters that are difficult to forecast accurately. Thus, in a number of countries, social security payments and other entitlements, debt servicing and, payments for governmental functions that are independent of the executive branch of government (such as the judiciary), are authorised under special legislation. These authorisations are often called "standing" or "permanent" appropriations, or "entitlement spending". They account in some industrialised countries for the larger part of government expenditures.[5] The estimates of relevant expenditures that are to be incurred over the fiscal year are generally shown in the annual budget, but are either not included in the annual budget act, or are included for information only.

Some countries (e.g. France) distinguish three categories of appropriations: (i) compulsory spending limits; (ii) "approximate" estimates which are only indicative (mainly debt servicing, which depends on external factors not fully under the control of government); and (iii) provisional appropriations (for expenditure items such as relief aid). Provisional appropriations are spending limits, but the executive is authorised to transfer funds from a contingency reserve in case of overspending. "Approximate" estimates are strictly equivalent to standing appropriations.

Standing appropriations have helped in the past produce major deficit problems in a number of countries (O'Toole, 1997). Implementing such procedures in countries that have not traditionally used them would present significant risks in relation to fiscal discipline. They can lead also to fragmented decision-making processes, since decisions on entitlements must be traded off against other expenditure decisions, and may tempt governments to place some programmes outside the budget. Defining annual spending limits for entitlements and personnel expenditures has decisive advantages. It encourages the establishment of appropriate budgetary targets. It obliges the government to be precise in defining its budgetary measures so as to comply with the overall resources available for spending.

In transition countries, all expenditures should be appropriated when enacting the annual budget and, except perhaps for interest, all appropriations should defined as annual cash limits. This requires accurate forecasts, and careful analysis of decisions and laws that grant entitlements, personnel benefits, etc. In parallel, a contingency reserve should generally be included in the budget in order to fund unexpected increases in entitlements. The amount of the contingency reserve, however, should not exceed a small percentage of total spending, and its uses should be precisely defined and strictly regulated.

5. Authorisations for forward commitments

A few EU Member States include in their budgets, in addition to cash appropriations, "authorisations for forward commitments" or "commitment appropriations" for some categories of expenditures (mainly for capital investment). In the same way, the European Union budget includes two categories of appropriations: payment and commitment appropriations (see Chapter 3). The "authorisations for forward

commitments" authorise commitments to be made over a multi-year period, but annual appropriations are still required in order to make payments. They differ from "obligation-based appropriations", which also cover multi-year programmes, but are authorisations to pay as well as to commit. In some countries, these authorisations for forward commitment are laid down in multi-year estimates presented to parliament. Including such forward commitments in the budget authorisations gives an effective instrument to control and manage the implementation of investment programmes or projects, and should be favourably considered for use in transition economies. Issues related to the management of multi-year commitments are discussed further in Chapter 7.

C. Coverage of the Budget

1. The need for a comprehensive budget

To be an effective instrument, the budget should be as comprehensive as possible. Two major issues are involved here: first, if the budget excludes major expenditures, there can be no assurance that scarce resources are allocated to priority programmes and that legal control and public accountability are properly enforced. Second, the amount of expenditures not included in the budget is itself often uncertain and lacks transparency. In turn, this makes macroeconomic programming more difficult and increases the risk of corruption and waste. Budget comprehensiveness does not mean that all expenditures should be managed according to the same set of procedures. In order to promote efficiency, specific arrangements for administering some programmes may be established, provided that they do not lead to a fragmented approach to budgetary planning and expenditure policy formulation, and loss of expenditure control.

The standards of scrutiny and accountability that are applied to expenditures financed from funds, autonomous agencies, or special accounts should not be lower than those applied to other expenditures.

Therefore, the following minimum rules should be applied to every expenditure programme, whatever its mode of management (including the expenditures that are managed through special and extra-budgetary funds) and source of financing:

- Estimates of all revenues and expenditures should be shown in the budget.
- Estimates of expenditures should be shown in gross terms in the budget, whatever the form of legislative authorisation for these expenditures, and not "netted out".
- All expenditures and revenues should be classified on the basis of the same classification system.
- Accounts of autonomous funds and special accounts must be subject to external audit on a regular basis.
- The government's financial reports should consolidate the operations of autonomous funds and agencies with its regular activities.

2. Expenditures financed by external loans and grants

Expenditures financed from external sources (loans and grants) should be budgeted in the same way as other government expenditures. It is necessary to set up procedures to authorise the contracting of loans and to control indebtedness. Only one government authority (the ministry of finance) should be authorised to contract external loans and grant guarantees. In some countries, each project-loan is subject to the approval

of parliament. This procedure allows parliament to control such loans. However, there is a risk of increasing budgeted expenditures through approving project-loans on a case by case basis. It must be clear that expenditures are authorised through the annual budget law, or supplementary budgets, not through approval of financing agreements. Moreover, the total amount of loans that the government intends to contract over the fiscal year should be submitted for approval to parliament with the budget bill. The list of these project loans and grants should be annexed to the annual budget. This list should show their expected amount and the financial terms, e.g. the expected repayment period and interest rate in the case of loans.

Expenditures financed from counterpart funds related to the use of external loans and grants should be included in the budget. From a macroeconomic point of view, disbursements from counterpart fund accounts represent domestic financing, which has an impact on the fiscal aggregates.

Issues related to debt management are reviewed in Chapter 9.

3. Extra-budgetary funds

In many countries, a significant share of government expenditures is managed through special funds and procedures. These special arrangements include: revolving funds; trading funds for business activities and other commercial services carried out by the government; emergency funds; special funds for specific expenditure purposes (such as road funds and health funds) managed at the sector level; expenditures financed by external loans; counterpart funds; budgets of autonomous/decentralised agencies, notably in the higher-education and health sectors; and special accounts managed by the ministry of finance or its treasury department. In a number of countries, expenditures managed through such arrangements are not shown in the budget and are managed through extra-budgetary funds (EBF). EBFs refer to accounts of government activities that are not included in budget documents and typically do not operate through normal budgetary execution procedures. EBFs, which are typically set up by specific legislative acts, can be distinguished from "off-budget" expenditures that should be within the budget (Potter and Diamond, 1998).

The reasons for creating EBFs in different countries are numerous and reflect various objectives such as protecting priority expenditures from budget cuts; avoiding problems in budget execution; side-stepping the inapplicability of some appropriation management rules to certain types of expenditures; conceding to requests from powerful political barons or lobbies; and meeting requests from donors to insulate their projects and programmes in priority sectors. In some cases, the main motive for establishing an extra-budgetary fund is the desire to hide transactions from scrutiny by parliament or the public, and may be a source of fraudulent and corrupt behaviour.

Not all the reasons for establishing an EBF are necessarily bad from an economic and social viewpoint.[6] For example, in many western countries, healthcare and social welfare programmes, paid for in whole or part by earmarked taxes, are managed efficiently and effectively through EBFs. However, whatever the motive, EBFs pose problems for the allocation of resources. Transactions outside the budget are unlikely to be subject to the same kind of fiscal discipline as are budget operations, partly because they are financially independent and partly because they are not explicitly compared with other expenditures. Consequently, activities that would not normally survive the scrutiny of a regular budget process often continue, through their own inertia or through the force of vested interests. The number of EBFs should be strictly controlled and the minimum rules indicated earlier should be systematically applied. The budgetary documents presented to parliament should include expenditure and revenue forecasts for EBFs, together with a statement of flows and balances. Wherever possible, budget execution and control procedures should be integrated with those of the national budget, e.g. so that all payments by EBFs are made through the treasury single account.

Many treasury departments hold "special accounts." Some of these accounts are used for managing EBFs placed under the authority of either the ministry of finance or line ministries, and therefore pose similar problems to other EBFs, as regards the allocation of resources. In some cases, transactions made through these special accounts concern internal financial transfers within the government rather than genuine expenditures. Such arrangements are often complicated and time consuming. Moreover, in reality, non-transparent and "true" expenditures are often made through these funds. In a similar way, "reserve funds" and counterpart fund accounts for foreign grants or loans are often not transparent.

In many countries, it is common practice to allocate windfall revenues and some non-tax revenues to particular programmes and create a fund to manage these programmes. From a fiscal sustainability viewpoint, the most efficient use of windfall revenues is to pay off the more expensive types of debt in the government's portfolio. Under unusual circumstances, it may be appropriate to assign windfall revenues to specific needs, but this should not be allowed to fragment the budget by setting up an EBF.

4. Off-budget expenditures

In general, EBFs are set up by law and, in principle, managed according to defined procedures and rules. Nevertheless, in some countries, the fact that the EBFs benefit from dedicated revenues that are held in separate bank accounts facilitates off-budget spending. Other forms of off-budget spending include expenditures financed by external loans and multi-year investment projects, since often appropriate instruments for managing these expenditures are not in place.

In some countries, information on the sources and uses of certain government revenues — particularly from minerals and other natural resources — is frequently hidden from scrutiny by parliament and the general public. Such revenues are often treated more as a contribution to the purse of the president or a political "slush fund" for use of the minister concerned, than as a contribution to the government budget. Including these revenues and expenditures in the budget is a prerequisite to improve transparency and promote good governance. Although there may be few exceptions (for example, for security reasons), there are rarely good reasons for secrecy concerning revenues and expenditures. Generally, the existence of such "black boxes" or secret "slush funds" should be interpreted as prima facie evidence of governance weakness or outright corruption.

5. Special management arrangements

The creation of funds with special management arrangements is sometimes due to lack of fiscal discipline, but may also be explained by the fact that the standard budgetary procedures are not adapted to the management of certain categories of expenditure. As discussed in Chapter 7, rules for managing budgetary appropriations, such as rules for transfers between line-items or the cancellation of appropriations at the end of the fiscal year, are necessary but should not be too rigid. In general, when existing budgetary procedures are inadequate to manage certain activities, the optimal choice is either to strengthen the budgetary procedures and/or to set up specific procedures for the activities concerned. These activities, however, should not be placed outside the budget.

Revolving funds may also be needed to make purchases of goods that will not be immediately delivered and the payment for which would otherwise be jeopardised by the budget annuality rule. Government enterprises need such mechanisms in order to carry out their trading activities.

Both for flexibility in management and institutional reasons, such as the special status of certain professions or activities, a number of "autonomous agencies" have been established in many countries,

notably in the higher education sector. These agencies are mainly financed through transfers from the budget of the central government, but have their own budgets (named "annexed budgets" in some countries). Certain OECD countries are currently increasing the number of autonomous agencies in order to improve operational efficiency.

However, establishing revolving funds or autonomous agencies for operational efficiency should never be used as an excuse to exclude programmes and policies from parliamentary scrutiny, and the minimum rules stated earlier should be applied systematically.

6. Tax earmarking and user charges

a. Tax earmarking

Extra-budgetary funds are often financed from earmarked revenues (e.g. social security contributions, road funds, regional funds, energy funds, etc.). Some economists (e.g. Buchanan, 1968) argue that total spending and its composition should be determined simultaneously. Earmarking could then be used, in principle, as an instrument to reveal taxpayers' willingness to pay for a desired service, and make trade-offs between decreased taxes and increased provision of public goods. In this way, both the level of public services output and taxes would be determined through earmarking mechanisms. According to the public choice school, this could lead to an optimal allocation of resources and a balanced budget, but only under restrictive assumptions that are generally not met for public goods (e.g. constant returns to scale and no externality).

In practice, however, fiscal discipline could not be enforced through a process in which the budget is derived from particular and unconstrained interests. In general, earmarking revenues, even when the funds are "consolidated" into the budget, decreases flexibility in resource allocation and impedes adequate programme prioritisation. It makes programmes dependent on specific revenues and can lead either to excessive expenditure if the necessary funds are available, or shortfalls of expenditure because the activities in question do not benefit from general tax revenues. Most troublesome is that sometimes, by earmarking, expenditure decisions are dictated not by criteria of efficiency and effectiveness but by the ability of politicians and lobby groups to put in place arrangements that protect their favoured programmes.

Earmarking arrangements include, for example (McCleary, 1991):

- A specific tax or fee matched to a corresponding end use, e.g. social security taxes, gasoline taxes for highway investments, etc.

- A specific tax or fee for a broad end use, e.g. lottery proceeds that finance investment projects that enrich the environment.

- General taxes earmarked for a specific end use, e.g. a fixed percentage of income tax revenue devoted to specific programmes.

In most cases, arrangements that earmark a share of total revenue from general taxation are questionable. Concerning specific taxes and fees, a distinction is generally made between: (i) "strong earmarking" where there is a close link between the payment of a user charge and the associated expenditure (e.g. fees for attending courses in a university); and (ii) "weak earmarking" where the link between the benefit and the fees or taxes is less clear (e.g. use of lottery proceeds for investments) (Hemming and Miranda, 1991).

When there is a strong benefit-revenue link and the service is provided to well-identified users, earmarking may be desirable to encourage agencies to improve performance and facilitate cost-recovery. The use of earmarked taxes may increase taxpayers' knowledge about how the taxes paid are used, increasing the chances that they will exercise vigilance over the efficiency of the services provided (Petrei, 1998).

b. User charges

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

Systems for setting and implementing user charges must be transparent and efficient (see also Box 1.1). The following principles should be adopted (drawn from OECD, 1998b):

- *Clear legal authority*. The legal authority for an organisation to charge for its services should be clearly defined. However, this authority should be a general framework and should allow for the level of charges to be adjusted without further legislative authority.

- *Consultation with users*. Consultations serve to avoid misunderstandings and are useful to design and implement the charging system.

- *Determine full costs*. The full cost of providing the service (defined to include both operational costs and the cost of capital assets, depreciation and interest, used each year) should be determined, regardless of whether the intention is to recover all or only part of the costs. In the latter case, the information on costs should make transparent the subsidy granted by the government when providing the service (the issue of measuring costs is reviewed in Chapter 11).

- *Equity considerations*. Consideration should be given to whether user charges should be reduced or waived for particular categories of user, e.g. pensioners or disabled persons.

- *Competitive neutrality*. When pricing services, the costing procedure should be accurate and incorporate all items of costs faced by private sector entities operating in the same (or a related) sector.

- *Effective collection*. The system for collecting user charges must be efficient. Non-payment of user charges should be followed up immediately.

- *Audit*. Regular audits of the organisation levying and collecting the charges are required.

- *Performance evaluation*. The performance of organisations should be monitored regularly to ensure appropriate levels of efficiency and service quality (see Chapter 15 for a detailed discussion of this issue).

Several countries include in their budgets only net expenditures of agencies that exercise commercial activities or impose user charges; and the budget appropriation corresponds to the difference between planned

expenditures and expected revenues. If the gross amounts are large, netting out could impede a sound analysis of the government activities and an accurate estimate of economic costs. "A move to net budgeting will reduce the measured size of government, and lead to a reduced comparability of expenditure data relating to general government" (Heald and Georgiou, 2000). Efficiency requirements cannot supersede the need of parliament and the public to have full information on the activities of government agencies. In some countries which net out appropriations (e.g. several FSU countries), accounts are kept by the agencies on an accrual basis and gross expenditures and revenues are recorded, but this is insufficient to satisfy the need for parliamentary scrutiny and public information.

Box 1.1 EXAMPLES OF USER CHARGING IN OECD COUNTRIES

Clear legal authority

The *Finnish Constitution* explicitly requires all user charges to be authorised by legislation. In 1992, the Finnish Parliament enacted the *User Charging for Government Services Act*. This Act provides general principles for what types of government services should be subject to charge and the basis upon which charges should be calculated. Within the limits set by the Act, the government is free to introduce user charges. Each ministry decides which of its services are to be subject to charge and then issues regulations to implement the necessary procedures.

Determine full costs

The *US Social Security Administration* is one of the world's largest information technology operators. On average, it handles 21 million transactions per day. In 1988, it decided to institute a cost attribution system whereby the cost of each transaction would be linked to the user of the service. Previously, all information technology costs had been attributed in total to the Office of Systems Operations. Extensive cost accounting systems were put in place. In the early stages, it was only possible to attribute four-fifths of costs to any specific user. Through improved systems, it is now possible to attribute nearly all of these costs. As a result, the management of this function has improved.

The *Ordnance Survey in the United Kingdom* sells maps and related data services to government organisations, utilities, commercial organisations and the general public. A number of consultative committees representing some 160 organisations with an interest in Ordnance Survey services have been established. These committees comment on the coverage, availability and pricing of Ordnance Survey services. Soliciting the views of clients in this manner has allowed Ordnance Survey to better tailor their services to the needs of the users.

Appropriate pricing strategies

When *Statistics Sweden* receives orders for specialised information contained in its computerised data systems, it offers differentiated prices based on the priority of the order. Premium prices are

(cont'd)

Box 1.1 **EXAMPLES OF USER CHARGING IN OECD COUNTRIES** *(cont'd)*

charged for orders that are required to be processed immediately; reduced prices are charged for orders that can be processed at night and at other times when demand on the data systems is low.

When *Germany* instituted a time-based road user charging system for highway use, the Euro-Vignet, it sought the co-operation of neighbouring countries in introducing a single system that would be jointly operated in a uniform manner across the countries. This minimised inconveniences to drivers and streamlined the collection process for the user charges.

Equity considerations

When *Iceland* introduced user charges for primary and specialist doctor services, it recognised that this would represent an unreasonable burden for lower-income individuals. As a result, it introduced discount cards that gave users access to these services for one-third of the regular charge.

Luxembourg takes the financial resources of each resident into account when user charging for retirement and nursing home services. If the resident's monthly income is less than or equal to the user charge, then the user charge is reduced accordingly and the resident left with a standard amount as pocket money. Special arrangements are also in place to take account of any assets owned by the resident.

Ensure competitive neutrality

In *Finland*, a major effort is made to ensure competitive neutrality. Government organisations are restricted in what commercial services they can offer; all such services must be closely related to the organisation's basic statutory function. Special provisions apply to the costing of such services to ensure their accuracy and completeness. Compliance is overseen by the Office of Free Competition which can order government organisations to revise their prices.

Source: OECD (1998b).

7. Social security funds

The compulsory nature of social security schemes and their far-reaching social, economic and financial implications call for including social security funds into the budget. A possible exception exists for countries where management of these funds involves also employers and trade unions (notably, in some EU Member States). It could be difficult to integrate into the budget social security funds that are not directly managed by government entities. Nevertheless, taking into account the fact that they may cover a significant share of government expenditures, it is essential at least to consolidate social security funds in a single financial report. Their budgets should be annexed to the budget of the central government and presented to parliament at the same time. They should also be subject to equivalent and parallel procedures of scrutiny and audit.

D. Other Forms of Government Activity with a Fiscal Impact

1. Quasi-fiscal activities[7]

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

2. Government liabilities and contingent liabilities[8]

In addition to legal commitments, governments have other explicit or implicit commitments that can have an immediate or future fiscal impact. Fiscal risks and uncertainties are increasing. The international integration of financial markets generates greater volumes, rapidity and volatility of cross-border flows, and governments may become obliged to intervene to support the financial system. State guarantees and insurance schemes have become common. Privatisation is often accompanied by implicit or explicit state guarantees.

Government liabilities can therefore be certain or uncertain (contingent); and explicit or implicit. In order of fiscal predictability:

- *Explicit liabilities and commitments* are legally mandatory and predictable. This category includes, for example, budgeted expenditure programmes, multi-year investment contracts, civil service salaries, pensions and debt obligations.

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

- *Implicit liabilities* represent an obligation or expected burden for the government which is not legal, but arises from public expectations. For example, governments are expected to maintain public infrastructure, and to support a social security scheme, even when it is not required by law.

- *Implicit and contingent liabilities* are the least predictable category, representing a non-legal obligation triggered by a discrete event that may or may not occur. For example, it is generally expected that the government will intervene if the banking sector risks bankruptcy, or the country faces natural catastrophe, etc.

Generally in budgeting, decision-making focuses on expenditure programmes, and, in part, on multi-year legal commitments, such as debt servicing. In most countries, no attention is paid in the budget to other long-term obligations and to implicit or contingent liabilities. When a country faces financial difficulties or is undertaking fiscal adjustment, there is often a tendency to overlook non-immediate or non-explicit fiscal risks. While understandable, this tendency makes future problems worse than they would be if the realities were faced directly.

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

Sound budgeting and policy formulation requires a wider and more ambitious approach, covering more effectively the fiscal risks faced by the governments in the short-term as well as in the long-term. Systems are needed to make governments both more aware of the financial impact of their decisions and more accountable. Most important, however, are issues of political will, leadership and effective communication to the public of fiscal realities. Accordingly, it is necessary to assess realistically the obligations arising from existing or new expenditure programmes and policy measures, whatever their nature (implicit or explicit, direct or contingent). This assessment is crucial for defining fiscal targets and for making choices among alternative policies, and expenditure programmes. Fiscal risks should be part of this assessment. Information on explicit liabilities and contingent liabilities should be disclosed in financial statements (see Chapter 12), and statements on debt and contingent liabilities presented along with the budget. Implicit and contingent liabilities cannot by definition be quantified or predicted. The reality of their existence, however, should add to fiscal prudence, and decision-making mechanisms should be in place to permit a rapid and effective response should an unexpected event arise.

Table 1.1 illustrates the measures that might be taken by a ministry of finance in order to manage the fiscal risks associated with public expenditure programmes.

Table 1.1. **MEASURES TO MANAGE THE FISCAL RISKS OF INDIVIDUAL GOVERNMENT PROGRAMMES**

Before the government accepts a new obligation.	• Assess how the obligation fits the announced role and strategic priorities of the state. • Assess the programme risks individually and, together with the existing risks, estimate the potential fiscal cost of the obligation, and set additional reserve requirements. • Consider the choices of policies and forms of support with respect to the associated financial risks, as well as government risk management capacity. • Design the programme well to protect the government against risks. • Define and communicate the standards for and the limits of government involvement so as to maximise moral hazard.
When a new obligation is accepted.	• Budget and account for the potential fiscal cost. • Monitor the programme risk factors.
When an obligation is executed.	• If implicit, assess whether fulfilling the obligation coincides with the state's announced role and promotes the desired behavioural response in the markets. • Execute the obligations within their pre-set limits and take lessons for future policy choices. • Compare and report the actual fiscal cost against estimated costs, evaluate performance and sanction failures.

Certain instruments reviewed in this book can help deal with these issues. For example, a multi-year approach permits an assessment of the fiscal sustainability of ongoing policy commitments, as well as some implicit liabilities, over the medium-term (see Chapter 6). Accrual accounting (either "modified" or "full") provides a framework for assessing the impact of explicit liabilities (see Chapter 11). However, these instruments are neither necessary, nor sufficient to make a full assessment of fiscal risk. The key requirements are awareness of the existence of fiscal risks, inclusion of an analysis of such risks in the budgeting process, and disclosure of information for public scrutiny.

3. Loan guarantees

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

While guarantees have long been recognised as an appropriate government instrument, they can have a significant fiscal impact. This became evident from the experience of many countries in Latin America in the 1980s, where many loans were defaulted by the borrowers. The costs of debt servicing and repaying the loans in default had to be assumed by the governments concerned, thereby adding a lasting burden to already overstretched government budgets.

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

The public expenditure cost of guarantees is difficult to estimate reliably, as it depends on a largely subjective judgement of the risk of default. At least, however, the budget should include the list of new guarantees that the government intends to grant and/or an aggregate monetary ceiling for these guarantees. (Appropriate management and accounting rules and procedures are also needed.) In several countries, the government levies a fee when it guarantees loans. This procedure has the advantage of creating a mechanism for registering and monitoring such guarantees, and also constitutes to some extent an insurance payment in case of default. If the guarantee fee is proportionate to the risk of default (and the risk is assessed correctly), taking one guarantee with another, it will suffice to cover the cost.

Effective budget management calls for equally effective management of guarantees. First, there should be system that requires prior consideration of the financial implications of the proposed guarantees, and to allow the risk element in such guarantees to be calculated. Second, there should be procedural safeguards to minimise the adverse impact of guarantees on the government's fiscal position. Third, there should be a system for monitoring the financial performance of the recipients of guarantees. Finally, there should be sufficient scrutiny and accountability to prevent guarantees from being misused .

A ceiling on guarantees should be prescribed. This ceiling should be authorised by parliament, when enacting the annual budget. Without such ceilings, liberal provision of guarantees could adversely affect

the creditworthiness of the government itself, and as a consequence, could cause higher interest costs in the medium-term. Moreover, ceilings on guarantees promote more rigorous scrutiny and thus encourage competition among potential borrowers, channelling the guarantees to financially more sound entities. The risk element therefore needs to be computed and explicitly recorded and shown in the budget documents.

In some countries, every guarantee must be authorised by parliament. In other countries, only the ministry of finance is authorised to grant guarantees. For guarantees of more than a certain amount, additional approval procedures can be desirable, such as submission to the council of ministers or to the parliament.

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

4. Government lending

Government loans are another possible means to achieve government policy goals, and in some circumstances can substitute for direct spending. Therefore, loans should be decided in a transparent manner, be submitted to the same scrutiny as direct spending, and be recorded clearly in the budget.

Government lending is often directed to entities that cannot afford borrowing at commercial terms, either because these activities need to be subsidised or because the creditworthiness of beneficiary entities is weak (a typical example is lending for crop production or to state-owned enterprises). Government lending can also be used to leverage commercial lending and supplement it. External loans that finance public sector entities are often granted to the government which then "on-lends" these loans to the beneficiary entity.

The fact that loans are (in principle) repayable can make government lending a more cost-effective instrument to achieve public policy than direct spending. However, lending can also be used to bypass budget constraints. Loans are often submitted to a weaker scrutiny than direct spending and not submitted to the authorisation of the legislature.

Typically, government loans include an interest subsidy[9] and present higher risks than loans granted by commercial banks. Concessional external loans granted to the government to be on-lent to public entities usually include a provision that the on-lending should be at commercial terms, in order to avoid favouring public enterprises to the detriment of the private sector. In practice, however, this provision is not systematically enforced. Exchange rate losses may be incurred and borne by the government, and risks of insolvency can be high.

The budgetary treatment of government lending should include the following elements:

- Since lending must be traded-off against expenditure decisions, during budget preparation the lending programme should be reviewed together with the expenditure programmes.

- Loans should be included in the budget, with full explanations of their terms and conditions, and be submitted to the authorisation of the legislature.

- Interest subsidies must always be budgeted as an expenditure. Two approaches may be considered: (i) budgeting the discounted value of the subsidies when the loan is granted; or (ii) budgeting the

subsidy according to the interest schedule. The first approach is preferable, since the subsidy is budgeted in the year the decision is made, and is much simpler administratively.

- Lending should be included in gross terms in the budget.

5. Tax expenditures

Tax expenditures are another instrument of fiscal policy, and should be submitted to the same budgetary procedures and criteria of transparency as government lending. A tax expenditure is "the revenue foregone because of preferential provisions of the tax structure" (United States, FASAB, 1995) and covers the following:

- *Exemptions*, when revenues of a special group of taxpayers are excluded from the tax base.
- *Deductions*, when some expenses or lump-sum amounts are deducted from the tax base.
- *Credits*, which are deducted from the tax due (in contrast to deductions, which reduce taxable income).
- *Deferrals*, when the deadline to pay taxes is postponed without interest or penalties.
- *Reduced tax rates*, when certain categories of taxpayers or activities benefit from a reduction in the normal rates of tax.

Tax expenditures aim at achieving targeted public policy objectives by providing benefits to qualifying individuals or entities or by encouraging particular activities. They may also be intended to improve tax equity or offset imperfections in other parts of the tax structure. The same set of objectives (for example, financial assistance to families) can be achieved either through direct spending or through tax waivers or exemptions.

To determine whether a particular tax measure generates a "tax expenditure," it is necessary first to establish the "normal" tax structure from which the measure represents a departure. This is relatively easy when the tax expenditure corresponds to specific exemptions (e.g. a special income tax rate for agricultural activities), but the existence of a tax expenditure may be debated when the whole tax structure is affected (e.g. a differentiated income tax rate according to the family situation of the taxpayer). There is also a debate on the methodology used to assess the impact of tax expenditure, since some tax expenditures may have a different impact to direct spending, taking into account any resulting changes in behaviour of taxpayers.[10]

Tax expenditures are granted through tax laws that in several countries are presented together with the annual expenditure budget. Nevertheless, they are not submitted to the same system of internal control and legislative authorisation as other expenditures. Therefore, tax expenditures are often an easy and less transparent way to grant special benefits to specific groups. In certain cases, the group or groups that benefit from tax expenditures are less clearly identified than those who would benefit from direct spending, and this may yield results that differ from the government's stated policy objectives. For example, high-income households can benefit more than needier households from differentiated income tax rates aimed at supporting large families. Moreover, tax offsets (particularly on goods and services) create loopholes within the tax system itself.

Tax expenditures should always be compared with equivalent spending initiatives and should be as transparent as possible. Ideally, as in the case of government lending, the direct impact of tax expenditures should be budgeted in gross terms both on revenue and the expenditure side. This approach can be adopted for tax expenditures that are easy to measure and monitor (such as tax refunds or tax offsets granted according to the provisions of a contract). Since measuring tax expenditures is difficult, this approach cannot be applied in all cases.

However, an assessment of the impact of tax expenditures should always be included in the regular process of budget decision-making. For this purpose, a statement on tax expenditures should be regularly produced in order to review tax expenditure policies when preparing the budget, and to make trade-offs between tax expenditures and direct spending. Some EU Member States (e.g. Belgium, France and Spain) annex such a statement to the annual budget documents (see Box 1.2). This enhances legislative scrutiny of government policy.

Box 1.2 TAX EXPENDITURES IN FRANCE

The Tax Expenditure Report has been published annually in France since 1980 as part of the Report on Ways and Means appended to the Finance Bill. The report covers all central government taxes. The taxes are classified in three ways: (i) by the economic nature of the tax; (ii) by the main purpose of the tax expenditure (economic development, savings, regional or sectoral support, housing and social policy); and (iii) by the category of beneficiary (households, enterprises or both).

In each case, the immediate beneficiary is identified; no attempt is made to take account of the shifting of the tax burden. A formal definition of tax expenditure is used: "the designation 'tax expenditure' may be applied to any legislation or regulation which entails a loss of revenue for the State and hence an easing of the burden on the taxpayers by comparison with the charge that would have resulted from the application of the 'norm', i.e. the general principles of French tax law."

The main tax expenditures in France include:

- The reduction of tax due to "quotient familial" which takes into account the number of pensioners living off the income.
- Exemptions of income tax for veteran pensioners, interest on certain savings scheme, certain social benefits, etc.
- Allowances for the elderly and the disabled.
- Additional standard deductions for certain business expenses.
- Deduction of expenses for certain major housing repairs and improvements.
- Allowances for certain dividends and interest income.
- Common flat rate tax for farmers.

(cont'd)

Box 1.2 **TAX EXPENDITURES IN FRANCE** *(cont'd)*

- Various exemptions and special allowances for the corporation tax.
- Special arrangements for VAT.
- Exemptions or reduced rates from the internal tax on the consumption of petroleum products for certain ships, jet aircraft fuel, home heating, etc.

Source: OECD (1996g).

E. Budgetary Documents

Budgetary information presented to the parliament should include all the elements needed to assess government fiscal policy and its future impact. These issues are discussed earlier in this chapter and in more detail in Chapters 4, 5 and 6. The budgetary documents should contain most or all of the following information:

- Medium-term macroeconomic and fiscal projections.
- A statement of budget policies and fiscal policy objectives.
- Ministry or agency narrative statements explaining the sectoral activities to be funded, their objectives and expected results.
- Revenue and expenditure estimates, measured in gross terms even when appropriations are calculated on a net basis. These estimates should cover all central government revenues and expenditures, including special funds and accounts, if any.
- Authorisations for forward commitments, if any.
- Financing from external sources, grants and loans.
- A statement of contingent liabilities resulting from state guarantees of third party debts, and an estimate of payments likely to be required under those guarantees during the budget year.
- A statement of major identifiable fiscal risks.
- A statement of tax expenditures.

NOTES

1. "Budjet" was derived itself from the ancient French word "bouge", which referred to a small bag.

2. The levels below central government are often referred to collectively as "subnational governments". This term is used throughout the book.

3. Throughout this book, we use the term "public enterprises" to refer to organisations that are controlled by the government and run on commerical lines. These include the entities called public corporations and public quasi-corporations in SNA93 and ESA95. See the Glossary at the end of the book for definitions of these terms.

4. In centrally planned economies, the demarcation line between the activities of public enterprises and government activities is unclear, since state owned enterprises are often involved in delivering social services.

5. For example, in Australia, standing appropriations accounted in 1993/94 for more than 80% of the estimated general government expenditure (Allan, 1994).

6. For an interesting discussion of the arguments for and against using EBFs and tax earmarking in the environment area, see the OECD's Environmental Action Programme for Central and Eastern Europe (EAP) (2000). This paper concluded that "these funds usually operated in the most successful market reform countries, where transition is coming to an end, and the main rationale for earmarked, extra-budgetary environmental funds disappears".

7. See Mackenzie and Stella (1996); and Robinson and Stella (1993).

8. This section is drawn up largely from Hana Polackova (1999).

9. Methods to separate the "pure loan" from its "grant" element are reviewed in Wattleworth (1993).

10. A joint study by the United States General Accounting Office and the Office of the Auditor General of Canada (1986) comments that: "Removal of a major tax expenditure might in fact have a negative impact on outputs and incomes in the economy, producing less additional tax revenue in total than the estimates in the table would suggest... Tax expenditures may have a greater effect than direct aid in the form of grants, because selective measures directly increase after-tax income and grants would normally be taxed or would reduce deductible expenses."

CHAPTER 2

THE LEGAL AND INSTITUTIONAL FRAMEWORK

Effective budget management begins with a clear distribution of responsibilities and duties within the government, and between the different levels of government, and a carefully balanced division of powers between the parliament and the executive branch of government. For this purpose, the legal framework must be properly designed. This chapter reviews the broad principles concerning the distribution of responsibilities within the executive, the role of the legislature, the relationships between the different levels of government, and the major provisions that should be stipulated in the legal framework.

A. Distribution of Responsibilities within the Executive

1. Authority of the ministry of finance[1]

Ministries of finance are responsible for the custody and management of all public money. To be effective as the guardian of the collective fiscal integrity of government, the ministry of finance must be sufficiently empowered through the necessary legal and technical instruments, and have staff with the required skills and training. Ministries of finance have generally extensive powers in OECD countries. In some developing countries and medium-income economies, finance ministries are also powerful institutions that sometimes misuse their authority by interfering excessively in line ministries' budget management. In transition economies, however, ministries of finance are often not sufficiently empowered to perform effectively their policy-making, monitoring and enforcement functions.

Ministries of finance have a lead role in maintaining aggregate fiscal discipline, ensuring compliance with the budget law and enforcing effective control of budgetary expenditures. They must also prepare the draft budget and scrutinise all financial requests going to the council of ministers. These powers, however, are interpreted differently. For example, under a central planning system, the budget prepared by the ministry of finance was basically a mechanical assembling of figures resulting from decisions already made in planning offices, line ministries and public enterprises. In most EU Member States, however, the ministry of finance is given strong authority to act as a "gatekeeper" to the council of ministers on all financial proposals and thus plays a key role in disciplining the whole budget process.

The ministry of finance must be enabled to monitor and control the implementation of the budget. It should have the authority to regulate accounting standards, financial control and internal audit procedures and related personnel and administrative activities. It should have right of access to any information from other ministries and agencies, and other tiers of government (especially important in federal countries like Austria and Germany), which it deems necessary for analysis and control. Box 2.1 describes, for illustrative purposes, the role and responsibilities of the Federal Ministry of Finance in Germany, including in the budget area.

Box 2.1 ORGANISATION OF THE FEDERAL MINISTRY OF FINANCE IN GERMANY

The Federal Ministry of Finance (FMF) can be regarded as one of the "classic" government departments. Within the sphere of budgetary matters, the Minister of Finance is responsible in particular for preparing the draft federal budget and rendering accounts on federal revenue and expenditure, assets and debts. For many years, the tasks of the Ministry of Finance have extended far beyond the mere provision of funds. Taxation and fiscal policy have increasingly been used to help achieve economic and social objectives and to regulate economic activity. In this respect, too, the Ministry's responsibility for monetary and credit policy both at national and international level is of special significance.

The FMF has a special status in relation to other ministries at the federal level. For example, the Minister of Finance is not bound to accept the expenditure estimates submitted by the supreme federal authorities. The Minister may amend them after consultation with the agencies concerned. The Minister is also entitled to challenge decisions taken by the federal government on matters of financial importance. Only the Federal Chancellor combined with a majority of federal ministers may overrule the vote of the Minister of Finance.

The Federal Ministry of Finance is also responsible for co-ordinating fiscal policies with other levels of government. Thus, the Minister chairs the Financial Planning Council which makes recommendations for the co-ordination of budgets and financial plans of the federal government, Länder and municipalities. This ensures that the budget and the financial plans of public authorities are comparable and employ a standard system of budget classification.

Given the important co-ordinating role of the FMF, a sectoral Directorate within the Ministry deals with the financial relations with the *Länder* and the municipalities. The activities of this Directorate are concerned with the allocation of tasks and responsibilities between the Federation and *Länder*, including the division of tax revenues between the federal government, *Länder* governments and the municipalities.

In 1999, the Ministry consisted of 11 Directorates, 30 subdirectorates and 192 divisions or administrative units with about 2,300 employees. It was responsible for the following main areas:

I Fiscal and Economic Policies.
II Federal Budget.
III Customs Services.
IV Property and Excise Taxes.
V Financial Relations with the *Länder* and Municipalities.
VI Asset Management.
VII Money and Credit.
VIII Privatisation and Securities Policy.
IX International Monetary and Currency Policy.
X European Policy.

The FMF is also responsible for supervising several public-law bodies and institutions such as the Pension Fund Institution of the Federation and the *Länder*, the successor organisations to the *Treuhandanstalt* and the Bank for Reconstruction and Development.

(cont'd)

Box 2.1 **ORGANISATION OF THE FEDERAL MINISTRY OF FINANCE IN GERMANY** *(cont'd)*

Subordinate Federal Authorities of the Federal Ministry of Finance are as follows:

Federal Authorities

- Federal Debt Administration.
- Federal Spirits Monopoly Administration.
- Federal Finance Office (incorporating the Federal Pay Office and the computer centre of the revenue administration).
- Customs Authority for Criminal Offences.
- Federal Office for the Settlement of Unresolved Property Issues.
- Federal Banking Supervisory Office.
- Federal Insurance Supervisory Office.
- Federal Supervisory Office for Securities Trading.

Regional Authorities

- Regional Finance Offices.

Local Authorities

- Main Custom Offices with their administrative units.
- Customs Office for Investigation.
- Federal Property Offices and Federal Forestry Offices.

2. The council of ministers and policy co-ordination

The council of ministers constitutes the key decision-making body at the centre of government.[2] It approves the main budget parameters and fiscal targets on the recommendation of the finance minister; sets priorities for spending; decides major policy issues; resolves budget disputes between the finance minister and his ministerial colleagues; and approves the draft budget for submission to parliament. It must be noted that much of the council of ministers' power stems from the fact that it has an exclusive right to present the budget to parliament. This is where parliament's authority reinforces that of the council of ministers. Since no minister can go to parliament independently to seek funds, all are bound

to submit their spending plans to the collective judgement of their colleagues. The dynamics of the council of ministers' role in budgeting may be usefully seen as balancing the interests of the ministers as a collective body against the interests of ministers as individuals. The most basic interest of the council as a collective body is to retain the confidence of parliament and stay in power. How it taxes and spends are dominant factors in its success or failure. In the nature of things, the individual minister favours ever-increased spending within his sector, a view which conflicts directly with the council's collective interest in holding down taxes and borrowing while directing spending to the politically most important priorities.

Circulation of information within the government is crucial. Because it is often seen as a commodity to be traded, information will simply not flow by itself. Formal and robust mechanisms are needed, such as systematic consultation of other ministries, clear rules for circulation of draft decisions before meetings of the council of ministers[3], guidelines for documenting decisions, appropriate rewards or penalties, etc. But restraint must be exercised to keep communications relevant and avoid the reverse problem of information overload, which impedes genuine communication almost as mush as inadequacy of information. Committees dealing with cross cutting issues at different administrative levels generally facilitate the circulation of information, but such mechanisms must not be allowed to dilute the responsibility of line ministries in their own areas.

Formal rules of procedure and clear communication and clearance channels are important to avoid misunderstandings, particularly in countries where strong personalised networks are established. The council of ministers must be the locus where key policy decisions are made; initiatives from ministries should be submitted to the centre of government; initiatives that affect the public finances to the ministry of finance; and decisions must be systematically documented and formally communicated.[4]

Close co-ordination and alliance between the minister of finance and the prime minister is important to ensure overall discipline of the budgeting system. In some countries, an explicit budgeting role for the prime minister is defined in the organic budget law, but in most cases this key axis and special relationship takes the form of continuous consultation and development of firm bilateral agreements on major issues.

The centre of government should co-ordinate the policy formulation process. It should be able to determine policy priorities, prepare council of ministers' meetings, co-ordinate interministerial committees, act as an arbiter, and co-ordinate the preparation of strategic plans by sector ministries. The centre of government needs a strategic planning capability, which might consist of a small group of advisers in regular contact with the operational ministries concerned. In some countries, a dual policy decision-making process exists, since government is co-ordinated both by the president's office and the office of the prime minister. In these cases, a clear demarcation between the respective roles of these two offices is needed.

Interministerial committees are needed to deal with cross-cutting policy issues (e.g. employment, environment, etc.); to co-ordinate policy areas that are covered by several ministries; or deal with special problems (e.g. regional issues). Setting up task forces can be a flexible way to tackle some special issues, provided that a specific "sunset provision" is enacted to prevent such entities surviving long after the need for their establishment has disappeared.

A cohesive civil service "culture" is important for effective policy co-ordination. Normally, a flexible system under which, to the extent practicable, officials are encouraged to move among ministries, and between professional "streams" such as economics, engineering and general administration, promotes better policy co-ordination than a system in which civil servants spend most of their careers in the same ministry. Nevertheless, if this leads to excessive turn over of personnel, efficient co-ordination may be impeded. Several transition countries face this later problem.

3. Line ministries

Budget management and control is, of course, not the exclusive responsibility of the ministry of finance. Line ministries are responsible for planning, managing and controlling their own budgets. They are accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and their sectoral budgets as well, but within the framework of policies, regulations and procedures laid down by the government. Moreover, line ministries (and not the ministry of finance) have the technical capacities and information needed to make effective trade-offs among ongoing programmes and appraise new policies and programmes.

Line ministries should be responsible for policy-making within their portfolios. This obvious principle bears underlining because it is sometimes violated — either by excessive interventions from the centre on sector policy issues; or from the ministry of finance on sector budget issues; or from the ministry of economy when selecting sectoral projects to be included in a public investment programme; and/or by an evasion of responsibility by the line ministry itself using any of the above as reasons.

The effectiveness of the line minister in co-ordinating sector policy can also be impeded by internal organisational arrangements within the line ministry itself. Thus, for example, in countries where substantial cuts have been made in a ministry's budget for operational and capital expenditures, an autonomous fund that benefits from earmarked revenues, or a state-owned enterprise in the sector concerned can exercise more power than the relevant minister.

Line ministries are accountable for operational efficiency in public service delivery and must develop actions for improving it. Tight operating budgets are the norm in almost every country. Therefore, line ministries are ultimately responsible for improving public service productivity in their sector, reduce the cost of goods and services purchased by government, and identify the areas in which savings can be made without reducing the quality of service delivery.

There is no blueprint for an optimal organisational structure of government. The common requirement is that the organisational arrangements must ensure coherence and close co-ordination among the different actors. Australia has been successful in implementing super-ministries ("portfolio ministries"), which were made responsible for defining priorities in their sector. This organisational arrangement facilitated adjustments in the composition of expenditure programmes. Putting complementary programmes under a single portfolio highlights the need for policy trade-offs and gives room to finance new priorities through offsetting savings, while complying with overall expenditure ceilings. Nevertheless, in Canada in the 1980s, the Policy and Expenditure Management System (PEMS), which included grouping federal government's expenditure programmes into nine to ten "policy envelopes" and establishing four policy committees, did not achieve satisfactory results (Sims, 1996). In some countries, a "super-ministry" could be the simple juxtaposition of "junior" ministries. However, this tends to make policy formulation more complex, since an additional layer of decision-making needs to be introduced in the machinery of government.

B. The Role of the Legislature

1. The need for balanced powers

Effective budget management begins with a carefully balanced division of responsibilities between the parliament and the executive branch of the government. Competition for budgetary power is common

but the tension between these two institutions is accepted as one of the vital checks and balances of democracy. With a well-designed constitution and organic budget law, the powers of each are made to reinforce the other. It is an accepted criterion of democracy that the elected parliament holds "the power of the purse"; i.e. it must authorise all expenditures, all borrowings, and all revenues to be collected through the power of the state. In an apparent paradox, however, parliament's power is reinforced by granting strong authority to the executive government and ministry of finance. Parliament acts by holding the executive accountable. But if the council of ministers does not itself possess the necessary tools or lacks the authority to manage the use of public money, parliament's control of the executive is left with little meaning. Hence the paradox.

2. Presentation of the budget to the parliament

The enactment of the budget should not be a formal exercise carried out merely to comply with the constitution. The legislature is, generally, the appropriate locus of overall financial accountability. In essence, its role should be to approve future actions rather than to rubber-stamp decisions effectively taken already. Thus, the budget should be presented to the legislature in timely manner, that is two to four months before the beginning of the fiscal year, in order to allow budgetary debates to be completed before the beginning of the fiscal year.

The budget is sometimes submitted to the legislature after the commencement of the fiscal year, owing to exceptional circumstances such as a change in the composition of the council of ministers, economic or financial crises, natural disasters or negotiations with international financial institutions (IFI). However, in some countries, delay is institutionalised. In China, for example, the National People's Congress does not meet to approve the budget until after the commencement of the fiscal year.[5] As a result, it is asked to approve appropriations for a budget that is already being implemented.

Since delays in adopting the budget may occur, the organic budget law should include provisions authorising the executive to commit expenditures before the budget is approved, under specified circumstances. These provisions should be based on the budget of the previous year, rather than on a budget not yet scrutinised.

3. Enactment of the budget

A fundamental issue is the extent of parliament's power to amend the budget. Members of the legislature have different preferences regarding the manner in which resources are allocated and are subject to a variety of pressures from constituents. The sum of these various preferences and related claims can generate a systematic tendency to increase expenditure during budget debates (a phenomenon known as "log-rolling"). Accordingly, many countries have adopted procedural rules to regulate and limit legislature debates on the budget. These rules cover (i) the sequence of voting on the budget; and (ii) the legislature's powers to amend the budget.

In order to enforce ex ante fiscal discipline, in several countries the budget is enacted by parliament in two phases. The overall expenditure ceiling is approved first, and appropriations and the allocation of resources among ministries are approved only in the second phase. This procedure is aimed at protecting the aggregate expenditure limit and the overall fiscal targets. Some commentators argue that the real impact of this procedure is unclear since legislators can anticipate the broad impact of the budget on their favoured programmes before the first stage and decide the overall expenditure ceiling accordingly.[6] However, reviewing aggregate expenditures and revenues together has the advantage of allowing the legislature to discuss macroeconomic and fiscal policies explicitly and should be considered favourably by transition countries.

Sweden has even gone further and uses a two-stage, top-down, budgetary approval process (see Box 2.2). The fiscal targets adopted by parliament in April create the limits within which the budget is prepared.

Box 2.2. THE BUDGET APPROVAL PROCESS IN SWEDEN

A key reform implemented in Sweden in 1994 has been the introduction of a top-down approach for discussing and approving the government's budget proposal. In April each year, prior to the presentation of the budget, parliament approves the level of *aggregate government expenditures* (and aggregate government revenues) in a Fiscal Policy Bill. The government's budget proposal must conform to this limit unless the government separately proposes a higher limit. Parliament's deliberation of the actual budget proposal is then divided into two distinct phases. Parliament approves the level of *expenditures for each of 27 expenditure areas*. Only then does Parliament approve the level of *individual appropriations* within each of these areas.

The timetable for parliamentary scrutiny of the government's budget proposals is as follows:

15 April	The Government presents the Fiscal Policy Bill to Parliament.
Early June	Parliament approves the Fiscal Policy Bill.
20 September	The Government presents the Budget Bill to Parliament. Expenditures are divided into 27 Expenditure Areas which are in turn divided into 500 individual appropriations.
End November	Parliament approves in one vote the total expenditure for each of the 27 Expenditure Areas.
End December	Parliament approves individual appropriations within each of the 27 Areas with one vote for each Expenditure Area.
1 Jan	Start of the fiscal year.

Source: OECD (1998a).

In most transition countries, priority should be given to strengthening the budget preparation process as discussed in Chapter 5. However, consideration could be given to a two-stage approach to budgetary approval, or at least to informing the parliament of decisions taken by the government in the first stage.

The powers of the legislature to amend the draft budget vary from country to country. These differences can be classified as follows:[7]

- *Unrestricted power* is the ability of the legislature to vary both expenditure and revenue in either direction, without consent of the executive. Some presidential systems have adopted this model. The US Congress, for example, has very extensive powers of amendment. Frequently, it discards entirely the draft budget submitted by the President and, taking advantage of its extensive research resources,

compiles a quite different budget. However, these extensive powers granted to the legislature are partly counter-balanced by a presidential veto.

- *Restricted power* is the power to amend the budget within set limits, often defined as a maximum increase in expenditures or a maximum decrease in revenues. The extent of these restricted powers varies from country to country.[8] In several countries within the Westminster tradition, the parliament is forced to approve the budget without amendment, otherwise forcing the government to resign. In France, the Parliament is not allowed to propose amendments that increase expenditure. By contrast, Germany allows such amendments, but only with the consent of the executive.

- *Balanced budget power* is to the ability to raise or lower expenditure or revenue as long as there is a counter-balancing measure to maintain the budget balance.

Limits on the power of legislature to amend the budget are particularly needed where debates in parliament lead systematically to increased expenditures, as has recently been the case in a number of transition countries. More generally, a parliament that makes many amendments to the budget undercuts its own ability to criticise the council of ministers later if these changes result in a weakening of fiscal discipline. Central and eastern European parliaments, therefore, are well advised to design their legal framework to ensure a sound balance between the legislative and executive powers. They should also develop strong and effective expenditure review procedures and other measures for holding the government to public account. The supreme audit institution can provide valuable support to the parliament in this role (see Chapter 14).

The legal framework should also stipulate that legislative actions that increase expenditures can go into effect only if these expenditures themselves are authorised in the budget or supplementary legislation. Two other legislative practices are being considered in some OECD Member countries — namely, permanent or standing appropriations, and very detailed programme laws. The second procedure, reflecting an attempt by certain parliaments to extend their reach into day-to-day administration of programmes, has been found to create the very rigidities and inefficiencies that all governments are trying to eliminate (O'Toole, 1997).

4. The role of parliamentary committees

Strong and capable parliamentary committees enable the legislature to develop its expertise and play a greater role in budget decision-making. Generally, different committees deal with different facets of public expenditure management. For example, the budget and finance committee reviews revenue and expenditures and in many countries plays an important co-ordinating role in processing the annual budget law; a public accounts committee ensures legislative oversight and provides a link with the supreme audit institution; sectoral or standing committees deal with sectoral policy and may review sector budgets. Co-ordination between the activities of these committees should be effective. In countries where the role of the legislature in amending the budget is significant, amendments are generally prepared by sectoral committees, and co-ordinated by the budget and finance committee, rather than being proposed on the floor by individual members.

The time allocated for the legislative budget process and, within this process, to committee reviews, must be sufficient to ensure a sound scrutiny of the budget. In the German *Bundestag*, for example, legislative budget deliberations may last up to four months.

The legislature and its committees should have access to independent expertise for proper budget scrutiny. Committees should also have access to any information from the ministry of finance and line ministries

that is relevant to its scrutiny procedure. In Germany, the budget committee interacts quasi-permanently with government departments through regular departmental briefings and expenditure reports. Frequent consultations between the administration and the legislative committees on budget policies and their implementation, outside the pressured environment of the discussions and debates surrounding the annual budget, are desirable. They provide the executive with an effective mechanism for consulting widely on the appropriateness of policies, and strengthen the capacity of the legislative to scrutinise the budget and the government's fiscal policies.

5. Approval of final accounts

In every democratic country, the circle of parliament's budgetary authority is closed with the approval of the final account and the report of the supreme audit institution (SAI) which in many cases issues a formal certification of that account. Important characteristics of the SAI are that it is responsible only to parliament, is independent of government or other political factions and possesses high professional skills. The role of external audit and the SAI is discussed in Chapter 14.

C. Distribution of Responsibilities between Different Levels of Government

This book is focused on central government expenditure. Nevertheless, certain key issues related to the fiscal relationship between national and subnational levels of government must be considered. As mentioned in Chapter 1, each governmental entity (central government, state, municipality, etc.) should have its own budget, enacted according to the provisions stipulated in the constitution or by law. However, there are strong linkages between the budget of the central government and the budgets of subnational governments. Moreover, the expenditure, tax and borrowing policies of subnational governments have important implications for the overall fiscal and economic performance of a country. The design and implementation of these policies are therefore matters of direct concern to the national government, and to the ministry of finance in particular.

1. "Fiscal federalism": key issues

The degree of authority and the range of responsibilities assigned to subnational governments, the assignment of expenditures and the borrowing powers of subnational governments, and the revenue raising or revenue sharing arrangements, should be tailored to the country context and depend on many policy and political issues.

From an efficiency perspective, the Oates' "decentralisation theorem" (see Shah, 1994) states that: "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise benefits and costs of such provision." According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government. Similarly, the European Union has adopted the general principle of "subsidiarity" to define the areas where Member States have independent rights of action, i.e. where the acquis communautaire does not apply.

Decentralisation is a very complex matter, both in general and in relation to the management of public expenditure. It is generally desirable from the viewpoint of efficiency and local accountability. These criteria must be balanced with other elements, such as spatial externalities; economies of scale; overall fiscal efficiency (e.g. more generous public services in one region will encourage people to move there, even if employment opportunities do not exist); regional equity; and the redistributive responsibilities of

the government. The administrative capacity of subnational governments, and the administrative and compliance costs of decentralisation must be taken into account when assigning expenditures among levels of government. Political issues and, in a number of countries, ethnic or nationality problems cannot be ignored either.

The literature on fiscal federalism discusses these issues and gives hypothetical and real-life examples of expenditure assignment.[9] It also presents various and, to some extent, contradictory point of views on the desirable degree of decentralisation. The need for some increas in fiscal decentralisation is generally admitted. Many observers, however, stress the risks of loss in expenditure control, increased corruption and inefficiencies in resource allocation that may result from hasty or over-extended decentralisation, even when such decentralisation is justified on other grounds (see Prudhomme, 1994).

Tax and revenue arrangements should be in conformity with expenditure assignment, and take into account efficiency issues in tax administration. Such arrangements may include: (i) assigning certain taxes to subnational governments; (ii) tax sharing agreements; (iii) providing a share or pool of tax revenue to subnational levels of government; (iv) unconditional grants or transfers from the central government; (v) conditional grants or transfers that are subject to certain conditions or standards in delivering services; and (vi) targeted grants for specific purposes or projects.

2. Broad principles

Whatever the degree of devolution appropriate to the country, the framework that governs the relationships between the central and local governments and arrangements for budgeting should be clear and efficient. A legal framework should govern the relationship between the different levels of the government. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to ensure smooth intergovernmental fiscal relations. Such mechanisms can operate through specialised bodies. In Germany, the second chamber of the Parliament and representatives from the *Länder* contribute to intergovernmental policy co-ordination. Specialised sectoral co-ordination councils are common in many countries.

For transparency and efficiency of management:

- Each level of government should have clearly assigned responsibilities, regardless of what responsibilities are assigned to government as a whole. Overlaps should generally be avoided, and long "concurrent lists" of shared responsibilities are particularly ambiguous.

- Fiscal and revenue-sharing arrangements between the central and local governments should be stable and predictable. They may be amended from time to time, but renewed bargaining each year should be avoided.

- Subnational governments need to have a reliable estimate of the revenues available to them before preparing their budgets. In some transition countries, subnational governments have to wait for the draft budget of the central government to be finalised before preparing their own budgets. Such lack of predictability impedes both efficiency and financial control at local level. Without an indication of the level of resources to be transferred to them, subnational governments cannot adjust their expenditures to meet perceived fiscal constraints. Accordingly, forecasts of revenues should be transmitted to subnational governments as soon as they are decided, and estimates of grants to local government need to be prepared early in the budget process.

- Incentives for increased efficiency in delivering services at subnational level are needed. Often the central government adjusts downwards its transfers to subnational governments when they make economies in public spending or improve their own tax collection. This can create perverse incentives at the local level. Consideration should be given to allowing subnational governments to take a share in any savings they make through improved efficiency.

- It could be desirable to agree on multi-year "contracts" between the central government and subnational governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include minimum standards for services rendered by subnational government. They should define relationships in a transparent manner and establish procedures for monitoring and control.

- National law should provide standard accounting and budgeting rules for subnational governments.

For expenditure control and the strategic allocation of resources:

- Fiscal targets should cover the *general* government sector (see Chapter 5).

- Revenue assignment should be fully consistent with expenditure assignment. Sufficient resources should be assigned to subnational governments in order to allow them to fulfil their duties. When new duties or responsibilities are transferred to subnational governments, supplementary funding should be provided. On the other hand, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.

- "Downloading" the fiscal deficit should not be permitted (defining fiscal targets for general government should help avoid this problem). When balancing its budget, the central government should avoid passing its financial problems to subnational governments through cuts in intergovernmental transfers or increased expenditure assignments, without compensatory measures. To do so would either not change the aggregate borrowing requirements of the general government, or generate arrears.

- Special mechanisms are needed to control subnational government borrowing (see Subsection 3 below).

- In the case of subnational government budget overruns or the accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, subnational authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited period of time until the situation is stabilised.

- A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal (management) control and internal audit for subnational governments should be similar to those of the central government. Ideally, they should be subject to regulation by the ministry of finance.

- For the purposes of policy analysis (as well as setting fiscal targets at the general government level), it is necessary to consolidate the expenditure of the different levels of government. In many countries, it would be very difficult to know what is spent on key sectors, such as education and health, based only on the accounts of the central government. For this purpose, subnational governments and central government should have a common functional and economic classification of expenditures, based on international standards (see Chapter 4).

3. Control of borrowing of subnational governments[10]

As discussed in Chapter 5, fiscal targets, such as the overall surplus or deficit and the net borrowing requirement should be set for the general government. The central government can control its deficit when preparing the budget, then directly through the procedures that are established for controlling the execution of the budget. Since subnational governments have their own budgets, the central government needs generally special instruments to control any deficits that subnational governments incur. Depending on the degree of decentralisation, these instruments consist of grant mechanisms, fiscal targets set up by law and direct controls on borrowing. Control of borrowing is the more effective instrument to ensure that net borrowing, and therefore, the cash deficit will be in line with the fiscal targets.

Many EU countries have adopted a "golden rule", which limits subnational governments' borrowing for investment purposes (e.g. Germany). Moreover, several EU countries in addition to the "golden rule" have set up additional controls on borrowing (e.g. the UK). Some countries allow short-term borrowing for liquidity purposes, but generally stipulate that such borrowing has to be repaid by the end of each fiscal year.

In transition economies, the stage of development of financial markets and weaknesses in the system of public information do not allow the central government to rely only on market discipline to control the borrowing policy of local governments. A golden rule for subnational government budgets is generally desirable, but additional controls and/or rules may be also needed to ensure compliance with the fiscal targets.

Direct controls over borrowing may take different forms such as annual borrowing ceilings; ex ante authorisation of individual borrowing operations; or centralisation of all local government borrowing through the ministry of finance and/or central bank. Two elements need to be considered when designing procedures for controlling subnational government borrowing. First, the objective of increasing devolution and diminishing bureaucratic procedures suggests developing a system, at least for domestic borrowing, that is based on rules which apply at the level of the subnational organisation rather than on ex ante control of individual operations through a central government agency. Second, rules should be appropriately designed to avoid the creation of mechanisms to bypass them, such as, for example, misclassification of expenditures or the setting up of ad hoc funds for borrowing.[11] They could, for example, be based on the ratio of the current and projected levels of debt to revenues. Some countries lay down detailed eligibility criteria that determine which local governments are allowed to borrow.[12] These criteria are based on the soundness of the subnational government policy and administrative procedures, and the nature of projects that can be financed from borrowing.

In relation to external borrowing, central co-ordination of the external debt policy is required. Its impact on the balance of payments must be taken into account. Approaches to foreign capital markets and negotiations with international financial institutions need to be co-ordinated. Moreover, foreign lenders, when lending to subnational governments, generally require an explicit or implicit guarantee from the central government. Therefore, at a minimum, lending operations made abroad by subnational governments should comply with conditions set by the central authorities.

D. The Legal Framework

1. Components of the legal framework

The legal framework for public budgeting consists of several levels, namely: the constitution, the organic budget law (or budget management law) and related laws (e.g. accounting, public debt management, treasury

management, financial control, external audit, and local government finance), the annual budget law and supplementary budgets, and financial regulations and instructions.

The constitution deals in general with the broadest principles of public finance covering for example: (i) the requirement that all public funds be paid into designated accounts, and that these funds can be spent only under the authority of the legislative; (ii) the financial relations between the national and subnational levels of the government; and (iii) the distribution of powers in budgeting between the executive and the legislature. When they are not stated in the constitution, these key principles should be dealt with in the organic budget law.

An organic budget law[13] (OBL) provides the indispensable legal base for all key roles and relationships described earlier in this chapter, and binding principles for budget management and auditing. In some countries (e.g. the US), fiscal management is framed by several acts covering specific areas, instead of one single organic law. The United Kingdom and some other common law countries, have a number of financial regulations and accounting guidelines, but do not have an organic law. They rely heavily on established administrative practice and the procedures of parliament as a basis for budgeting rules. By contrast, civil law countries such as France, Germany and Italy have extensively codified their legal framework, and their organic budget laws. Transition countries cannot rely on their previous administrative and legislative practices and need to establish binding principles in fiscal management. They should, therefore, adopt the latter approach and frame their fiscal management by an OBL that meets the standard of best practice.

Transition countries may find it useful to use the OBL to deal with specific weaknesses of budgetary management and control. For example, in relation to the central government, it should deal with the following issues: (i) the array of special powers and prerogatives conferred on the ministry of finance, which are often insufficiently specified; (ii) the respective roles of the executive and the legislature; and (iii) regulations concerning the implementation of the annual budget laws.

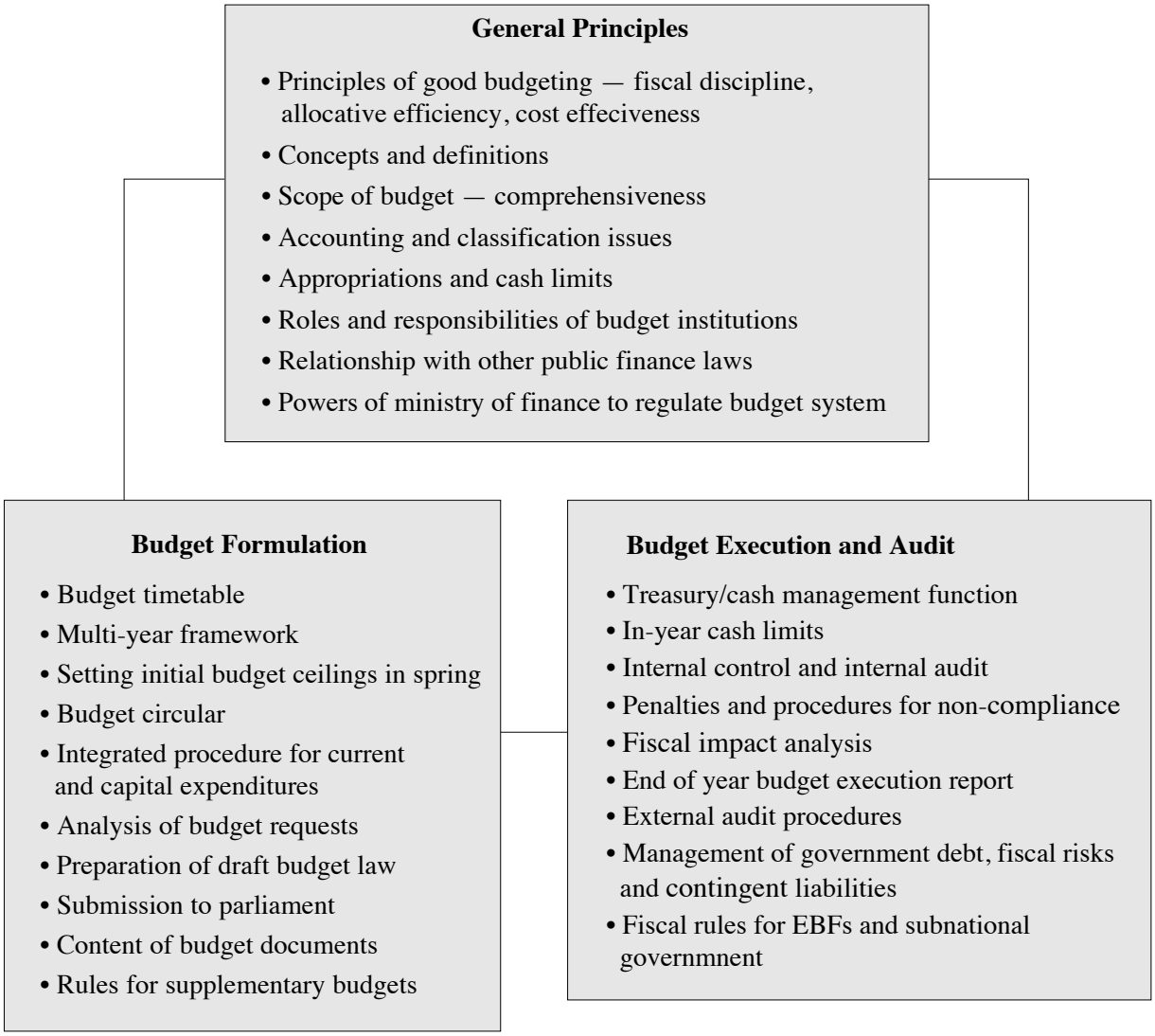
In relation to subnational governments, it is preferable to introduce in separate legislation local government finance issues relating to the allocation of powers over taxes and expenditure assignment. Provisions in the OBL can focus on control of borrowing and reporting requirements. In some FSU countries, the OBL includes detailed provisions on the preparation of the budgets of *oblasts* (regions) and *rayons* (counties) and their consolidation into the national budget. In practice, however, these levels of government are deconcentrated entities rather than local self-governments.

Depending on legal traditions, some countries include less detail in the OBL and more in secondary legislation and administrative policies. Others do the opposite. It is generally preferable to limit the OBL to key provisions of lasting importance, and define other rules in lower-level legislation and instructions, which can be amended more easily when circumstances change. The main provisions to be included in the budget legislation are reviewed below, but the respective coverage of the OBL and lower-level legislation, and the level of detail included in the OBL must be defined in the light of specific national practices.

2. Main provisions of budget legislation[14]

Figure 2.1 summarises the main elements of an OBL. Features of an OBL can be divided into three broad areas: general principles, issues related to budget formulation, and issues related to budget execution and audit. To ensure a common understanding of budgetary principles, the OBL should include a section that defines the terms and concepts used.

Figure 2.1. **MAIN ELEMENTS OF AN ORGANIC BUDGET LAW**



a. Fundamental principles

The principles of integrality and universality of the budget should be clearly stipulated in the OBL. The principle of integrality requires that revenues and expenditure be presented in a single document, while the principle of universality requires that all revenues and expenditures be presented in that document. Both principles are fundamental to the strategic allocation of resources and fiscal discipline.

The OBL should also:

- Authorise the government accounts into which all public money must be paid and from which expenditures are made only by appropriation of the parliament. All government receipts should go either to a single account, or to accounts placed under a single authority (the ministry of finance/treasury). The management of some accounts/sub-accounts can be delegated by this authority to line ministries but under strict conditions to be specified in the financial regulations. Consolidated financial statements must be regularly produced.

- Limit the creation of special or extra-budgetary funds to exceptional cases, authorised by separate statute, and stipulate that the expenditures and revenues of these funds are included in the budget and presented according to a standard classification, together with the relevant financial statements.

b. Budget classification and definition of the budget deficit/surplus

The OBL should specify that the classification of revenues, expenditures and financing transactions, and the form of accounting, is prescribed by regulations under the authority of the minister of finance (see also paragraph k). To consolidate its role in macroeconomic management, the budget should give a clear picture of the fiscal situation, based on clear analytical definitions. For this purpose the OBL should also include the following:

- Definitions of the main elements of receipts and expenditures that are to be included in the estimates (for example, tax revenue must be separated from non-tax revenue and repayment of debt principal from interest payments).

- Definitions of the deficit/surplus. In countries with ambitions to join the European Union, the deficit should be preferably defined according to the EU standards (ESA95). But the fact that loans granted by the government are "below the line" when calculating the deficit does not mean that they should not be appropriated.

- Provisions which stipulate that the deficit limit should be explicitly included in the annual budget law (or appropriation law).

c. Powers of the ministry of finance over budget management

As discussed earlier, the ministry of finance must be sufficiently empowered to and have sufficient skilled staff to accomplish its functions. The financial legislation should therefore stipulate that the minister of finance is responsible for the following:

- Supervising the preparation of the annual budget, all government bank accounts, receipt and disbursement of funds, and all central government assets and liabilities, and be the signatory for all borrowing and lending by government.
- Ensuring that expenditures and the use of credit are controlled within limits specified in the annual budget law.

- Scrutinising all expenditure or financing proposal and make recommendations on these matters prior to approval by the legislature.

- (With approval of the council of ministers) sequestering appropriations if the amount of collected revenues is insufficient to cover the expenditures.

- Requesting reports on all public accounts (even when they are set up outside the budget framework).

d. Appropriations

The OBL and other financial regulations must specify the way in which the use of public money is to be authorised. They should include provisions in the following areas:

- The degree of freedom of the executive in reallocating funds between budget items, or rules for transfers between appropriations. As mentioned earlier, the border between the spheres of responsibility of the executive and the legislature is defined through an appropriation act separate from the budget, or through the rules defining the degree of freedom of the executive in re-allocating funds among "chapters", or both. The OBL can give a certain degree of flexibility to the executive in making transfers between appropriations or chapters, but this flexibility should be properly defined in order to prevent altering, during the budget execution phase, policy objectives that are clearly stated in the budget. The level of flexibility should depend, in a large part, on the degree of aggregation of the appropriations.

- Appropriations are spending limits for the purposes specified in the annual budget law. However, special provisions may be established for some compulsory expenditures, such as debt servicing, or for proprietary funds related to the sales of goods and services.

- Time limit for the authority to spend should generally lapse at the end of the fiscal year. In countries with good fiscal discipline, carrying over capital expenditures and, eventually, a small share of current expenditures can be considered. This promotes efficient resource allocation. In such cases, however, the financial regulations must specify rules to authorise carry over, which should be submitted to prior approval of the ministry of finance (see Chapter 7).

- Contingency reserves included in the budget may cover urgent expenditures, unforeseen expenditures or increases in entitlements. They should be used under restrictive conditions and their uses fully reported to parliament. Their amount should be limited to a small percentage of the total spending. They should be spent (or funds transferred to another appropriation) on the authority of the ministry of finance.

- Special provisions for budgeting and scrutinising secret activities of the state.

- Special provisions for continuing the normal activities of the government if the annual budget law has not been approved by parliament prior to the start of the fiscal year (for example, one twelfth of the previous year's appropriation per month).

- Provisions for managing forward commitments through "authorisations for forward commitment", if such authorisations are included in the budget.

e. Revenues

The government's legal rights to collect revenues (taxes, fines, various levies, etc.) should be authorised by law. In a number of countries these rights are granted by the annual budget law. The OBL should contain a provision to ensure that such obligations to the government shall not be waived without the express or delegated authority of the minister of finance. The ministry of finance should report on tax expenditures to parliament and such expenditures should be audited.

f. Presentation of the budget to parliament and the approval procedure

The OBL and other financial regulations should specify the following:

- The time by which the executive must present the budget estimates to parliament.

- The time by which the parliament must approve the budget.

- Basic requirements concerning the form and content of the budget.

- Requirements to specify the fiscal targets (e.g. the deficit and debt ratios) for the budget year.

- Requirements to present the medium-term macroeconomic strategy of the government and its economic policy objectives with the budget. Such documents show the policy commitments of the government, but do not have the binding status of a law. Because of the difficulty of proposing a realistic and sustainable target, setting medium-term budget deficit limits by law will be difficult in most countries (see Allan, 1994).

- Provisions to regulate parliamentary debates and the powers of parliament to amend the budget.

- Provisions stipulating that legislative or executive decisions which increase expenditures should go into effect only if these expenditures themselves are authorised in the budget or its supplementary acts.

- Provisions concerning the presentation of supplementary budgets. As discussed in Chapter 6, the number of budget revisions during the fiscal year should be very limited. If under special circumstances, the government is obliged to make a budget revision, the revised budget should be submitted to parliament for approval within a specific time period.

g. Preparation of the budget

As noted earlier, the ministry of finance should be empowered to co-ordinate the budget preparation process. The formulation of budget requests by spending agencies should be based on statements of government policy priorities and fiscal policy objectives and on detailed assumptions and guidance issued by the ministry of finance each spring as a "budget circular". The OBL should require line ministries to comply with directives and guidelines given by the ministry of finance in the budget circular. The ministry of finance should be empowered to establish guidelines for evaluating investment programmes within overall budget priorities. Transfers from the government's budget to public enterprises should be subject to specific guidelines. The financial legislation should also give the deadlines for presenting the budget to parliament (see paragraph f above).

h. Execution of the budget

In relation to budget execution, the OBL should include the following provisions (some of which will empower the minister - or ministry - of finance to issue detailed regulations on issues relating the financial management of public funds):

- A provision that no expenditure can be undertaken by any ministry except under authority issued by the minister of finance (for example, apportionment of appropriations, budget implementation plans, warrants, etc.).

- Requirements for implementing the budget and setting in-year cash limits.

- Provisions empowering the ministry of finance to issue regulations concerning transfers between budget items, within the same appropriation or chapter, and the respective powers of line ministries and the ministry of finance in authorising them.

- Provisions for the minister of finance, through the council of ministers, to report back to parliament any major changes that have been implemented in the budget or if it is clear that the deficit specified is likely to exceeded under existing policies and economic conditions.
- Provisions that monitoring reports on the expenditures, revenues and debt of state and local budgets should be issued monthly, and prepared according to the guidelines established by the ministry of finance.
- Provisions that the minister of finance should submit a mid-year report to parliament on the progress of budget execution.
- Sequestering procedures (see paragraph c above).
- Provisions to define the responsibilities of the treasury for financial execution of the budget.
- Provisions to define responsibilities for internal control, notably to ensure compliance with budget authorisations and procurement legislation and to prevent misuses of funds and mismanagement of assets.
- Provisions for internal audit.

i. Government borrowing and issuance of guarantees

Concerning government borrowing and issuance of guarantees, the OBL should include the following provisions:

- Only the minister of finance is authorised to borrow and grant guarantees. Other ministers are not authorised to negotiate loans without a mandate from the minister of finance.
- Loans can be contracted for amounts only up to the financial limits specified by the annual budget law.
- The government, through the minister of finance, can issue guarantees for debt incurred by private or public entities under certain conditions, for example: (i) guarantees or an annual ceiling for guarantees must be approved by parliament; (ii) all guarantees are presented to parliament and published in the official gazette; (iii) possible liabilities falling due in the financial year are shown as a supplement to the annual estimates and a contingent provision is included in the estimates to cover possible losses; and (iv) the ministry of finance maintains a register of all contingent liabilities of government.
- The government has no liability for the debt of its autonomous entities, except any loans it has guaranteed or amounts it is required to contribute by law.
- Strict rules to control subnational government borrowing.

j. Banking and financial assets

The minister of finance should be responsible for opening, closing and either directly operating or monitoring the operating of all bank accounts of the central government.

k. Financial reporting and audit of accounts

The minister of finance should prepare appropriate reports and submit financial documents to an external auditor, usually the supreme audit institution. The following provisions should be included in the OBL:

- The ministry of finance is required to prepare a consolidated statement giving the financial position of general government and statements for each of the central government funds for that financial year. The statements to be prepared should include, at a minimum: (i) the financial position at the beginning and end of the year; (ii) revenue and expenditures (compared to appropriations); (iii) borrowings for the year and total borrowings to date; (iv) contingent liabilities as at the end of the year; (v) emergency procedures incurred during the year; and (vi) comparative outturn figures for the previous financial year.

- The supreme audit institution is independent of the executive and is responsible for auditing all public moneys, assets, accounts and other financial records.

- The treasury is required to forward the annual financial statement to the supreme audit institution (by no later than, say, two months after the end of the financial year).

- The supreme audit institution is required to issue an audit opinion on the government financial statements by a specified time.

- The minister of finance must submit the annual financial statements together with the audit report to parliament.

- The form of accounting is prescribed by regulations under the authority of the minister of finance. The supreme audit institution, in consultation with the ministry of finance, should establish accepted accounting practices for preparation of government financial statements.

- The ministry of finance establishes the requirements for annual financial statements and management reporting by ministries and budget-dependent agencies of government.

l. Accountability and sanctions

A general section on accountability and sanctions, requiring compliance with the provisions of the OBL and the annual budget law should be included in the OBL. This section should define clearly the respective responsibilities of line ministries and the ministry of finance in ensuring compliance.

The regulations should impose a duty on public officials to report suspected criminal behaviour, and establish a graduated set of administrative sanctions for infractions of budget legislation. To be practicable the system of sanctions must fit the degree of mismanagement. In some transition countries, the system of sanctions covers only "criminal activities", and is therefore difficult to apply in cases of less serious misdemeanours.

m. Subnational levels of government

Detailed provisions concerning the budget process and financial management procedures at the various levels of subnational government, and the often complex fiscal relationships between the central and subnational levels, need to be defined in separate legislation. However, the OBL should include provisions on:

- The basic principles of financial management, control and external audit, and of revenue sharing arrangements, if any.

- Restrictions on borrowing.

- Budget accounting methodologies and classifications so that these are coherent and common to all levels of government.

n. Definition of government entities

The budget legislation should define the difference between those bodies that carry out the functions of the central government (agencies of the central government), and those that function in their own right (entities of the public sector). It should define the different classes of budgetary institutions, agencies and enterprises, the authority for creating and dissolving such bodies, and the rules for financial management and control of the entities in each class.

o. EU budget issues

In candidate countries, it is necessary to provide a legal basis for the management and control of financial flows to and from the EU budget, for the functioning of the National Fund and the distribution of responsibilities under the Memorandum of Understanding between the countries concerned and the European Commission. The legal framework should stipulate that all expenditures from the National Fund are included within the budget, according to a standard classification and are submitted to similar scrutiny and control as other expenditures. In all EU Member States, EU budget flows are fully integrated with the national budget in this way.

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1. Drawn up in a large part from O'Toole (1997). The expression "ministry of finance" as used in this chapter can also refer to the power and authority of the ministry of finance, within the executive branch of the government and in relation to the parliament. Such powers are vested both in formal rules and procedures and in informal behavioural norms and cultural traditions, which can vary widely from country to country. Some traditions and legal systems confer all authority to the finance minister personally; in other countries, the ministry itself exercises certain powers and authority in its own name.

2. Depending on the country, the "centre of government" comprises the office of the president and the office of the council of ministers or prime minister's office.

3. Throughout this book the term "council of ministers" is used to mean the group of senior ministers, chaired by the prime minister, that meets regularly in order to discuss government policy. Equivalent terms include "cabinet", "cabinet of ministers" and "government".

4. In France, for example, this function is exercised systematically by the General Secretariat of the Government; in the United Kingdom, by the Cabinet Office.

5. Ahmad, Kennedy and Klering (1995).

6. See discussion in Alesina and Perotti (1996).

7. Drawn up from Krafchik and Wehner (1998).

8. See Von Hagen and Harden (1996); Von Hagen (1992); Milesi-Ferretti (1996).

9. See, for example, Shah (1994) and Ter-Minassian (1997).

10. See Ter-Minassian (1997).

11. In China, local governments are not permitted by law to run deficits or to borrow from the local branches of the Peoples Bank of China. However, local governments undertake indirect borrowing mainly by creating financial companies that borrow to finance local government expenditures. See Ahmad in Ter-Minassian (1997).

12. For example, Korea; see Chu and Norregaard in Ter-Minassian (1997).

13. In some countries (e.g. France) an organic law has a special constitutional status, in others its status is equivalent to that of other laws.

14. See Allan (1994).

CHAPTER 3

THE EUROPEAN BUDGET AND THE IMPACT OF EU ACCESSION

For central and eastern European countries, membership of the European Union will have many consequences in the area of budgetary policy implementation and the management of public finances — consequences for which national administrations need to prepare. This chapter outlines the main implications of future accession for public finances, such as they are perceived today. It is clear, however, given the amount of time remaining between now and the period during which enlargement is likely to take place, that some of the policies and procedures described below may undergo a number of changes.

A. The European Budget

1. Budgetary Structure, Rules and Procedures

a. Background

The development of the European Union's budgeting system has been the result of a lengthy, intricate and at times tumultuous process; the outcome forms a set of rules and procedures that differs in many respects from that found in the budgeting systems of other organisations, national or multinational.

The origin of the system can be traced back to 1951—the year in which the European Coal and Steel Community (ECSC) was created by the six States that initiated the process of European integration: Germany, France, Italy, Belgium, the Netherlands and Luxembourg. Until 1970, this system, which had been retained under the Treaty of Rome that formed the Common Market in 1958, was financed by contributions from the Member States, as computed using percentages laid down by treaty. Accordingly, for example, France, Germany and Italy each had to finance 28% of the budget. Indeed, this is how most multinational organisations are funded: the organisations' treaties and conventions stipulate fixed scales of contributions for calculating the annual contribution that each participating country must pay the organisation in question.

In 1970, when the so-called "own resources decision" was adopted, the budgeting system of the European Community changed radically, since the decision endowed the Community with resources of its own and ended its dependence on direct contributions from the Member tates. Along with the direct allocation of customs duties and agricultural levies, the European budget henceforth benefited from a portion of VAT revenues which was earmarked for spending on Community policies.

While it constituted a decisive step towards the Community's budgetary autonomy, the decision on own resources did not avert the development of a budget crisis that lasted from the mid-1970s until the late 1980s. This crisis was created by a combination of three factors. First, expenditure increased rapidly

due to the strong growth in the agricultural sector and the development of new Community policies. At the same time, traditional own resources were declining and revenue from the VAT resource was limited by the low level of economic activity. In addition, some Member States — primarily the UK — challenged the way in which the budgetary burden was apportioned among the members. Lastly, the Community had yet to find its own internal institutional balance, particularly as regards the relationship between the role of the Parliament, Council and Commission in the budget-making process.

This difficult period in the Community's budgetary history came to an end in 1988 with the adoption, as part of an interinstitutional agreement[1], of a multi-annual financial framework and the reform of the own resources system. These changes helped to normalise the Community's budget position in the following decade and bring spending under stronger control.

A new medium-term financial framework (or "financial perspective" in the Commission's terminology) for the period 2000-2006 was agreed in 1999, taking into account the possible impact of a future enlargement of the budget. This is shown in Table 3.1. Some changes were introduced in the own resources system, mainly in order to reduce the disequilibria in the budgetary positions of some Member States. A reform of the financial management system has also been launched, to strengthen the efficiency and effectiveness of Community programmes, and to introduce new financial control and anti-fraud procedures (see below).

b. Principles

The main rules of the European budgeting system are derived from continental budget systems, and from that of France in particular. All amounts in the Community budget are denominated in euros. The principles involved are as follows:

- *Unity*. Some activities and financial instruments are budgeted, financed and/or administered according to special rules:

  — The European Regional Development Fund, ERDF.

  — The operating budget of the ECSC.

  — Separate budgets for autonomous European establishments and agencies.

  — Borrowing/lending transactions.

  — The operational expenditure connected with joint foreign or security policy, as well as co-operation in the areas of justice and internal affairs, if the Council exceptionally decides, by unanimity, special rules for financing certain measures.

- *Annuality*. In accordance with a classic principle of budgeting, the European Union's revenue and expenditure budgets are adopted for a period of one year (1 January-31 December). Of course, the rigidity of this rule has been reduced by a number of special provisions:

In the Community budget, appropriations are "differentiated" into two categories: first, there are commitment appropriations, which cover the total cost of legal obligations contracted during the current financial year in respect of actions to be carried out over more than one year. Second, there are payment appropriations, which cover the effective settlement of expenditure arising from the execution of

Table 3.1. **FINANCIAL PERSPECTIVE 2000 — 2006**

Euro Million (at 2000 prices)	2000	2001	2002	2003	2004	2005	2006
1. Agriculture	**41,738**	**43,656**	**44,778**	**44,646**	**43,615**	**42,768**	**42,493**
Agriculture expenditure (except rural development)	37,352	39,250	40,361	40,219	39,178	38,321	38,036
Rural development & accompanying measures	4,386	4,406	4,417	4,427	4,437	4,447	4,457
2. Structural operations	**32,678**	**32,076**	**31,474**	**30,882**	**30,180**	**30,180**	**29,746**
Structural funds	30,019	29,417	28,815	28,223	27,622	27,622	27,193
Cohesion fund	2,659	2,659	2,659	2,659	2,558	2,558	2,553
3. Internal policies (1)	**6,031**	**6,143**	**6,255**	**6,366**	**6,478**	**6,590**	**6,712**
4. External action	**4,627**	**4,638**	**4,648**	**4,658**	**4,668**	**4,678**	**4,688**
5. Administration (2)	**4,638**	**4,678**	**4,780**	**4,882**	**4,983**	**5,085**	**5,187**
6. Reserves	**906**	**906**	**656**	**406**	**406**	**406**	**406**
Monetary reserve	500	500	250				
Emergency aid reserve	203	203	203	203	203	203	203
Loan guarantee reserve	203	203	203	203	203	203	203
7. Pre-accession aid	**3,174**	**3,174**	**3,174**	**3,174**	**3,174**	**3,174**	**3,174**
Agriculture	529	529	529	529	529	529	529
Pre-accession structural instrument	1 058	1 058	1,058	1,058	1,058	1,058	1,058
Phare (applicant countries)	1 587	1 587	1,587	1,587	1,587	1,587	1,587
Ceiling, appropriations for commitments	**93,792**	**95,271**	**95,765**	**95,014**	**93,504**	**92,881**	**92,406**
Ceiling, appropriations for payments	**91,322**	**92,860**	**96,037**	**96,714**	**93,684**	**91,898**	**91,347**
Ceiling, appropriations for payment, as % of GNP	1.13%	1.12%	1.13%	1.11%	1.05%	1.01%	0.98%
Available for accession (appropriations for payment)			**4,221**	**6,842**	**9,065**	**11,666**	**14,501**
Other expenditure			1,632	2,071	2,499	2,989	3,468
			2,589	4,771	6,566	8,677	11,033
Overall ceiling, appropriations for payment	**91,312**	**92,860**	**100,258**	**103,556**	**102,749**	**103,564**	**105,848**
Overall ceiling, payments (% of GNP)	1.13%	1.12%	1.18%	1.19%	1.16%	1.14%	1.13%
Margin	0.14%	0.15%	0.09%	0.08%	0.11%	0.13%	0.14%
Own resources ceiling (% of GNP)	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**	**1.27**

(1) Under Article 2 of Decision No. 182/1999/EC of the European Parliament and of the Council and Article 2 of Council Decision 1999/64 Euratom (OJ L 26, 1.2.1999, p. 1 and p. 34), the share of expenditure available for research over the period 2000-2002 is 11,510 million euro at current prices.

(2) Expenditure on pensions included within the ceiling for this heading is calculated net of staff contributions to the pension scheme, with a maximum of 1,100 million euro at 1999 prices for the period 2000-2006.

Source: European Commission.

commitments contracted during the current year and/or prior years. Accordingly, payment of an operation for which a commitment is made during one year may be spread over more than one year. While it is useful from a management perspective, the distinction between commitments and payments may create problems of budgetary control.

In relation to appropriations, carry-forwards and supplementary periods, the Community budget makes similar arrangements to most national budgets in order to avoid any administrative discontinuity. Under certain conditions, a fraction of the budget appropriations for a given year may be carried forward to the following year; in addition, the financial year is not closed on 31 December, but in practice is extended by two to four weeks, depending on the type of appropriation.

Lastly, and most important, the fact that multi-year planning cycles have been in use since 1988 imposes a framework within which both the overall level of the budget and its distribution by major category of expenditure is determined over a five-year period.

- *Universality*. Under this rule, budget revenue must not be earmarked for particular categories or items of expenditure. However, this rule applies only to the general budget, since some activities and financial instruments, which also escape the rule of unity noted above, are allocated their own resources. There are a number of other minor exceptions, including the mechanism of so-called "negative" expenditure (e.g. forfeited guarantees and reimbursed payments).

- *Speciality*. Each appropriation must be allocated to a specific function and purpose. Theoretically, the budget can contain appropriations only in respect of programmes previously defined by a Community decision setting forth the relevant objectives and conditions. The budget nomenclature makes it possible to break down appropriations among the various institutions (Parliament, Council, Commission, etc.), and then, within the Commission's budget, among the various Community policies. Under certain conditions, appropriations may be transferred from one item to another, using a special procedure. The budget also contains a number of "reserve" chapters for meeting contingencies.

- *Balance*. The principle of budgetary balance has always been fundamental. Despite pressures to the contrary, the Member States have always refused to authorise recourse to borrowing. The EU financing system clearly reflects the adoption of this principle by providing for a marginal adjustment resource (previously VAT, at present revenue from GNP or the so-called "fourth resource"), the amount of which is equal, by definition, to the financing requirement.

There is no exception to the principle of a strictly balanced budget. The EC may only borrow to relend the corresponding amounts. The borrowing-lending instruments presently in force concern: the ECSC's activities, nuclear safety in third countries, medium-term support to the balance of payments of the Member States, and medium-term macroeconomic assistance to third countries. The EC also guarantees part of the lending extended by the European Investment Bank (EIB) from the Bank's own resources outside the EU. In the event of default by the beneficiary of a loan granted or guaranteed by the Community, the repayments to the creditors are financed by the general budget. In 1994, a Guarantee Fund was established for loans granted to third countries. This Fund, which is endowed by payments from the general budget, functions as a buffer to protect the general budget from the impact of defaulting loans. If the reserves in the Fund are insufficient to cover defaults, the balance is paid from the general budget.

All amounts in the Community budget are denominated in euros.

c. Revenues

The Community budget comprises four main categories of revenue that are shown in Table 3.2:

- *Customs duties*. Duties levied at the Community's external borders on imports from third countries are collected by the respective customs authorities of each Member State. However, the funds they collect are paid directly to the Community budget, less a 10% deduction for collection fees.

- *Agricultural levies*. For certain products for which the world market price is generally below the European price, the rules of the Common Agricultural Policy impose a levy when such products are imported into the Community. A levy is also imposed on sugar production.

These first two resource categories constitute what are known as "traditional" own resources and have been in existence since the start of the European Community (they are a natural feature of any customs union). The rules determining the bases and rates of these duties and levies are defined by the EU. These revenue payments are paid directly by importers of goods and services and, though collected by Member States, are legally the property of the EU from the moment they accrue.

Table 3.2. **EU BUDGET REVENUES, 1999 AND 2000** *(Euro million)*

Type of Revenue	Budget 1999		Provisional Draft Budget 2000	
Agricultural duties and sugar levies	1,921.0	2,2%	2,038.4	2,3%
Customs duties	11,893.9	13,9%	11,070.0	12,4%
VAT	30,374.2	35,5%	32,554.6	36,4%
Fourth resource	39,260.0	45,9%	43,049.8	48,2%
Miscellaneous and surpluses available from the previous year	2,108.6	2,5%	674.1	0,8%
Total	**85,557.7**	**100,0%**	**89,387.0**	**100,0%**

Source: European Commission

Despite their name, the "other own resources" have different characteristics:

- The *VAT resource* consists of payments by the Member States of an amount equal to the VAT "uniform rate" times the calculated VAT base. The calculated VAT base is equal to the VAT taxable base, harmonised to take national exceptions into account. The uniform rate is equal to the so-called "maximum rate" minus a correction factor that represents the reduced payments made by the UK. The maximum rate is 1% until 2001, 0.75% in 2002 and 2003 and 0.50% from 2004 onwards. The size of the UK correcting factor is usually about 0.15%. This implies a uniform rate of approximately 0.85%, 0.60% and 0.35% in the three periods.

- The *"GNP" resource*, which was created in 1988 to offset the reduction in the "VAT" resource, is designed to ensure that budget revenue and expenditure are in balance. By definition, this fourth category of resource is equal to the residual expenditure not covered by the other three resources. Its level is therefore variable and depends on the difference between projected expenditure and the estimated yield of other revenue.

Lastly, the EU's own resources are subject to an overall ceiling, which has changed. Beginning in 1999, the ceiling limits the Member States' total contributions to the EU to 1.27% of their GNP. The amount

paid by each Member State is in general directly proportional to its share of the total GNP of the Community. However, in 1984, after protracted discussions with its partners, the United Kingdom obtained a reduction in its contribution which, after complex calculations, means that this country pays substantially less than the amount resulting from application of the general rules.

In each enlargement of the Community, the new Member States have always benefited from transitional measures which reduce their contributions to the Community budget. The rationale for such arrangements is that, while the full amount of own resources payments is due immediately upon accession, Community expenditure in favour of the new Member States only reaches its "normal" level after a number of years. The procedure used in all but the last enlargement was to apply diminishing reductions to the contributions of new members during the transitional years stipulated by the respective treaties of accession. However, the most recent entrants — Austria, Finland and Sweden — were granted diminishing pre-determined lump-sum payments (budgetary compensations) from the EU budget.

d. Expenditure

The breakdown of EU budget expenditures by the main categories (or "subsections") for 2000 is shown in Table 3.3. The two main categories of Community expenditure are agriculture and the so-called "Structural Funds". While it has been declining significantly for a number of years, agricultural expenditure still accounts for about 42% of the Community budget. The Common Agricultural Policy was initially successful in encouraging the development of agricultural production, the growth of export markets, efficient use of agricultural land and self-sufficiency for many farmers. Nevertheless, the propping-up of artificially high prices has led to a sharp growth in budgetary costs which, after more than 15 years of attempted reforms, combined with pressures from outside competitors, have barely begun to ease in the last few years, and (unless the rules are substantially changed) will increase with the further enlargement of the EU.

Table 3.3. **EU BUDGET 2000: BREAKDOWN OF EXPENDITURE BY SUBSECTION** *(Euro million)*
(appropriations for commitments)

	Subsection	Amount	%
1	EAGGF Guarantee Section	41,493.9	44,5%
2	Structural operations, structural expenditure and cohesion expenditure, financial mechanism, other agricultural and regional operations, transport and fisheries	32,811.5	35,2%
3	Training, youth, culture, audio-visual media, information, social dimension and employment	841.6	0,9%
4	Energy, Euratom nuclear safeguards and environment	211.2	0,2%
5	Consumer protection, internal market, industry and trans-European networks and area of freedom, security and justice	1,210.7	1,3%
6	Research and technological development	3,630.0	3,9%
7	External action	8,127.8	8,7%
8	Common foreign and security policy	47.0	0,1%
9	Compensation, guarantees, reserves	203.0	0,2%
10	Administrative expenditure (of all the institutions)	4,703.7	5,0%
	Total	**93,280.4**	**100,0%**

Source: European Commission

The term "Structural Funds" (or strictly "structural operations" since the Cohesion Fund is not a structural fund as such) is used for a variety of Community budget subsidies for the least developed regions, declining industrial activities and employment creation. There are five categories of structural operations:

- *ERDF* (with a budget allocation of euro 12 billion in 2000) is used primarily to finance investment in infrastructure.
- *ESF* (euro 6.8 billion) is used for vocational training and redeployment in regions in transition.
- *EAGGF-Guidance* (euro 3.5 billion) helps finance investments in agricultural infrastructure.
- *FIFG* provides finance for investment in fisheries.
- The *Cohesion Fund* (euro 2.6 billion) subsidises investment in transport infrastructure in the four least developed EU countries.

Structural fund programmes and their financial allocations are driven by a number of key "objectives":

- *Objective 1*: The least developed regions of the Community (whose GDP per capita is less than 75% of the Community average).
- *Objective 2*: Areas with structural problems linked to economic development (e.g. declining industrial areas and rural areas).
- *Objective 3*: Training and employment.

There are also programmes for areas that are dependent on fisheries activities outside Objective 1 and "Community initiatives programmes" designed to deal with Community-wide problems or cross-border operations.

In 1999, structural operations accounted for some 40% of Community expenditure. It is the fastest-growing category of expenditure.

Other expenditures are used for a range of community policies including, research, culture and education. Budgeted expenditure on pre-accession aid to the candidate countries in 2000 is some euro 3.2 billion, about 3.4% of the total budget.

Lastly, mention should be made of the Community's administrative outlays, which account for about 5% of total expenditure and mainly cover the personnel costs of all Community institutions (primarily the Commission, which consumes 52% of the total).

e. Role of the Parliament, Council and Commission

The basic principles and requirements, as well as the main features of the budgetary procedures, are laid down in the Treaty. More precise rules for the implementation of these procedures are defined in financial regulations and the decision on own resources. Moreover, there have been several agreements between the three budgetary institutions (the Parliament, the Council and the Commission) in order to improve interinstitutional collaboration and to overcome potential conflicts.

- *Commission*. The main budgetary players are as follows:

  — 20 Commissioners.

  — The Directorate-General for Budget (DG Budget), formerly DG XIX, which has a staff of 335 officials.

  While DG Budget performs an essential role of co-ordination in the budget process, each spending directorate (responsible for policy areas such as agriculture, Structural Funds, research, and so on) is responsible for forecasting and planning its own expenditure.

  Formally, decisions of the Commission are taken by the Commissioners meeting as a body, with each of the 20 members having one vote. In practice, however, decisions tend to be taken by consensus, without resorting to a formal vote.

- *Council*. Formed by representatives of the Member States at ministerial level, the Council meets in its "budget" configuration at each step in the annual budget cycle. As a rule, the Budget Council comprises the ministers or secretaries of state with responsibility for their national budgets. Nevertheless, circumstances may require the ECOFIN Council (made up of ministers of finance themselves) or, in exceptional cases, the European Council (heads of state or government) to deal with budgetary issues. For example, highly sensitive political matters such as the rules for determining Member States' budgetary contributions or the "financial perspective" are usually resolved at the highest level.

  The Council, assisted by its Secretariat, deliberates on the Commission's proposals. It decides by a qualified majority in accordance with general weighting rules set by Treaty.

  The Council delegates preparation of its decisions to the Committee of Permanent Representatives (COREPER, made up of the Member States' ambassadors to the EU), which in turn delegates the main decisions to the "Budget Committee", composed of senior budget officials from each Member State. These committees follow similar rules of procedure and voting as the Council of Ministers.

- *Parliament*. Alongside the Council, the Parliament forms the second branch of what is usually referred to as the "budgetary authority".

  Sitting in both Strasbourg and Brussels, the Parliament includes a Committee on the Budget, which lays the groundwork for parliamentary budget discussions prepared by rapporteurs. Whilst the Council decides on the so-called "compulsory" expenditures, the Parliament rules on the "non-compulsory" expenditures (see Section f below for a definition of these terms and details of the procedures under which the draft budget is discussed and adopted).

  Successive interinstitutional agreements have attempted to introduce procedures and agreements that might lessen the risk of conflict between the two arms of the budgetary authority on compulsory and non-compulsory expenditures. In particular, the most recent interinstitutional agreement, of 6 May 1999, confirms the principle of conciliation to determine the level of compulsory expenditures, while extending this procedure, introduced in 1993, to all budget expenditures.

f. The budget cycle

The budgetary procedure is set out in Article 272 of the EC Treaty which stipulates the sequence of stages and the time-limits which must be respected by the two arms of the budgetary authority: the Council and Parliament. The budgetary procedure, as defined in the Treaty, extends from 1 September to 31 December of the year preceding the budget year in question.

In practice, however, the timetable adopted since 1977 has essentially been based on a pragmatic approach. The different stages of the procedure are broadly as follows:

- Establishment of the preliminary draft budget by the Commission and transmission to the budgetary authority by no later than 15 June.

  After an internal policy debate to lay down the main political and budgetary priorities for the coming year, the Commission prepares its "statement of estimates" by compiling the budget requests of all spending departments and arbitrating between conflicting claims. It also takes account of the conclusions of a "trialogue" meeting between the Parliament, Council and Commission to discuss budgetary priorities. In addition, the Commission receives the estimates of the other institutions and combines these in a preliminary draft budget, which is the overall forecast of revenue and expenditure for the forthcoming budget year. This preliminary draft is usually adopted by the Commission early in May and sent to the budgetary authority in all Community languages by no later than 15 June.

  The preliminary draft budget can subsequently be amended by the Commission by means of a letter of amendment, to incorporate new information that was not available when the preliminary draft was established.

  The remainder of the budget procedure relies heavily on the distinction made between compulsory expenditures and non-compulsory expenditures since it determines the division of the budgetary power between Parliament and the Council.

  The somewhat vague definition of the two expenditure categories contained in the Treaty was clarified in 1982 in a Joint Declaration by the three institutions. This declaration states that "compulsory expenditures are those which the budgetary authority is obliged to enter in the budget to enable the Community to meet its obligations, both internally and externally, under the Treaties and acts adopted in accordance therewith." All other expenditures are classified as non-compulsory. However, the problem of classifying expenditures is still from time to time a source of conflict between the Parliament and Council.

- Establishment of the draft budget by the Council.

  The Council conducts its first reading of the preliminary draft budget and, on this basis and after a conciliation meeting with a delegation from Parliament, establishes, before 31 July, the draft budget, which it sends to Parliament in the first half of September. While this process is taking place, an ad hoc "conciliation procedure" is initiated on the compulsory expenditures to be entered in the budget, leading to a trialogue meeting between the institutions in late June.

- First reading by Parliament.

In order to enable the institutions to identify the programmes on which the conciliation is to focus, so as to reach an agreement on the budget allocations, a new trialogue meeting is held prior to the first reading by the Parliament in October. At that meeting, the institutions also exchange views on the state of implementation of the current year's budget with a view to discussing a possible supplementary and amending budget.

The first reading by the Parliament takes place on the basis of the Council's draft. Amendments to non-compulsory expenditures require the votes of an absolute majority of members. Proposed modifications to compulsory expenditures require an absolute majority of votes cast.

If it considers it necessary, the Commission may present an ad hoc letter of amendment to the two arms of the budgetary authority before the end of October. The purpose of this letter is to update the figures underlying the estimate of agricultural expenditure in the preliminary draft budget and/or to correct, on the basis of the most recent information available concerning fisheries agreements in force on 1 January of the financial year concerned, the breakdown between the appropriations entered in the operational items for international fisheries agreements and those entered in reserve.

- Second reading by the Council.

The institutions continue the conciliation process after the first reading of the budget by each of the two arms of the budgetary authority. The objective is to secure agreement on compulsory and non-compulsory expenditures and, in particular, to discuss the ad hoc letter of amendment. Another trialogue meeting is usually held for this purpose immediately after the European Parliament's first reading. The results of this meeting are discussed at a second conciliation meeting held the day before the Council's second reading, which usually starts in the third week of November. The draft budget is amended in the light of Parliament's amendments (non-compulsory expenditures) or proposed modifications (compulsory expenditures). In general, the Council's decisions on the second reading relating to compulsory expenditures determine the final amounts in the budget. Unless the entire budget is subsequently rejected by Parliament, the Council has the "last word" on this category of expenditure. The draft budget as amended is returned to Parliament around 22 November.

- Second reading by Parliament and adoption of the budget.

As the Council has had the last word on compulsory expenditures, Parliament devotes most of its December part-session to reviewing non-compulsory expenditures, for which it can accept or refuse the Council's proposals.

Acting by a majority of its members and three fifths of the votes cast, Parliament then adopts the budget. The President of Parliament declares the budget adopted and it can then be implemented. In the event of unavoidable, exceptional or unforeseen circumstances, the Commission may propose during the year that the budget be amended. This is done by submitting preliminary draft supplementary and/or amending budgets. The procedural rules for handling supplementary or amending budgets are similar to those for the general budget.

g. National institutions and the Community budget.

When joining the European Union, Member States have to take a number of important steps in order to integrate their national budget laws and procedures with the EU's budget system.

Traditional own resources pose no particular problems. As noted above, these revenues are collected by national authorities, paid over directly to the Commission and require no special accounting or budget procedures.

In contrast, while the Community rules that determine the calculation of VAT and GNP resources are very precise, the administrative procedures used by Member States in making these contributions to the budget vary widely. Some countries treat the contributions as off-budget cash transfers, while some treat them as budgetary expenditure included in their national budget; other Member States have found intermediate solutions.

In some expenditure areas (e.g. Structural Funds), the European budget finances policy measures jointly with national budgets. This raises a fundamental question: should Community expenditure substitute for or supplement national expenditure? The Member States have offered a full range of pragmatic solutions, depending on the areas involved. While it is therefore difficult to derive any one general rule, the following may be taken as guidelines:

With regard to *agricultural expenditure*, the general rule to date has been fairly widespread substitution of Community expenditure for national expenditure. Beginning with the Treaty of Rome (1957), agricultural policy has essentially been a Community matter with a very large budget that leaves little room for national expenditure. By closely monitoring the rules of competition, moreover, the Community regulates the few residual programmes of national assistance to farmers. Even so, it remains possible that certain areas of agricultural expenditure will be "re-nationalised" in the future, bearing in mind the additional pressures that enlargement of the Community will impose on the EU budget.

In the case of Structural Funds, this basic principle is reversed: the Community budget is used to supplement national appropriations in order to magnify their economic and financial impact. The Commission therefore seeks to ensure that ERDF, ESF and EAGGF-Guidance appropriations add to national funding and do not serve as a pretext to diminish the efforts of the Member States. As a result, the planning of appropriations for European Structural Funds attaches much importance to this notion of complementarity — an issue that is further complicated by the multiplicity of levels of intervention, since expenditures involve subnational levels of government, and in some cases the private sector, as well as the national budget.

For *other policies* (such as research and education), the general rule would seem to be one of complementarity between national appropriations, which are still paramount, and European appropriations, which are more modest. While the problems of co-ordinating the various levels of appropriation are less far-reaching, they should, however, be regulated by an appropriate information system and suitable monitoring procedures.

Forging close administrative linkages between the two levels of the budget—national budgets and the Community budget—is of vital importance to national budget authorities. Spending ministries generally adopt the attitude that it is important for Member States to obtain the European appropriations to which they are entitled, seeing the EU budget as a potential resource for financing their policies and, in some instances, attempting to obtain from the EU budget funding that they have been unable to obtain from their own ministries of finance.

Such efforts must be compatible, however, with the overall interests of each Member State. In particular, there must be coherence with the Member State's general budget policy, adherence to national policy priorities (and to intersectoral choices in particular), and consistency with the Member State's position vis-à-vis the financing of the Community.

Accordingly, it is important that the ministry of finance in each Member State, and especially its budget department, should oversee the co-ordination of national positions on European budget issues and closely supervise the budget requests that the line ministries concerned would like to submit at the Community level. Each national "Permanent Representation" in Brussels should include one or more budget specialists (often these are officials on loan from the ministry of finance); and any communication or proposed position on European budget issues should be submitted to the ministry of finance for approval. Within each Member State, these positions should of course be co-ordinated with other ministries concerned, and with the centre of government.

In this regard, adherence to European budgeting procedures requires a high level of knowledge and responsiveness by the Member States which must take positions on each line of the budget and on all proposed amendments at each stage in the cycle during which the draft budget is examined. The links between Brussels and each national capital must therefore be highly "reactive" (and deployed by appropriate technical means), so that national positions can be clearly defined and expressed with clarity and effectiveness, and in a timely manner, during the discussions in the Budget Committee, and subsequently in COREPER and finally the Budget Council.

h. The future of the system

The EU's budgeting system is probably in need of reform. The basic elements were designed forty years ago during a period of rapid growth for a Community of six Member States at a similar level of economic development. Since then the Community has expanded to 15 countries, and a further expansion to between 25 and 30 Member States, most of the new members being at a relatively low level of development, is expected to take place in the next ten years. This expansion will require a re-examination of Community policies in areas such as agriculture and the Structural Funds. In addition, the budgeting system may need adaptation to reflect factors such as the changing roles and responsibilities of the three budgetary instiututions, possible reform of the Community's voting arrangements and need to strengthen financial management and anti-fraud procedures. While many elements of the current system are likely to endure, attention is drawn to the need to update the information and analysis contained in this chapter, by carefully and continuously monitoring developments in the Community.

2. Deploying Community funds

a. Administration

1. Organisation of the Commission

The administration of Community funds involves departments of the Commission and of each of the Member States.

Legally, it is the Commission that has responsibility for implementing the Community's budget. In practice, however, this formal power has certain limits:

- First, the Commission, in deploying appropriations, is assisted by a large number of "committees". There are roughly 250 technical committees covering a wide variety of fields, bringing together representatives of the Member States and, in some cases, socio-professional interest groups. These committees, which were created as the various Community policies were introduced, have varying degrees of authority and political influence. Theoretically, their authority is merely advisory, but in some instances their deliberations have an important influence on the Commission's administrative

decisions. Complicated and difficult discussions between the Commission, the Parliament and the Member States have for years been a fact of life for these committees. Their role was clarified to some extent in 1988, in the so-called "Single Act" treaty.

- Second, the Commission relies heavily on the administrative departments of the Member States to manage Community appropriations, in respect both of revenues and expenditures, and to engage in financial control and audit activities. Since they lack the administrative skills and resources needed for effective fund management, the Commission largely delegates this task to Member State administrations.

Implementation of the Community budget follows a rule — traditional in many continental European countries — that Community expenditure should involve four distinct phases:

- The *commitment* is the legal act by which the Commission assumes a financial obligation with a third party, which may be an entity in the public sector or a private enterprise.

- *Validation (verification)* enables the authorising officer to check the creditor's entitlement to payment and to verify the authenticity and exact amount of the claim. This takes place once the contracting party has fulfilled its obligation, satisfying the so-called "service rendered" rule.

- *Authorisation* is the act by which the authorising officer gives the accounting officer an order to make a payment once it has been checked and approved.

These first three phases are carried out under the responsibility of the authorising officer.

- *Payment* is the fourth and final phase in the implementation of expenditure. Payments are made by the accounting officer, subject to the availability of funds.

The two main players in this process are the authorising officer and the accounting officer.

- *The authorising officer* is empowered to commit expenditure and revenue alike. It is he or she who decides to commit expenditure, establishes entitlement to revenue and issues payment orders and collection orders. Concretely, the authorising officers are the Commissioners, the Director-General for Budget, the other Directors-General, and a number of senior Commission officials appointed personally in each of the Directorates-General.

- *The accounting officer* is responsible for collecting revenues and making payments. Working with a staff of several assistants, the Commission's accounting officer is one of the senior officials of DG Budget.

2. Management of revenue and expenditure

i) Revenue. In this area, the Commission's own role is limited, since it merely checks and monitors the amount of revenue that each Member State must transfer to it. As noted above, the European Union's own resources are collected by the respective Member State administrations, since the Commission does not have any customs or tax authorities of its own.

Management of revenue involves three administrative stages:

- Revenue is first assessed. Traditional own resources are assessed on the basis of amounts effectively collected by national customs authorities. VAT and GNP resources are assessed using calculation

methods laid down in European regulations. These procedures amount in effect to statistical calculations based on macroeconomic data.

- Once a claim is assessed, the amount is "booked" to an account opened by the Commission with each national treasury, or with another body specified by the Member State.

- Once they have been booked with each national treasury, the resources are at the Commission's disposal to be used as they are needed.

This procedure for managing own resources is overseen by the "Advisory Committee on Own Resources", comprising representatives of the Member States and the Commission, which chairs it. The Committee deals with technical problems involving the assessment and transfer of own resources, and can be useful in heading off potential political conflicts which would otherwise be escalated to a higher level.

ii) Expenditure. The administrative arrangements vary from country to country and between the different categories of expenditure.

Agricultural funds (EAGGF), which still account for nearly half of the Community's spending, follow a special procedure. Community regulations require each Member State to set up one or more disbursing agencies for transferring Community funds to the final beneficiaries. Disbursing agency status is granted to agencies or establishments demonstrating their capability in the areas of management, accounting and financial control. The required criteria are spelt out in a 1995 Community Regulation. In addition, Member States must also designate a "certification" agency (public or private) to audit the annual accounts of each disbursing agency.

Technically, Community financing takes the form of reimbursement by the Commission of funds that must first be advanced by the Member States. New members must therefore be prepared to provide the initial working capital that is needed to get the system started. The Commission's reimbursement comes only after a procedure known as "clearing the accounts". Each year, after verification and control, the Commission reviews the annual accounts of each disbursing agency and reimburses only those amounts corresponding to expenditure properly disbursed on its behalf by national administrations. Agricultural expenditure that is not in strict compliance with Community regulations is not reimbursed.

National administrations, and ministries of finance in particular, must therefore ensure that disbursing agencies apply Community rules to the letter: any irregularity may result in substantial penalties. As an incentive to greater prudence in this area, some countries have decided to charge the amount of these "fines" to the budgets of the ministries deemed at fault.

Expenditure on structural fund programmes is allocated on a multi-year basis, and requires co-financing from the Member States' national and subnational budgets. In addition to issues of managing and controlling payments, this involves Member States in setting up arrangements at national and subnational level for setting priorities, preparing the necessary plans, and carrying out technical analysis of projects. National administrations should get involved from the initial stages of requesting assistance: experience shows that a great deal of co-ordination is necessary at that point to select worthwhile projects and ensure that all parties involved will be able to provide their financial contributions in a timely manner. In some Member States, this co-ordination is performed both by interministerial groups and special administrative units that have the status of ministries.

iii) Control. Control over the management of Community funds, both revenue and expenditure, involves three categories of player and procedure:

- *The Directorate-General for Financial Control (formerly DG Audit),* which performs an overall internal control function in respect of all of the budgets under the Commission's responsibility. This is in addition to the internal control functions of the Directorates-General that are responsible for specific areas of budgetary expenditure.

  The Director-General of DG Financial Control is the Commission's Financial Controller. He or she exercises prior control over all expenditure and revenue operations by initialling all of the proposals submitted to him by authorising officers. This enables him to check that appropriations are available, that transactions are legally valid and that financial management procedures have been carried out correctly. In the event of a dispute, the authorising officer can overrule a decision by the Financial Controller, in which case the Court of Auditors is informed immediately. In addition, the Financial Controller is consulted about the accounting systems used by the Commission; he reports on any management problem of which he becomes aware; if necessary, he can conduct on-site inspections.

  Lastly, DG Financial Control conducts regular audits of the internal control systems of the Commission's Directorates-General.

- *The European Court of Auditors (ECA),* based in Luxembourg, performs an external auditing function for the budgets of the European institutions. The Court has no jurisdictional power and can therefore impose no sanctions or financial penalties in cases of misuse of Community funds.

  The ECA performs an ex post audit of all budgetary and financial operations, including both revenues and expenditures, and has broad powers to inspect documents and perform on-site investigations. Its analysis and recommendations are summarised in an annual report which is circulated to all Community institutions by 15 July each year and published by 15 November, along with the responses of the Member States and the Commission. Each year it is invited to certify the reliability of the Commission's accounts through the so-called "Statement of Assurance" to the Parliament.

The Court performs two main types of function:

- To ascertain whether management operations have been conducted properly, in terms of formal budgetary and accounting procedures.

- To assess the quality of the Community's financial management systems in terms of economy, efficiency and effectiveness.

As a rule, the Court focuses more specifically on the analysis and evaluation of decision-making and internal auditing systems than on operations themselves. It maintains close ties with the supreme audit institutions of all Member States.

- *The audit departments and institutions of the Member States*, which are called upon to co-operate in various auditing operations and procedures employing funds that the Member States manage by delegation from the Commission. These activities account for some 80% of the Community's budget.

  The Member States' involvement in such audits differs according to the category of expenditure concerned.

Agricultural expenditure (EAGGF) is managed within the Member States by agencies that are certified by the Commission, which ensures and regularly checks that the agencies have effective audit departments and procedures. The effectiveness of such controls is one of the major criteria guiding the Commission in its "clearing the accounts" procedure mentioned above.

With regard to Structural Funds, which are co-financed by the Community, the Member States and subnational authorities, each Member State is bound by a number of obligations that determine the nature of the control regime:

- It must designate appropriate agencies (in many cases the respective ministries that are responsible for managing the funds or programmes concerned) to check the validity of requests for payment.
- It must provide the Commission with a description of the management and control system it uses.
- It must make all audit reports and control documents concerning the management of funds available to the Commission.

Commission directorates may conduct on-site audits or request that their national counterparts do so.

Within the Commission, DG Financial Control has been assigned responsibility for co-ordinating the work on financial control. In this connection, it has signed agreements with a number of Member States regarding the harmonisation of methods, co-ordination of programmes and exchange of data. Co-ordination meetings are held twice a year.

Similar procedures have been developed in relation to the control of own resources.

Recent years have brought growing concerns within the Community, and the Commission, about the problems of combatting fraud in the area of agricultural spending and other Community programme. The Commission's Unit for the Co-ordination of Fraud Prevention (UCLAF) was set up in 1987. An effort was also made to strengthen co-operation between the Commission and Member States in the anti-fraud area. In April 1999, following financial scandals in the Commission and the resignation of the Commission itself, UCLAF was replaced by OLAF (Office de Lutte Anti-Fraud), with enhanced powers and resources. The financial management arrangements within the Commission are also being strengthened.

B. National Budget Policies in the European Union

Mechanisms for participation in the Community budget are the most immediate and most visible consequence of EU membership for a country's public finances. But there is also a wider issue, namely the effects of European integration across the full spectrum of Member States' economic and financial policies, reflecting in particular the influence of the Maastricht Treaty and the adoption of a single currency.

This phenomenon began long before decisions were taken to create an Economic and Monetary Union (EMU) with a single currency: for example, the establishment of the Common Market (1958), strengthened by the creation of the Single Market (1993), prompted important changes on the revenue side of Member States' budgets.

Initiated in the 1970s, the adoption of a harmonised system of VAT, followed in the 1980s by an effort to bring excise duties closer together, had important budgetary implications. Countries in which indirect

taxation took a bigger-than-average share of the budget lost revenue by lowering their rates, while countries in which indirect taxation was initially more moderate had to raise their rates, thereby increasing budget revenue. Convergence of tax structures and rates has also occurred in the area of the taxation of savings and (especially) corporate taxes, partly as a result of the impact of open capital markets and cross-border competition within the single market and between the EU and world markets.

This trend towards the convergence of European tax rates and tax structures is of particular interest to economists and tax experts. But it is also of concern to budget authorities insofar as it affects the general level of revenue and the conditions of budget balance. Membership of the European Union does in fact lessen Member States' degrees of freedom in terms of varying the rates and structure of taxes, which can no longer be used with as much discretion as in the past.

These tendencies towards convergence are heightened by provisions concerning the single currency. Economic and Monetary Union has budgetary consequences that are more demanding and more formal than the effects of the single market. These effects are both direct (provisions stemming from the Maastricht Treaty) and indirect (the implications for how national budgets are managed).

1. The Maastricht Treaty and the Stability Pact

European policy-makers considered that the culmination of the single market required a single currency —as the monetary instability in 1992-93, immediately after the Maastricht Treaty was signed, clearly illustrated.

A single currency can only be introduced after the macroeconomic conditions of all participating countries have been brought into balance. Accordingly, the Maastricht Treaty lays down five criteria, two of which are directly relevant to public finances:

- *Public debt:* Aggregate public debt may not exceed 60% of GDP.

- *Budget deficits:* The budget deficit for a given year may not exceed 3% of GDP.

In addition, under the so-called "no bailout" principle, no Member State nor the EU itself is permitted to assume the commitments of a country that is in financial difficulty. The application of these criteria were subsequently formalised in secondary legislation.

a. Criteria: calculation methods and interpretation

The economic rationale for the 3% and 60% criteria has been questioned extensively. Clearly, the value of these benchmarks is affected by economic developments, and especially by movements in interest rates and trends in economic growth and inflation. On a technical level, the main issues are as follows:

- The 3% and 60% figures are consolidated across the budgets of all national and subnational government authorities, and mandatory social protection schemes. Public enterprises engaged in commercial activities are not included. Consolidation requires the elimination of intra-governmental transactions involving debts/claims and revenues/expenditures, in order to avoid double counting. This implies that at least the most significant internal transactions between public sector entities be identified, preferably as soon as they accrue.

- The figures are based on a gross concept of public debt that includes only financial liabilities and excludes from measurement all assets except cash and cash equivalents. In particular, financial claims on businesses, foreign countries or international agencies are disregarded. Logically, fixed assets should similarly not be taken into consideration.

- Lastly, purely financial transactions are not taken into account: in particular, receipts arising from asset sales have no impact on the budget deficit even though they can contribute to reducing the burden of debt. Cases of asset substitution, as when the proceeds of privatisation are directly earmarked for financing public investment, are more difficult to categorise, but in general they add to the expenditure side of the budget with no offsetting addition to the revenue side.

Other special transactions warrant close examination in the light of the Maastricht criteria. For example, can a transfer from a public enterprise to the government of a pension guarantee fund be considered a revenue item, at the same time as the government is assuming a future liability in relation to staff who retire? Can unrecognised capital gains on liquid assets be considered budget revenue?

The statistical experts of Member States, meeting at the European Community's statistical office (EUROSTAT), often review such difficult cases and have built up a "case law" that can be applied in given circumstances. In order to avoid any mistakes in this area, the budget administrations of some Member States participating in EMU have adopted the rule that any expenditure or revenue transaction about which the treatment under the European standard (ESA95) is unclear should first be examined by their competent experts. In the most complex cases, national experts may consult EUROSTAT for an opinion.

Questions have been raised about what is sometimes perceived as the excessively mechanical nature of the Maastricht criteria. In practice, however, the criteria need to be interpreted in a political context, and it seems likely that in future a country's eligibility for participation in EMU will also be judged in relation to how its fiscal performance evolves over a number of years.

b. Sanctions

In order to satisfy the qualification criteria, a Member State needs to maintain a sound fiscal position consistently over the long term. Whilst the economic and political benefits of qualification for the third phase of EMU – the irrevocable fixing of exchange rates on 1 January 1999 — was a powerful incentive for Member States to implement restrictive fiscal policies, it was feared in some quarters that, once this critical point was passed, efforts would be relaxed and there would be a return to more lax budget policies, thereby threatening the stability of the common currency. It was therefore necessary to find a mechanism for sustaining sound budget policies on a continuing basis; this was the central idea behind the Stability Pact (which is centred on deficits more than on debt).

The main provisions are as follows:

- In the event that a Member State has an excessive deficit and has failed to comply with Council recommendations, the country is required to deposit in EU accounts an amount equal to 0.2% of its GDP, plus an amount equal to one-tenth of the deficit in excess of the authorised 3%. In all, the deposit may not exceed 0.5% of GDP.

- If the situation is not rectified within two years, the deposit is converted into an irrevocable fine, the proceeds of which are redistributed to the other EMU members.

- Lastly, application of this mechanism, which is in principle automatic, takes economic circumstances into account. In the event of an economic recession, the stringency of the measure is eased as follows: if GDP contracts by 0.75%, sanctions are no longer applied automatically; rather, they are contingent upon a decision of the Council, which assesses the circumstances and determines whether sanctions are warranted; if the recession involves a contraction in GDP of 2% or more, all financial penalties will normally be waived.

Discussions of the Stability Pact emphasised the fact that the 3% budget deficit criterion was not an average level to be achieved across a run of years, but an upper limit not to be exceeded. Taking into account the cyclical nature of economic activity and the distinction between structural deficits and cyclical deficits, the rule implies that, in practice, a balanced budget should be achieved over the economic cycle or even, if a country has substantial debt to repay, a slight budget surplus.

The mechanism described above has now been written into Community law. The emphasis is placed, however, on its preventative aspects rather than its punitive nature, and special attention has therefore been given to the development of preventive measures.

c. The prevention procedure

In line with this approach, the EU has adopted a monitoring procedure intended to prevent slippage and thus avoid in practice having to make use of the financial penalties described above. This procedure, which was formulated within a framework of economic policy co-ordination, provides that Member States submit stability/convergence programmes that are updated annually.

Such programmes provide the following information (see Chapter 5 for a discussion of the relationship between these programmes and a government's medium-term fiscal framework):

- The medium-term objectives for the government balance and the expected path of the debt ratio.
- The projections of the same aggregates for a period of three years.
- The underlying macroeconomic assumptions.
- An analysis of the sensitivity of budget data to changes in the macroeconomic assumptions.
- A description of the budgetary and other economic policy measures that are necessary to achieve the projected government balance.

In accordance with EC regulations, the Council is required to examine this information and make comments. The Council's reports shall be made public. These provisions became effective for the first time in 1999.[2]

d. Fiscal surveillance for the candidate countries: PEPs

The Commission has proposed that, for candidate countries, a new annual fiscal surveillance procedure —based on "pre-accession economic programmes" (PEP) — should be introduced. This procedure will replace the existing joint assessments of economic policy priorities. It is aimed at bringing the reporting, monitoring and control of public finances, specifically fiscal positions, into line with EU procedures, and would lead, after EU accession, to the convergence and stability programmes followed by Member States,

as described in Sections a to c above. The Commission thus sees the new procedure as a mechanism for helping the candidate countries prepare for eventual membership of EMU and, later, adoption of the single currency.

The new procedure will be informal and will include a number of steps. First, candidate countries will notify the Commission of their fiscal deficits and debt levels according to the ESA methodology.[3] Second, the countries will prepare PEPs. Third, the Commission and EUROSTAT will give its opinions on the adequacy of (a) the deficit and debt notifications and (b) the PEPs in relation to the Copenhagen criteria, including macroeconomic stability and the fiscal position. Fourth, multilateral meetings between candidate countries, Member States and the Commission services will take place in order to exchange views on the PEPs. Finally, the Commissioner for Financial Affairs will present an official evaluation to the finance ministers of the countries concerned. The Commission has recommended that this fiscal surveillance procedure should start in July 2000 and be completed by March 2002.

The Commission has proposed that PEPs prepared by the candidate countries should include the following main components:

- A review of recent economic developments.
- A coherent and consistent macroeconomic framework, identifying the main goals and objectives of macroeconomic policy.
- Public finance — a statement of the government's approach to fiscal adjustment and an analysis of the sustainability of fiscal policy; the medium-term fiscal framework; issues relating to debt management, deficit financing and fiscal risks.
- Structural reform objectives relating to the private (enterprise) sector, the financial sector, the labour market, administrative reform, agriculture, etc.

2. The implications for the management of public finances

Membership of the European Union, and especially participation in the oversight mechanisms and budgetary discipline procedures connected with the single currency, will reinforce the need for the budget administrations of the Member States to modernise the management of public finances. A number of issues, stemming directly from the mechanisms described above, and described below, require special attention on the part of budget officials. It should be emphasised, however, that the European Commission leaves Member States free to manage their public finances as they see fit; this is unquestionably an area in which "subsidiarity" prevails. (Larsson and Allen, 1998; SIGMA, 1997b).

a. Debt management

The most immediate budgetary consequence of the single currency involves a change in the way deficits are financed, because one of the fundamental rules of the Maastricht Treaty is a prohibition on direct monetary financing by the national central bank and, as a corollary, the requirement of independence of the national central bank.

This apparently simple principle has many concrete consequences and raises a number of questions in respect of the management of i) the treasury system, and ii) payment services:

i) Treasury system

- On terms to be decided at the time a country joins the single currency, overdrafts or credit facilities of the state treasury with the national central bank are suppressed.

- Other financing methods may need to be developed in order to cover short-term needs in particular.

- Ease of access to central bank financing has at times discouraged national treasuries from developing effective procedures and tools for forecasting. A more sophisticated and more reliable cash flow forecasting system needs to be developed in close co-operation with departments in charge of expenditure and revenue. In this regard, sound accounting systems are required.

ii) Payment services

- The central bank's independence does not prevent the treasury from continuing to use the bank's banking services, including its payment service which, because of the network's geographical range, allows the treasury to ensure its own internal liquidity through a single account.

- The central bank is also an economic entity that manages public resources and a balance sheet of assets and liabilities. The state, alone or together with other public authorities, is the shareholder. The bank has influence over how its assets and liabilities are managed, and over any resulting profits or losses.

b. Comprehensive control over aggregate public finances

The degree to which a country's public finances are centralised depends on its cultural traditions and administrative systems. Alongside the central government budget there generally exist subnational budgets, in many cases at a number of different levels (regions, municipalities, counties and so on). In some Member States, social security budgets are independent. The extent of central government control or influence over these entities, along with their capacity to take on debt, varies considerably from one country to another, and these matters are not subject to regulation by the Community.

Even so, the requirements of the Maastricht Treaty indirectly compel central governments to tighten their control over the budgets of these autonomous entities, since the 3% and 60% criteria apply to aggregate budgets, not those of the central government or subnational authorities. As a result, the governments of Member States are deemed responsible for the overall financial condition of all public entities that come within the definition of the Maastricht criteria, regardless of the legal or institutional relationship between these entities.

This "enforced solidarity" has several consequences:

- The central government must first acquire the capability of closely monitoring the budget situation of other government authorities and public entities. An appropriate statistical or accounting system must be developed, comprising nomenclature that has been harmonised across the various types of budget. Consolidation techniques must be able to eliminate double counting (mutual claims and debts).

- The deficits and debt levels of autonomous bodies must be overseen by the central government. In practice, several types of solution are possible and may be combined:

— Controls that are designed to avoid imbalances between revenues and expenditures: such an approach can lead to a revision of how costs and revenue are apportioned between the various authorities.

— Restriction of options for borrowing, which may be either prohibited, limited to certain amounts or reserved for certain purposes.

— A guarantee of financial support from the central government: while technically possible, such a solution in fact amounts to transferring the imbalance of autonomous budgets to that of the central government. It is therefore somewhat risky unless used in conjunction with other types of control (see above).

- In the event that the overall state of public finances were to deviate from the Maastricht criteria, thought should be given to how any remedial measures decided at the Community level should be apportioned. One possible approach, which has in fact been adopted in Germany, would be to formulate rules on how fines, as provided for in the Stability Pact, should be shared between government authorities at the central and subnational level.

In sum, the rules for budgetary discipline between central governments and decentralised authorities should be just as strict as the ones that the Maastricht Treaty imposes between the EU and each Member State.

c. Paying more attention to the results of budget policies

In most western democracies, the main interest of politicians and the general public in budget issues is concentrated on the budget preparation and approval process, which is essentially a forward looking exercise. The actual budgetary outturn of a financial year, which may not be known until some time has elapsed, generally attracts little attention. Under these circumstances, the work of budget administrations tends to be focused on budget preparation, leaving accounting experts and treasury officials to monitor implementation.

In contrast, the rules of budgetary discipline that are enshrined by EMU will prompt budget administrations to concentrate a substantial portion of their efforts on budget implementation, since the Maastricht criteria concern actual budget balances and debt ratios and not merely forecasts.

This shift in approach has some major practical consequences:

- Sustained attention must be paid to the quality of accounting reports. Information on budget implementation, in respect of revenue as well as expenditure, must be reliable for both the central budget and other public budgets. In addition, such data must be available soon after the accounts are closed for the year, so that a country can comply with the Community's oversight procedure.

- Concern for the budget outturn should not be limited to events after the financial year is over. The objective of keeping to budget must be a dominant preoccupation throughout the year. Interim reporting, while less comprehensive than at year-end, must be able to provide sufficient information and, in particular, enable the authorities to be alerted in time to any risks of deterioration in the revenue or expenditure side of the budget.

- Accordingly, instruments for regulating expenditure, and even revenue, during the course of the year should be set in place in order to keep the forecast deficit under close control and to cope with unexpected developments arising from shifts in the economic outlook or new policy decisions.

d. Multi-year budget projections

The need to go beyond a strictly annual framework became clear very soon after the Maastricht Treaty was implemented, and in particular when the Stability Pact was being drawn up. Greater attention to the cyclical nature of economic activity, the policy-makers' concern with judging countries' budgetary performance on the basis of trends rather than the most recent developments, and the need, increasingly acknowledged by public administrators, to ensure a certain continuity in public policies — all of these factors argue for a multi-year approach to budgeting. As explained above, such an approach was incorporated in the supervisory procedures that form the core of the Stability Pact.

It is still too soon — the first application of this supervisory procedure was in respect of 1999 — to draw conclusions about whether or not these requirements have been complied with in practice. A number of Member States already engage in various forms of multi-year planning — some more detailed, more binding and more extensive than others. For other countries, more faithful to the principle of annual budgeting, these rules will prompt certain changes:

- Development of medium-term economic forecasting tools. The unsophisticated methods that are still in common use will have to be improved; in particular, it is necessary to have a better grasp of the sensitivity of predictions to changes in variables, because the external credibility of governments in the area of economic policy co-ordination depends on it.

- Control over tax revenue-producing mechanisms (including familiarity with the requirements of tax yields to changes in incomes, spending and other measures of economic activity).

- More sophisticated forecasts of public expenditure. Because the rules of the Stability Pact do not require a very high level of detail, multi-year projections need only cover the broad categories of expenditure, distinguishing between mandatory and discretionary spending, between operations, investment and social transfers, and so on.

- Apart from these technical aspects, multi-year budgeting gives rise to problems of a more administrative, and even political, nature: for example, the sharing of responsibilities and information between the ministry of finance and spending ministries; the legal and political repercussions of the projections; consistency with preparation of the annual budget, and so on.

e. An emphasis on saving money

An emphasis on financial sustainability dominates the Maastricht mechanism, while at the same time, as noted above, the convergence of corporate (and other) tax rates brought about by competition within the single market limits the ability of Member States to raise additional revenues. As a result, the need to generate budget savings is an important objective of budgeting. Because of this, procedures that had been formulated for an environment of ever-expanding budgetary resources, a characteristic of the first thirty years of the Community, must be reviewed in response to the need for budgetary discipline. This suggests that:

- Familiarity with the natural dynamics of spending growth, combined with reliable forecasts of tax revenue, would make it easier to assess the room for manoeuvre — positive or negative — from the outset of the budgeting cycle.

- Bottom-up budgeting, a characteristic feature of periods of growth, will have to be supplemented by top-down procedures: negotiations between budget agencies and spending agencies must be limited by target trends or ceilings.

- The interface between annual budgeting and any regular public policy review procedures should be organised with great care. The budget process is often used to achieve savings, and this is a powerful and compelling mechanism. However, it also has its drawbacks: it is fast but formal, but at times can preclude the consideration of savings mechnaisms that would be better informed and more realistic. On the other hand, periodic review procedures, carried out outside the framework of the annual budget, allow more thorough, and at times more consensual, consideration of the reforms to be undertaken, but they do not always provide effective leverage.

f. Improving the efficiency and effectiveness of public spending

The budget discipline procedures that are needed to ensure satisfactory application of the Maastricht criteria, with the quest for savings that this entails, present a danger — that of focusing so exclusively on financial performance as to neglect the appropriateness of how resources are allocated and the quest for quality in management. The limitations on public resources must therefore prompt efforts to improve the way those resources, including funds obtained from the EU budget, are allocated and managed, and more effective systems for collecting and managing budgetary information.

Techniques for dealing with these issues, and the issues discussed in earlier sections of this chapter, are described in later chapters of the book.

NOTES

1. This is an agreement between the three budgetary "institutions" of the Community: the Parliament, Council and Commission.

2. See, Commission of the European Communities (1999).

3. In order to help candidate countries prepare this information, the Directorate-General for Economic and Fiscal Affairs and EUROSTAT have prepared a number of useful technical documents. See, in particular, the "Framework for the Reporting of Government Deficits and Debt Levels" prepared by DG Economic and Financial Affairs in March 2000; and the "ESA95 Manual on Government Deficit and Debt", First Edition, published by EUROSTAT in January 2000. This latter document is a presentation of EUROSTAT's "case law" approach to resolving difficult technical issues relating to the interpretation of ESA95.

SUMMARY — PART I

A. KEY POINTS

1. Budgetary and PEM Objectives

The national budget is the single most important policy instrument for giving effect to a country's economic and social priorities within the scarce resources that are available to government for public expenditure. The three core objectives of public expenditure management systems are fiscal discipline, efficient resource allocation and operational efficiency. Transparency is another key objective. Successful reform of public expenditure management systems, just like reform in other areas of public administration, requires effective communications, co-operation and co-ordination of activities. Building a commitment to reform, and a capacity for implementing necessary changes, within the ministry of finance, and within the budget and finance departments of ministries and government agencies directly affected by the reform process, is of key importance.

2. Scope of the budget

a. The budget and authorisations by the parliament

The "general government" consists of the central government and subnational governments (state governments and local governments). The public sector includes the general government and all entities that it controls (e.g. state-owned enterprises). Each government and public sector entity should have its own budget. But, in order to ensure accountability and effective control, the financial reports should consolidate the financial operations of the general government and (so far as possible) the financial activities of all public entities controlled by the government.

The authorisations to spend money for a specific purpose are generally granted by parliament through "appropriations". Most countries have a "cash-based" budget system, where the appropriations define a limit for cash payments. A cash-based budget system fits the needs of expenditure and macroeconomic control, and budget administration.

Most appropriations are authorised on an annual basis. Some countries authorise a number of entitlement programmes under special legislation (called "standing" appropriations). Nevertheless, defining annual spending limits for entitlements and personnel expenditures has decisive advantages, since it obliges the government to define structural measures to comply with the annual appropriations. In transition countries, all expenditures should be appropriated when enacting the annual budget, and in general appropriations should define annual cash limits. Besides the annual appropriations, the budget can also include authorisations for forward commitments that are helpful in monitoring and controlling capital investment projects and other multi-year expenditures.

b. Comprehensiveness of the budget

For purposes of expenditure control and efficient allocation of resources, the coverage of the budget should be comprehensive. The budget should include all revenues and all expenditures of the government, whatever the arrangements for managing particular programmes and the legal provisions for authorising expenditures. Specifically, on the expenditure side the budget should include the following:

- All spending authorisations.
- Estimates of expenditures financed by loans and grants.
- Transactions of special extra-budgetary funds (EBF) or extra-budgetary accounts.
- Fiscal transfers to subnational governments for general and special purposes.
- All investments, transfers and other transactions between the budget and state-owned enterprises.
- Transactions in financial and non-financial assets and liabilities.

Operational efficiency requires taking into account the specificity of some expenditure programmes when designing budget management rules. Thus, when (but only when) there is a strong link between the revenues and benefits related to a particular programme or activity (anti-pollution controls or road building, for example), earmarking arrangements and user charges may be considered as a means of improving performance in delivering the programme concerned. Nevertheless, special arrangements for managing some programmes should not impede expenditure control and efficiency in resource allocation. The following minimum rules should be enforced, whatever the method of managing an expenditure programme:

- Funds, special accounts, expenditures financed by external sources, etc. should be submitted to the same scrutiny as other expenditures.
- Funds, special accounts, autonomous agencies, etc. should adopt the same expenditure classification system as other programmes.
- Transactions should be systematically recorded and presented in the budget in gross terms (even when parliamentary authorisations are netted out).

The same principles should be applied to the budgets of subnational governments.

c. Beyond cash spending

All policy commitments and decisions that have an immediate or future fiscal impact, or generate fiscal risks, should be disclosed and scrutinised together with information on direct spending. The budgetary documents should include, wherever feasible, supplementary information on contingent liabilities, government loans and guarantees, fiscal risks and quasi-fiscal expenditures, and tax expenditures.

To control indebtedness, the annual budget should include provisions that, for the fiscal year concerned: (i) authorise the ceiling on borrowing and government debt; (ii) authorise guarantees on government debt.

3. Responsibilities and powers over fiscal management

Effective budget management requires a clear distribution of responsibilities and duties within the central government, and between the different levels of the government. It also requires a carefully balanced division of powers between the legislative and the executive branches of the government. For this purpose, the legal framework must be properly designed.

To be effective as the guardian of the collective fiscal integrity of government, the ministry of finance must be sufficiently empowered, and have adequate legal and technical instruments and sufficient skilled staff to carry out its functions. The council of ministers constitutes the key decision-making body at the centre of government. The discipline of the budgeting system relies in a large part on a close co-ordination and alliance between the ministry of finance and the prime minister. Line ministries are accountable for defining and implementing government policies in their sector, within the policy framework and the budget constraints defined by the government.

The legislature should have adequate means to assess government policies, scrutinise the budget and control the effectiveness of its implementation. The government must present to parliament an essential minimum of budget documentation, which should specify its fiscal policy objectives, the macroeconomic framework, the proposed budget measures and major identifiable fiscal risks. Special parliamentary committees should be set up to review the budget and fiscal policy and to study the final account and external audit reports.

However, to ensure fiscal discipline and limit pressure to increase expenditures during parliament's debates, the powers of the legislature in amending the budget bill should be regulated (e.g. by requiring a spending increase to be offset by equivalent reductions in other expenditures).

Whatever the degree of devolution in the country, the framework that governs the fiscal relationships between central and local governments on issues such as arrangements for budgeting, powers over taxes and tax-sharing, and expenditure assignment should be transparent. To ensure fiscal discipline, control mechanisms to regulate local government borrowing must be established.

4. The legal framework and the OBL

The legal framework for public budgeting consists of several levels, namely: the constitution, the organic budget law, other statute laws (such as, depending on the country, laws on accounting, treasury, public debt management local government finance, etc.), and financial regulations and instructions. An organic budget law (OBL) provides the legal base for all key roles and relationships between the different actors in fiscal management, and lays down the major principles of budget management and auditing.

The legal framework should include, among other matters, the following principles and rules:

- Principles of integrality and universality of the budget. The principle of integrality requires that revenues and expenditures be presented in a single document, while the principle of universality requires that *all* revenues and expenditures be presented in that document.

- An analytical definition of the budget deficit and surplus, which, notably, excludes borrowings and the use of bank balances from the receipts side of the budget, and excludes repayments of principal from the expenditure side.

- Principles governing the distribution of power between the executive and the legislative branches of the government, including defined limits on the powers of the parliament to amend the budget bill and specific requirements for the presentation of budget documents.

- Rules for presenting the budget bill to the legislature and enacting the annual budget law (or the appropriation act). Procedures for the presentation and approval of supplementary spending authorities during the year, if needed.

- Rules for interim funding to continue normal government business when parliament has not approved the budget in time for the start of the fiscal year (such as monthly release of 1/12 of prior year appropriations).

- The timetable for reporting financial information to the parliament during the year and presenting the final account.

- Empowerment of the ministry of finance in financial management, including: (i) responsibility for supervising the preparation of the budget; (ii) responsibility for ensuring that expenditures are controlled within the deficit limit; (iii) authority on all government's bank accounts; and (iv) authority on government borrowing and loan guarantees.

- Rules that limit the creation of extra-budgetary funds to special cases, authorised by separate statute.

- Rules to authorise the government accounts into which all public money must be paid and from which expenditures are made only by authorisation of parliament.

- Rules for auditing government accounts.

- A legal basis for management control and internal audit.

- Rules for sanctions in the event of infractions of budget legislation and imposing a duty on public officials to report suspected criminal behaviour.

- Rules for the control of borrowings by subnational governments stipulating either that subnational governments are allowed to borrow only from the central government or that their borrowing is subject to prior approval by the ministry of finance.

The legislative framework must also provide a legal basis for the management and control of financial flows to and from the EU budget and for the functioning of the National Fund which is set up to manage EU pre-accession funds.

5. Preparing for EU Membership

The goal of accession to the European Union, and especially participation in the oversight mechanisms and budgetary discipline procedures associated with the single currency, reinforces the need for the countries concerned to strengthen the management of their public finances.

The Commission has proposed that, for candidate countries, a new informal fiscal surveillance procedure, based on the preparation by the countries concerned of "pre-accession economic programmes" (PEP), should be carried out in the period 2000 to 2002. PEPs would then be updated annually. The

PEP procedure, which replaces the existing system of Joint Assessments, is seen as a mechanism for helping candidate countries prepare for eventual membership of EMU and, later, adoption of the single currency.

In preparing for accession, in the field of public finance, candidate countries will need to give special attention to the following areas:

- Because of the prohibition under Maastricht of direct monetary financing by the central bank, the counterpart of central bank independence, the government needs to take direct responsibility for the debt management and treasury (cash management) functions. These functions should normally be located in the ministry of finance.

- Under the broad definition of public finances used in the Stability Pact, Member States need to exercise tight control over the expenditure and borrowing activities not only of the central government but also of social security funds, other extra-budgetary funds and off-budget expenditures, and the financing of subnational entities. In many countries, this requires the scope and coverage of the national and subnational budgets to be redefined in order to ensure their comprehensiveness.

- Member States are required to submit annually convergence/stability programmes to the Council (an extension of the proposed PEPs for candidate countries). The information required is based on the ESA95 standard for national accounts and public finance statistics laid down in EC regulations. Countries are also required to set their economic and fiscal projections in a medium-term framework.

- Similarly, access to pre-accession funds requires candidate countries to create a multi-annual framework for preparing bids, and to strengthen their information systems and procedures for monitoring, controlling and reporting expenditures, in accordance with the relevant EC regulations. Countries also need to develop techniques for measuring the efficiency and effectiveness of spending programmes and projects financed from EU sources.

B. DIRECTIONS FOR REFORM

Priority actions should consist of laying the foundations required for a sound system of budgeting and policy formulation, recognising specific EU requirements, including:

- A comprehensive coverage of the budget.

- Assessment, disclosure and review procedures. These should cover not only decisions relating to budgetary expenditures but all policy decisions that have an immediate or future fiscal impact, such as contingent liabilities, lending, tax expenditures, and quasi-fiscal expenditures.

- Presentation of the budget to the legislature in a timely manner, to allow its proper scrutiny, and the completion of budgetary debates, before the beginning of the fiscal year. Aggregate revenue, expenditure, and fiscal targets should be reviewed together.

- An adequate legal framework, and particularly an organic budget law that frames budget processes and procedures, and distributes clear responsibilities for fiscal management, as discussed above.

These actions should be carried out jointly with the priority actions aimed at improving budget preparation, execution and accounting procedures (see Parts II, III and IV). They are a prerequisite for further improvements in the budget system.

In addition to fundamental actions relating to the preparation of the annual budget, methods that facilitate better assessment of the government's medium-term and contingent liabilities, its loans and guaratees, and quasi-fiscal transactions and fiscal risks, should be developed. These include improvements in accounting standards, control of multi-year commitments, and procedures for forecasting the impact of government policies over the medium-term.

Once the distribution of responsibilities in budgeting is clearly defined, and the role of the ministry of finance firmly established, further improvements can be aimed at increasing responsibilities of line ministries in budget management and developing the capacity of the legislature for scrutinising the budget. Flexible management arrangements can be considered for some expenditure programmes in certain areas (e.g. delegated management for some agencies that deliver services to the public). These arrangements, however, should not make the budget any less comprehensive or impede legislative accountability and control over expenditures in the aggregate.

Issues related to the distribution of responsibilities for expenditure management among the different levels of government should be addressed in a transparent manner as soon as the basic principles for intergovernmental fiscal relations are established.

PART II

ALLOCATION OF RESOURCES

CHAPTER 4

BUDGET CLASSIFICATION, PRESENTATION AND PROGRAMMING

This chapter deals with the basic requirements for expenditure classification and the presentation of the expenditures in the budget, which are an essential element in budget and policy formulation. Beyond these basic requirements, the chapter reviews various "programmatic" approaches in budgeting. It also examines whether the so-called "New Public Management"reforms recently undertaken in some OECD countries, challenging the common organisational model of the government, fit the context of transition countries.

A. Expenditure Classification

1. The importance of a classification system

Classifying expenditures is important for policy formulation and measuring the allocation of resources among sectors; for ensuring compliance with the legislative authorisations; for policy review and performance analysis; and for day-to-day administration of the budget. An expenditure classification system provides a normative framework for both policy decision-making and accountability.

Approaches in budgeting often determine the organisation of the expenditure classification system. Thus, compliance budgeting focuses on the uses of resources and, therefore, on the classification of inputs and administrative units. Policy formulation and concerns about the efficient allocation of resources are the basis of a classification of expenditure by function and programme. A classification of expenditure programmes by activity or output is appropriate if the focus is on operational performance. Aggregate fiscal control requires an economic classification based on clear concepts (e.g. separating borrowing from receipts), as in the standard Government Finance Statistics (GFS) classification established by the IMF.[1]

Expenditures may need to be classified in different ways for different purposes, such as: the preparation of reports that match the needs of report users (policy decision makers, the general public, budget managers); the administration of the budget and budgetary accounting; and the presentation of the budget to the parliament. Expenditures should also be reported according to the international standard classification, defined in the GFS. However, it should be noted that the GFS provides guidelines on classification for reporting purpose only. It is not intended as a budget or accounting classification. Moreover, the GFS focuses only on economic and functional reporting, while budget classification needs to be an instrument of policy formulation, administration of the budget and accounting.[2]

According to the different needs for policy formulation, reporting and budget management, public expenditures are generally classified according to the following categories:

- *Function*, for historical analysis and policy analysis.
- *Organisation*, for accountability and administering the budget.
- *Fund,* for administering the budget.
- *Economic categories*, for statistical reporting and aggregate fiscal control.
- *Line-item (or object),* for compliance controls, and internal management.
- *Programme*, for policy formulation and performance accountability.

2. The UN Classification of the Functions of Government (COFOG)

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

The "Classification of the Functions of Government"(COFOG) established by the United Nations is presented in the GFS manual. The main objective of COFOG is to give a standard classification for international comparisons. The COFOG is also used to prepare the national accounts according to the System of National Accounts (SNA) methodology established in 1993, which identifies government expenditures that benefit individual households. To calculate actual final consumption of households, these expenditures are deducted from the final consumption expenditure of the government and included in the actual final consumption of households.

COFOG can be applied to government expenditures, as well as to the consumption of fixed capital[3] and financial transactions for policy purposes, (e.g. loans granted to public enterprises). The COFOG methodology was revised in 1999, in order to take into account issues such as environmental accounting and SNA93 methodology, as well as ESA95. COFOG has three levels of detail: Division (1 to 10), Group and Class. Box 4.1 contains a presentation of these divisions and groups, based on United Nations (2000), *Classifications of Expenditure According to Purpose*.

In countries that have not already developed their own functional classification, adopting COFOG instead of a customised classification presents some advantages. Such an approach is already established and well documented in the GFS manual. It facilitates international comparisons. Many countries may decide, however, to reorganise the COFOG system to accommodate their actual programme structures and deal with specific policy issues. This is recognised in the GFS.[4] In any case, a mapping table between COFOG and the functional (and programme) classification used in a particular country, or between that country's organisational classification and COFOG, should be established in order to make reports that may be required using the COFOG system.

Public reports showing expenditures according to functional categories should be prepared. They do not need to be excessively detailed, but should show at least government expenditures, on the basis of the ten divisions recommended by COFOG and the groups that are most important in relation to government policy objectives (e.g. distinguishing the different divisions of the group "education").

Box 4.1. COFOG: BREAKDOWN BY DIVISION AND GROUP

01. GENERAL PUBLIC SERVICES
01.1 Executive and legislative organs, financial and fiscal affairs, external affairs
01.2 Foreign economic aid
01.3 General services
01.4 Basic research
01.5 R&D general public services
01.6 Other general public services
01.7 Public debt transactions
01.8 Transfers of a general character between different levels of government

02. DEFENCE
02.1 Military defence
02.2 Civil defence
02.3 Foreign military aid
02.4 R&D defence
02.5 Other

03. PUBLIC ORDER AND SAFETY
03.1 Police services
03.2 Fire-protection services
03.3 Law courts
03.4 Prisons
03.5 R&D public order and safety
03.6 Other

04. ECONOMIC AFFAIRS
04.1 General economic, commercial and labour affairs
04.2 Agriculture, forestry, fishing and hunting
04.3 Fuel and energy
04.4 Mining, manufacturing and construction
04.5 Transport
04.6 Communication
04.7 Other industries
04.8 R&D economic affairs
04.9 Other

05. ENVIRONMENTAL PROTECTION
05.1 Waste management
05.2 Waste water management
05.3 Pollution abatement
05.4 Protection of biodiversity and landscape
05.5 R&D environmental protection
05.6 Other

06. HOUSING AND COMMUNITY AMENITIES
06.1 Housing development
06.2 Community development
06.3 Water supply
06.4 Street lighting
06.5 R&D housing and community amenities
06.6 Other

07. HEALTH
07.1 Medical products, appliances and equipment
07.2 Out-patient services
07.3 Hospital services
07.4 Public health services
07.5 R&D health
07.6 Other

08. RECREATION, CULTURE AND RELIGION
08.1 Recreational and sporting services
08.2 Cultural services
08.3 Broadcasting and publishing services
08.4 Religious and other community services
08.5 R&D recreation, culture and religion
08.6 Other

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

10. SOCIAL PROTECTION
10.1 Sickness and disability
10.2 Old age
10.3 Survivors
10.4 Family and children
10.5 Unemployment
10.6 Housing
10.7 Social exclusion
10.8 R&D social protection
10.9 Other

Source: United Nations (2000).

3. The GFS economic classification

An economic classification of expenditures is required for analysing the budget and defining the macro-fiscal policy position. For example, the share of wages in government expenditures and the value of transfers to public enterprises are important measures of the impact of fiscal policy. For the purposes of fiscal and economic analysis, it is important to distinguish a) interest payments, which are expense transactions, from the repayment of loans, which are financing transactions, and b) current expenditures[5] from capital expenditures. The minimum requirement for the economic classification is to be consistent with the GFS economic classification of government expenditures.

The 1986 version of the GFS is on a cash basis, while the national accounts standards (SNA93 and ESA95) are on an accrual basis. GFS 2000 is on an accrual basis with a view to creating a greater statistical comparability between fiscal reports and national accounts. However, with the exception of the consumption of fixed capital, the line-items in the economic classification of government operations, as presented in GFS 2000, apply to the cash and the accrual bases equally (see Table 4.1 below).

In a number of cases, the standard GFS tables include net items. Net items can be sufficient for the purpose of macroeconomic analysis, but not for budget formulation and management. In the government accounts, gross flows must be registered. Thus, from the policy formulation point of view, the acquisition of financial assets for new policy purposes (e.g. lending to public enterprise) should be separated from the repayments of loans, which are the result of previous policy decisions.

The cross-classification of expenditure and/or expenses by economic character and function is a very useful tool for analysing the budget. Data from such an analysis reveal the means by which the government

Table 4.1. **FUNCTIONAL AND ECONOMIC CLASSIFICATION OF EXPENSES/EXPENDITURES**

Economic classification / Functional classification	Compensation of employees	Use of goods and services	Consumption of fixed capital (1)	Interest	Other property expenses	Subsidies	Grants	Social benefits	Capital transfers and other expenses	Acquisition of fixed capital	Net acquisition of financial assets for policy purposes
General public services											
Defence											
Public order and safety											
Economic affairs											
Environmental protection											
Housing and community amenities											
Health											
Recreation, culture and religion											
Education											
Social Protection											

(1) Under accrual accounting only

performs the functions it undertakes. Table 4.1 shows an example of the cross-classification of expenditures and/or expenses.

4. Line-item (or object) classification

For the purpose of budget management, traditional budgets include a line-item (or object) classification. This classification groups purchases according to categories used for budgetary control and monitoring, such as different categories of personnel expenditures, travel expenses, costs of printing, renting property, etc. For goods and services, the line-item classification is an input classification.

The line-item classification is broadly equivalent to an economic classification, but in a number of countries, should be revised or reorganised to be compatible with the GFS economic classification. Often, for goods and services, this can be done by re-organising the line-item classification to make the objects a subcategory of the GFS economic categories. For transfers and other items, it may be necessary to provide a breakdown of objects into homogenous categories that fit the GFS classification. Capital expenditures should be defined strictly according to the SNA93 and ESA95 standards.

The line-item classification is (or was) often associated with an approach to budget formulation that focused mainly on inputs and rigid appropriation management rules. However, in any efficient internal management system, close monitoring of inputs is required. The ministry of finance does not need to review the allocation of resources between expenditures for, say, paper and other supplies, but the managers of the spending units need to do so. Accurate monitoring of expenditure items for which there are risks of arrears generation (such as the consumption of gas, electricity and services of other public utilities) is desirable and this requires an input classification that is properly designed. In some cases, rules for either capping or protecting some line-items may be needed. However, this does not necessarily require a very detailed input classification.

5. Administrative classification

An administrative classification of expenditure (by governmental organisation) is needed to identify responsibilities for the main blocks of public expenditure and for day-to-day administration of the budget. Expenditures should be divided into separate sections for each ministry, department or agency. The administrative classification should be organised according to the different levels of responsibility and accountability in budget management (e.g. the administrative units in line ministries that deal with the ministry of finance in preparing the budget, and the unit(s) that submit financial reports to the parliament). It needs also to be tailored to the organisational arrangements for budget administration (e.g. the hierarchical levels within a line ministry that deal directly with the treasury for payment processing).

In some countries, statistical information on expenditures is presented by organisation, but not always at the same level of aggregation or in a consistent manner. For example, personnel expenditures may be presented at the level of the ministry, while other current expenditures are presented by lower level government entities (e.g. departments or subordinated agencies). This could be suitable for administration and control, but makes it difficult to carry out assessments of the operating costs of different ministries and agencies.

A project is a single, non-divisible activity with a fixed time schedule and a dedicated budget. Some projects are managed through special organisational arrangements, and have for example their own accounts. In such cases, the project can be seen as a subdivision of the spending unit responsible for its

management, and, therefore, is the lowest level of the administrative classification. Projects can be also regarded as a level within a programme and activity classification.

6. Programme classification

A programme is a set of activities that meets the same set of specific objectives (e.g. the development of crop production). In contrast to COFOG, a classification by programme takes into account the government's policy objectives and how these policies will be implemented.

A programme consists generally of several activities and/or projects. Within a budget system, the notion of programme can be used either for some special activities, or as an element of the expenditure classification system. When the programme is a category of the budget classification system and all expenditures are classified into programmes, they may or may not have a definite time schedule.

A programme has a clearly defined budget, and can be distinguished from a policy, which is a set of activities that may differ in type and may have different direct beneficiaries. Policies are directed towards common general objectives and goals. A policy is generally not restricted in terms of budget and time schedule. It consists often of a mix of actual or intended expenditure programmes, tax measures, and regulations. In terms of expenditure classification, an activity is a subdivision of a programme into homogenous categories (e.g. the vaccination activity within a disease prevention programme, which encompasses several activities).

The hierarchy of "broad function" or "strategic area", "programme", and "activity", is comparable to that of the government structure ("ministry", "directorates", and "divisions"). In theory, there is no systematic relationship between a functional and programme structure and the organisational structure of government, but it is important for both accountability and management purposes to establish the programme structure according to organisational responsibilities. Figure 4.1 below shows the relationship between programme/activity categories and other classifications. In this figure, the activities carried out by a given organisation ensure the necessary link between the programme structure and the organisational structure.

Classifying expenditures by programme can serve two purposes: (i) identifying and clarifying objectives and policies; and (ii) monitoring operational performance through performance indicators, which may relate to the inputs, outputs or outcomes of a particular programme. A classification by programme can contribute to improved transparency and accountability. However, programme classification is not an end in itself and should not be allowed to divert attention from more important matters, e.g. proper analysis of the underlying policy issues.

7. Other classifications

Other classifications may be needed: for example, for the management of EU pre-accession funds. Expenditures should be classified by the source of financing and counterpart funds used for recording external loans and grants. EBFs or treasury special accounts also need to be identified. Other special classifications may be needed for managing the budget. For example, parliaments often make requests to the government for information on expenditures by region. An information system for budget management should be sufficiently flexible to integrate classification requirements that were not expected when it was designed.

8. Implementation issues

a. Expenditure classification and budget management

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

- *For tracking uses of appropriations ("budgetary accounting"),* making bookkeeping entries, coding transactions, etc., it is necessary to define an expenditure classification that includes, at a minimum, the relevant administrative categories (i.e. spending units) and possibly an additional subdivision of spending unit by activity, funding and financing sources, and the economic-object classification.

- *For presenting the budget to the legislature,* it is necessary to define the "appropriation", i.e. what is binding for the executive (the budget of a ministry, a programme within a ministry, individual objects, etc.).

- *For managing the budget,* it is necessary to determine at which level rules for transfers between budget items, controls, etc. are established (i.e. at the level of line-items, economic categories, programmes, etc.). Sometimes, a "rationalisation" of the object code has lead to increased ex ante controls, because additional line-items have been introduced. A change in budget classification should include a review of appropriation management rules and of the impact of any proposed changes on the administration of the budget.

b. Administrative and institutional issues

Classifying expenditure requires first an identification of the technical and institutional constraints on reforming the system. Attention must be paid to the organisation of the books and the information systems. For example, when interest payments are mixed with amortisation (repayment of capital), there is an obvious need to separate them, but even more important is the scrutiny of how the debt management office keeps its books. In addition, badly designed or documented information systems can be an obstacle to reforming expenditure classification systems. Therefore, a review of current applications and software is generally required before undertaking such a reform. Software and application developments should not only be compatible with the existing classification but also allow for further developments of the system.

Reforming expenditure classification systems cannot resolve deficiencies in reporting caused by unsatisfactory institutional arrangements. For example, a powerful extra-budgetary fund may resist the introduction of a more "transparent" classification system. In such cases, the institutional issues must be addressed properly; it should not be expected that a budget classification reform can substitute for administrative reform.

c. Reporting and coding

When reforming an expenditure classification system, changes in the organisation of the accounting systems should focus on what is required to identify transactions properly. Often, a reform of the budget classification system attempts to include in the hierarchical nomenclature or the codes used in day-to-day administration, the codes of all categories needed for reporting (functions, programmes, etc.). Consequently, the coding system used to register the transactions becomes cumbersome and difficult to

manage, particularly if budget execution is not fully computerised. This has contributed to halting or delaying the reform of the expenditure classification system in several countries.

Such cumbersome structures can be avoided. For example, countries that have a detailed administrative classification do not need to change the format of the accounts and coding systems in order to report under COFOG. The SNA93 and the GFS manuals make a similar suggestion.[6] For example, if a report on payments uses a classification by "division/project" and if "divisions/projects" are categorised according to the COFOG system, it is possible to present the payments consistently with COFOG by simply linking the report on payments and the table which classifies organisations according to COFOG categories. This can be done easily with a personal computer and a spreadsheet. In a few special cases, where several functions are assigned to a spending unit, it is necessary to classify the activities of the relevant organisations according to COFOG, but this does not require a major change in the classification structure. A small addition to the administrative code is sufficient to identify the relevant activity. A similar approach can be adopted in the case of a programme classification.

Figure 4.1. **ILLUSTRATIVE RELATIONSHIPS BETWEEN EXPENDITURE CLASSIFICATIONS**

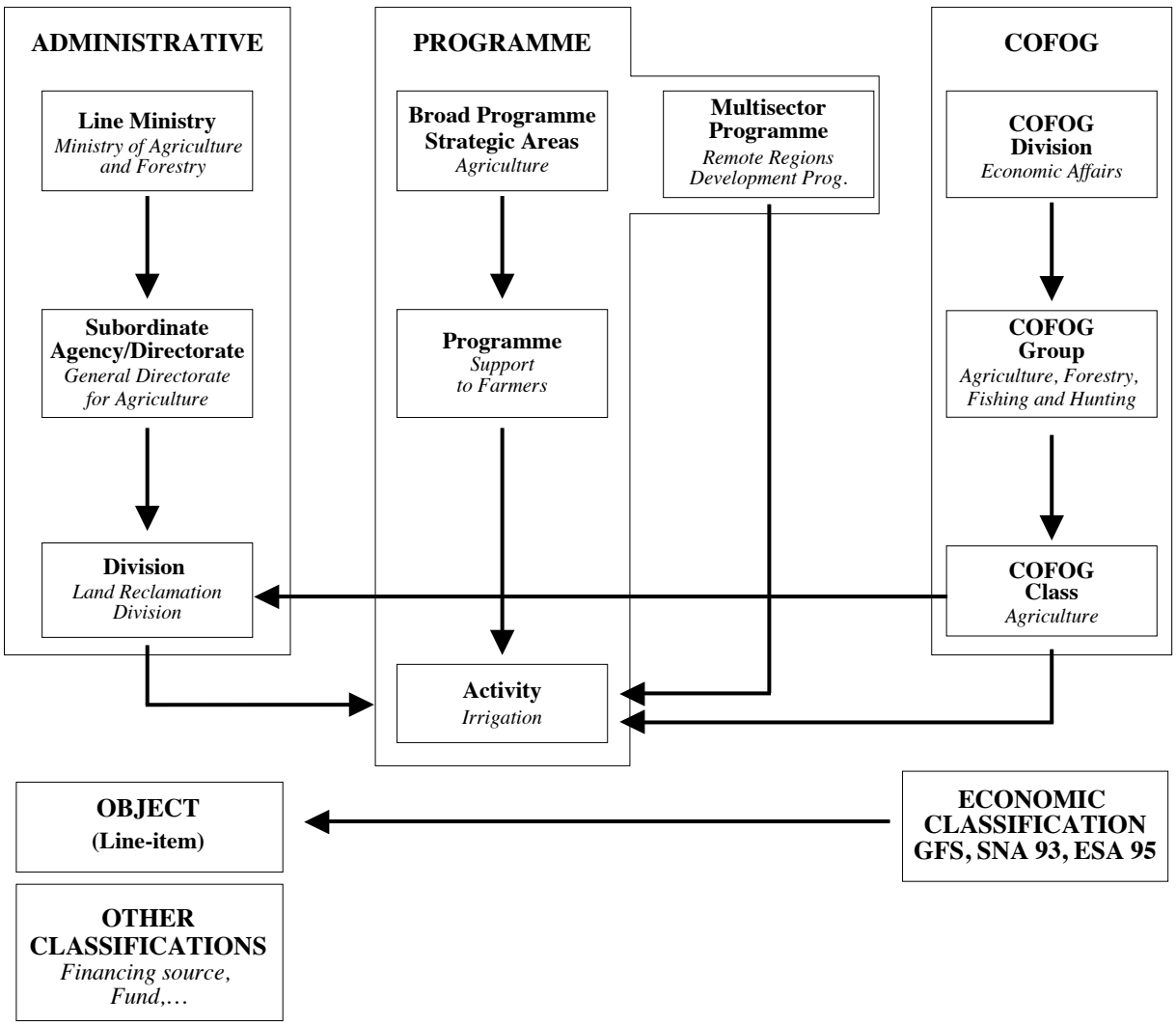

Figure 4.1 shows the different expenditure classification subsystems and the relationships between them. Combining the division (or in a few cases, the activity), the line-item and the financing source (or the fund) generally gives a "common denominator" to the expenditure classification subsystem. The coding system used in day-to-day administration of the budget must identify this common denominator, but does not need to describe all the other attributes of the expenditure item.

Generally within a single category of the classification system (e.g. the administrative category), a decimal or hierarchical coding is needed (e.g. to show the hierarchy of line ministry, general directorate, division). In a number of countries, this hierarchical approach is also adopted in the budget nomenclature used for day-to-day management. The nomenclature is, for example, organised as follows: line ministry ->directorate->spending unit->line-item/object->budget code (including the administrative and line-item/object codes).

Establishing such a hierarchy is important for defining the presentation of the outlays in the budget, or the appropriation management rules. A hierarchical, or decimal, coding is also useful within a financial management environment that is largely based on manual (as opposed to computerised) procedures, but it should be kept as simple as possible. Within a computerised environment and when the budget transactions are recorded in a "relational database", a hierarchical coding system is less useful. A relational budget database consists of tables linked by certain rules and definitions. Each table should correspond to only one category of the budget classification system, and the codes are defined table by table, and category by category (organisation, function, line-item/object, etc.). For reporting or implementing automated controls, various combinations of these elementary categories and codes are possible.

B. Presentation of Expenditures in the Budget

1. Major requirements

The budget submitted to the legislature should include all elements needed to assess budgetary and fiscal policy. It should also present the appropriations according to the needs of parliament to carry out its scrutiny activities. Information on revenues, expenditures, government borrowing and other fiscal data should be presented together.

The desirable number of appropriations depends on various elements, such as the rules governing transfers among these appropriations, the organisational structure of the government, and the distribution of powers in budgeting between the legislature and the executive. A large number of appropriations tends to rigidify budget execution, but the appropriations must be sufficiently detailed to show the major policy commitments of the government, and allow parliament to debate them.

In some non-European countries, the number of appropriations is limited to about 20 or even less. A detailed annual expenditure plan by organisation, programme, and economic category, is prepared but is essentially an internal management document for the use of the executive. In such cases, the powers of parliament in budgeting tend to be very limited and, if so, do not satisfy the essential criteria of good governance.

The budget appropriations may or not include subitems for information only. Some countries present thousands of such line-items in the budget, others a much more restricted number. Thousands of line-items can make analysis of the budget difficult and requires summaries to make the material readable.

It is very important to clearly identify in the budget which organisation within the government is responsible for managing each major item or programme of expenditure. Outlays should therefore be presented by line ministry and their major subdivisions, as shown in Box 4.2 below.

If a classification by programme is established, the programmes can be either integrated into the presentation of the outlays according to which organisation is responsible for managing them, or presented separately. The latter approach can offer more flexibility in organising the programme structure, and its relationships with the administrative structure. For example, when within a line ministry some programmes are attached to a general directorate, while other programmes are attached to a department or division, it is difficult to show such information in a single presentation. Relational database management systems allow various presentations of the outlays in the budget, which can either be detailed or summarised.

The outlays presented should be compared with the outlays of the previous year.

Box 4.2. **BUDGET OUTLAYS CLASSIFIED BY RESPONSIBILITY**

Line ministry (or agency)

Directorate (or other major administrative subdivision)
Programme and project (where appropriate*)*
Current expenditures
Domestic resources (General Fund)
Line-item
Other funds *(if any)*
Line-item
External resources
Line-item
Capital expenditures (domestic/external resources)
Domestic resources (General Fund)
Line-item
Other funds *(if any)*
Line-item
External resources
Line-item

2. Annexed budgets

In a number of countries, the budget is presented in several separate sections or documents, so-called "annexed budgets", such as the "current budget"; the "development budget"; the "administrative equipment budget"; and the "social security budget". Annexed budgets may be required because of legal or administrative arrangements. They are seen in some countries as necessary to grant autonomy to some certain bodies (universities, courts of justice, etc.). However, to limit the problems of such a fragmented presentation of the budget, it is desirable to show explicitly the whole budget of each line ministry (including memo items for the relevant annexed budgets). Expenditures of the annexed budgets should be classified according to the principles discussed earlier.

3. Other presentations of the budget

a. Presentation by function and programme

A presentation of the budget by function should show past developments of expenditures over several years. Comparisons by function are more relevant than comparisons by organisation, or even programme, since the administrative and programme structures tend to be less stable than the functional structure. Such a presentation should also include, at an appropriate level of detail, narrative statements, including explanations of goals and expected results, presented according to major sectoral policy objective and function (and by programme and activity, if a detailed classification is implemented). As indicated earlier, the programmes, if any, may be either integrated into the presentation by organisation or recorded separately.

If prepared in a consistent manner, multi-year estimates can be annexed to the budget.

b. Presentation of capital expenditures

A number of countries present capital expenditures and current expenditures in separate documents or in two distinct parts of the budget, rather than as an integrated structure. This makes the analysis of line ministries' budgets difficult and should be strongly discouraged. Nevertheless, a clear distinction between current and capital expenditures is necessary, for the purposes of analysis and efficient policy decision-making.[7] Showing separately (in an annex to the budget, or in summaries), the capital expenditures components of the budget and the forward costs of budgeted projects helps analysis of the budget. If such information is prepared, the authorisations of forward commitments should also be presented in the budget, preferably with an indicative schedule of forward payments. In countries that prepare a public investment programme that is distinct from the budget, it is desirable to compare the budget and the investment programme in the budget documents (for example, in budget annexes or in memorandum items).

c. Aid-financed projects

Aid-financed projects often include both capital and current expenditures. In a number of transition countries, it is difficult to identify the projects financed by external sources in the budget, because their capital component and current component are presented in separate sections of the budget of the relevant line ministry. This complies with the recommendations made above to classify expenditures according to their economic category. Nevertheless, for purposes both of good management and transparency, aid-financed projects should be clearly identified in the budget, especially when they are of significant size. Therefore, it can be desirable, in countries that benefit from aid-financing[8], to present in a budget annex the list of externally financed projects, with their domestic counterpart financing. In such cases, the list of project-loans and grants should be included in the budgetary documents. Such a presentation of aid financed projects, however, should not be seen as a substitute for presenting these projects in the budgets of line ministries.

C. Programmatic Approaches

1. Performance and programme budgeting: past experiences.

In several centrally planned countries (e.g. those of the former Soviet Union), the budget was traditionally presented by programme. This was consistent with the central planning approach and the

preparation of budget allocations on the basis of norms, a tradition that lingers on in many of these countries. In many other countries, what could be considered as the "traditional" budget is the "line-item budget" presented by organisational and economic category (line-item/object). As long as it is comprehensive and includes an appropriate classification system, a line-item budget fits well the requirements of expenditure control both at the lowest organisational level and at the aggregate level. It allows responsibilities in budget management to be clearly identified. Its strengths lie in its simplicity and lack of ambiguity for controlling the use of resources. Line-item budgets were (and in a number of countries still are) associated with an "input-oriented" budget preparation and rigid and detailed ex ante controls. However, approaches differ from country by country. In a number of countries, the main aim of the control system is to avoid making transfers between personnel expenditure and other items, and detailed line-items may be included in the budget for information only.

Nevertheless, a major criticism of the line-item budget is that it does not deal with key objectives of government policy; their links to the budget; and the search for the most efficient combination of inputs to deliver the services provided by the government. In order to address these issues many industrialised and developing countries have attempted, over the last 50 years, to implement performance or programme budgeting systems. Such budget systems are designed to assess the efficiency and effectiveness of government activities. Within a performance or programme budget, expenditures are classified by programme and activity, the operational aims of each programme are identified, and performance indicators are set up for every programme and activity. Historically, performance and programme budgets were intended to replace the line-item budget and become the main instrument of resource allocation.

The first experience with performance budgeting on a wide-scale was launched in 1949 in the United States, following the recommendations of the Hoover Commission. Emphasis was put on full cost measurement, evaluation of workload and reducing unit costs. The focus was on the work to be done, not on the usefulness of the objectives themselves. Performance budgeting was aimed at increasing operational efficiency rather than allocative efficiency. From 1951, the US budget included listings of the programmes or activities by budget account and narrative statements describing programmes and performance, some of them presenting workload and cost information, calculated on an accrual basis. Despite the substantial amount of performance information and analysis that was produced, the experiment was not deemed to have been a success. In addition to technical difficulties in areas such as cost measurement, concerns were raised that the budget did not adequately link policies with programmes.

The search for a method of budgeting that would also take into account the effectiveness of expenditure led to programme budgeting. (In the literature on budget reforms, programme budgeting is either considered as a form of performance budgeting or treated as a distinctive approach.[9]) The Planning Programming Budgeting System (PPBS) was implemented throughout the US government in 1965. PPBS was designed as an instrument for allocating resources among programmes. PPBS processes consisted essentially of three phases. In the planning phase, systems analysis was used to establish the objectives and identify related solutions. At the programming stage, means were reviewed and compared to the solutions identified at the planning stage. Sets of activities were grouped into multi-year programmes, which were appraised and compared. Cost-benefit and cost-effectiveness analyses were then used to compare the various programmes and activities as competing means of achieving a given objective. Finally, the budgeting phase translated these programmes into the annual budget.

After six years of effort and discouraging results, the PPBS was abandoned. Indeed, it seems that the goal of reaching a perfect and indisputable rational organisation of government objectives and activities is illusory. A fundamental problem with PPBS was that it neglected the political aspects of the decision-making process. The fact that government objectives and activities are political choices that reflect trade-

offs between different value judgements was not sufficiently recognised. PPBS attempted to overcome administrative compartmentalisation by making programmes independent of organisational affiliation. Such a technocratic approach broke an important link between the programme structure and the administrative structure and thus met resistance from managers. Moreover, the usefulness and applicability of economic analysis in this field were exaggerated. PPBS increased the volume of work significantly, since officials were charged with preparing both the regular annual budget and the programme budget. PPBS required highly trained administrators to conduct the various analyses and studies, and they were in short supply. Moreover, the imposition of the system from above was an unlikely basis of success.

In the late 1970s, another experiment — Zero Based Budgeting (ZBB) — was attempted in the US. Literally interpreted, ZBB consists of evaluating all programmes each year and preparing the budget from scratch, instead of concentrating on budgetary changes at the margin. In practice, the ZBB system did not go so far. Agencies were asked to rank the programmes within predetermined funding limits. The main features of the system consisted of: (i) formulating objectives for each agency; (ii) identifying alternative approaches to achieving the agency objectives; (iii) identifying alternative funding levels, including a "minimum" level normally below current funding; (iv) preparing "decision packages", including budget and performance information; and (v) ranking the decision packages against each other. In practice, some agencies did not identify minimum levels below current funding, and many identified these levels as an arbitrary percentage of current funding, generally in the range 75-90% (GAO, 1997a). Moreover, ZBB was excessively time-consuming and proved to be short-lived. The ZBB approach is useful for occasional expenditure reviews (and has been applied as such in the UK and other countries), but in practice it is impossible to undertake ZBB each year for the preparation of the annual budget.

In addition to the US, programme budgeting has been attempted in many countries,[10] but in most cases these experiments did not survive long. None proved to be successful in becoming an effective instrument for central resource allocation. For example, in the context of Latin America, Petrei (1998) notes: "In theory, several countries in the region have programme budgeting, and in some cases this includes quantitative goals. But they play no role in budget discussions, nor are they used to monitor the use of program funds."

Despite these disappointing results, past experiments with programme budgeting were not without some lasting benefit. For example, PPBS contributed to the development of economic analysis within government and the development of functional classifications of expenditure as a tool of policy prioritisation and assessment. The analytical methods underlying PPBS are still used today, but on a case-to-case basis rather than as generalised instruments for resource allocation among sectors. As Lacasse (1996) comments: "the need for budget comprehensiveness; the preoccupation with specifying ends-means relationships in policy formulation and evaluation; the concerns with cross-impacts and substitutability of programmes; the insistence on forecasting and comparative assessment of new policy initiatives; all these were not born with PPBS, but did at that time receive their basic formulation, which is still largely in use today".

2. Recent approaches to budget programming in OECD countries

Some OECD countries are currently developing a programmatic approach consisting of clarifying the objectives of each agency and programmes; preparing strategic plans and performance plans; and programme evaluation. The features of these approaches to budgeting vary from country to country.

These reforms meet many of the concerns that led to the disappointing outcome of many early experiments in performance and programme budgeting. Instruments such as performance and cost

measurement are regaining attention. As a result of the development of information technology systems, such procedures are nowadays easier to implement than in the 1950s, although a number of difficulties remain. Compared to the PPBS experience, the more recent approaches do not attempt to replace normal administrative arrangements with a programme budgeting approach. On the contrary, an emphasis is put on the key role of spending agencies. In a few countries, "resource agreements" between the centre (e.g. ministry of finance) and spending agencies may subject a certain portion of expenditures to performance agreements (for example, funds may be provided for investment on the condition that staff savings will result). But, in most cases there is no direct link between performance and the allocation of resources among programmes.

3. Possible approaches to budget programming in transition countries

a. Intersectoral resource allocation

Clarifying the objectives of the government and preparing sectoral budgets that match the government's policy objectives is always required. This requires mechanisms for policy co-ordination and for building hard constraints into the budget process, since defining objectives or preparing sector programmes without an effective control of fiscal aggregates often leads to the enunciation of generalised and poorly defined policy objectives, and the preparation of wish-lists by line ministers. Specifically, in the context of most transition countries, increasing the capacity of the ministry of finance to co-ordinate the preparation of the budget, and clarifying the role of each participant in the budget process are necessary (though not sufficient) conditions to develop a programmatic approach.

Developing a programmatic approach can be undertaken in different ways, such as preparing sector strategic plans and performance plans, strategy papers and sector reviews. Some transition countries have recently launched, or are in the process of developing, the preparation of programme budgets. Presenting expenditures by programme may help to focus thinking about public expenditure in terms of its objectives and outputs, provided that the budget formulation process encourages spending agencies to prioritise their programmes properly.

Programmes are generally described through programme profile forms. These forms include a narrative statement, indicators of past and expected performance, and cost projections. Box 4.3 shows an example of a programme profile form.

When the main purpose of developing a programmatic approach is to strengthen analysis of the budget and help in the intersectoral allocation of resources, the programme can be relatively wide in scope and correspond to a broad objective or function of the line ministry, or a strategic policy area (e.g. primary education). In such cases, the "programme" will be defined as a grouping of pre-existing budget items, provided that the functional and administrative classifications have been correctly set up. It can correspond, for example, to a grouping of the categories of COFOG. The COFOG system may need, however, to be adapted to deal with policy issues specific to the country concerned. Alternatively, the programme can be defined as a directorate within a line ministry; or a group of administrative divisions that perform a similar function.

Such approaches to defining "programmes" are empirical, while the logic of a systemic programme budgeting approach would suggest starting with the definition of policy goals and objectives before making a definition of programmes. An empirical approach is nevertheless more cost-effective. It would be difficult, and somewhat illusory, to define an organisation's objectives independently from its structure and pre-defined functions.

Box 4.3. AN EXAMPLE OF A PROGRAMME PROFILE

Background information on the spending ministry's budget request

- Ministry's broad policy goals and objectives.
- Ministry's policy priorities (linked to relevant legislation).

Programme profile

- Programme name.
- Programme objectives.
- Projects and activities included in the programme.
- Performance indicators (inputs, outputs and outcomes):
  - — Review of performance over the previous year(s) and targets for the current year.
  - — Targets for next year.
  - — Targets over a period of 2 to 3 years (if multi-year programmes are prepared).
- Cost estimates (by financing source):
  - — Actual data for the previous year.
  - — Budget for the current year.
  - — Request for the budget under preparation.
  - — Forward cost estimates for the next 2 to 3 years (if multi-year programmes are prepared).
- Contingencies and risks: key assumptions and external factors that may influence the success of the programme.

Indicators and narrative statements should be presented with the programmes. But at this level of aggregation, indicators serve basically to illustrate the major policy issues, and provide feedback to policy decision-makers, rather than to monitor operational performance. A few countries such as the UK have nevertheless, in some areas, set up both a system of higher level indicators and specific indicators aimed at monitoring the operational performance of government agencies. Of course, it would be unreasonable to allocate budgetary resources on the basis of programme performance alone. Poor performance in priority sectors often calls for increased resources, not decreased resources. Sometimes,

a budget detailing programmes and activities may include hundreds of pages of narrative statements and indicators. Such budgets can be very difficult to analyse and, as a result, sufficient attention may not be paid to them. A presentation of the budget by programme should focus first on strategic areas (or main programmes/functions) and on the strategic policy objectives of the government.

Disappointments arising from past experiments with programme budgeting suggest avoiding complex expenditure re-classification exercises and keeping the classification by programme simple. When developing a programmatic approach, efforts should be devoted to describing the objectives of the government, not to engaging in elaborate expenditure re-classifications. Indeed, presenting expenditures by programme may facilitate analysis of the budget, but only if the programmes are defined in a clear and simple manner.

b. Programming expenditures within agencies

At the agency level, programmes should be defined in the most convenient manner for internal management. The programme structure should be appropriately detailed, and programmes should generally be divided into activities. The activity corresponds, in principle, to a limited number of outputs. Performance indicators are set up by activity, and monitoring procedures provide feedback to programme managers, which is useful in allocating resources among activities. For example, the fact that an AIDS prevention programme has led to unsatisfactory results, should encourage the ministry of health to redefine the activities carried out under this programme. In addition to providing feedback to operational decision-makers, performance monitoring can be also used in results-oriented management systems (e.g. where part of the pay of managers is related to performance). However, as discussed in Chapter 15, caution is required in this area.

A standard functional classification such as COFOG does not necessarily meet the requirements of a system for monitoring the performance of detailed programmes. Line ministries are responsible for operational performance in their sectors, and therefore for defining and designing appropriate monitoring instruments. Similarly, the classification of expenditure by programme or activity should be prepared by the line ministries and agencies concerned, within a methodological framework established by the ministry of finance.

A wide and detailed programme budgeting exercise is not required in order to implement a system of performance indicators. For example, if the main outputs of a healthcare centre are medical visits and vaccinations, measuring the performance of that organisation does not require preparing programme budgets for such activities. The indicators can be based directly on the budget of the healthcare centre. Moreover, programmes and activities for supporting operational management can be established by spending agencies for internal management purposes only, and do not call for a government-wide programme budgeting exercise. For example, to achieve the objective of increasing the proficiency of students in the English language, the ministry of education may want, for internal management purposes, to set up an "English study programme", and plan and monitor various activities such as buying books, training teachers and preparing a new curriculum. However, this does not require dividing the budget into categories such as an "English study programme budget", a "mathematics study programme budget", and so on.

c. Accountability and management issues

A programme classification of expenditures should not be seen as a substitute for an administrative classification, which is an essential foundation of an effective system of public management and public accountability. Transition countries have largely abandoned their previous budgeting methods based on programmes and norms. However, many of them have yet to achieve efficient and transparent input

budgeting, with appropriations linked to the entities that will actually spend the money, rather than to Soviet "spheres" of activity, or to programmes. Transition countries would be mistaken to regard the development of a programme classification of the budget as a reason for reinstating these old practices. For example, it is recommended in this book that the ministry of finance should establish, with the agreement of the council of ministers, initial expenditure ceilings at the start of the budget preparation process, and notify these ceilings to line ministries. In most cases, such ceilings will be based on the budget of an organisational entity (i.e. a line ministry or major spending agency), rather than a programme budget, even when the ministry's budget is based on a programme classification.

Programme budgeting may create delays in preparing the budget, especially if the programme structure is very different from the administrative structure. "Mapping" programmes and organisations responsible for their implementation can be done with the aid of a computer, but conducting budgetary negotiations in terms of both programmes and organisations needs time. Expenditures classified by programme must be easily comparable with expenditures classified according to the budget classification used to administer the budget. If the budget is managed or monitored by programme, the programme structure must match the arrangements for preparing the accounts. When the budget preparation process is open-ended, line ministries may sometimes propose an arbitrary increase in the number of their activities in order to justify increased budget requests. Of course, the ministry of finance must be wary of such tactical devices.

It can be desirable to establish interministerial programmes for expenditures that have an impact on more than one policy area, and more than one ministry (e.g. a nuclear energy programme may impose environmental costs on society; a regional development programme often raises policy issues affecting several ministries). However, this should not prevent presenting the different components of a programme in the budget of the ministry or agency that is primarily responsible for its management. A table annexed to the budget showing which activities are covered by interministerial programmes should be sufficient for the purpose of decision-making and the monitoring and control of programme implementation.

d. Concluding remarks

In theory, programme and performance budgeting are aimed at improving both policy decision-making and operational performance. A cost-effective approach can consist of:

- For *documenting resource allocation and sector policies*: preparing descriptions of broad programmes or functions, including narrative statements supported by relevant performance indicators. Such a description of the main programmes can document the budgetary requests from line ministries and be presented with the budget in order to facilitate the scrutiny procedures carried out by the parliament.

- For *programme management*: implementing appropriate instruments tailored to the specific characteristics of a sector and the main policy issues for which it is responsible. Preparing internal multi-year programme budgets for programming and monitoring specific activities is highly desirable in sectors directly involved in public service delivery. However, such activities do not require a government-wide reclassification of all expenditures.

- Developing, progressively, *feedback mechanisms* such as programme evaluation (see Chapter 15).

The ministry of finance can encourage agencies to develop an internal programmatic approach by specifying requirements, in the annual budget circular, for line ministries' budget submissions. However, excessive expectations should not be placed on the capacity of such technocratic procedures to contribute

to central resource allocation decisions. "Where the budget system and processes are performance oriented it is because the institutional framework both encourages and demands performance, rather than because specific techniques and instruments are implemented" (World Bank, 1998). Moreover, as an OECD (1997e) study notes: "Inputs are still important as a budgetary guideline; the link between performance and the budget is indirect and often inferential rather then direct and automatic; and budgetary pressure moves the use of performance indicators more to the ex post evaluation [phase]."

D. Managerialism

1. What is "Managerialism"?

When developing a performance oriented approach in budgeting, some OECD countries are putting a special emphasis on the role of the agency and on the development of market-type mechanisms. These approaches challenge the public management models that are commonly used. Public administration has been based traditionally on a hierarchical model and a chain of command in which there is strict adherence to orders and instructions from higher to lower levels, and where a high degree of job security and strong internal discipline is prevalent, based on compliance with pre-set rules and regulations.

A concern for strengthening the performance of public administration, during a period when resources devoted to the public sector are tightening, has resulted in a search for systemic approaches to improving operational efficiency. To this end, two broad approaches can be considered.

The first approach is aimed at empowering managers by increasing their degree of operational freedom whilst also increasing their accountability. The array of management tools that have been proposed to achieve this result include planning and evaluation, devolution and flexibility in using resources, targeting and measuring performance, and corporate planning and regular evaluation using benchmarking criteria. This approach builds on existing management systems and organisational structures.

The second, generally more radical approach, often described as "managerialism", consists of applying or simulating market behaviour in government agencies, and is one of the key elements of what has been called the New Public Management (NPM) model.[11] The broad aim of introducing managerialism in government is to make public managers manage on terms similar to the private sector. It incorporates recent elements of the theory of the firm, which explore the relationship between the person (the principal) who engages another person (the agent) in order to undertake specified actions. The functions of the agent and the principal are clearly separated. The relationship between the agent and the principal takes the form of explicit or implicit contracts, which provide incentives to ensure that the actions of the agent are on the desired lines, and can avoid bureaucratic "capture" and distortions of the principal's objectives.

An important feature of the NPM paradigm is the role of the agency. In countries such as the UK and New Zealand a large number of separate entities or agencies has been created to perform operational activities. By drawing a boundary around operational functions and giving the task to a separate entity, it is assumed that the responsibilities of staff and managers can be clearly specified, performance measures developed, and staff and managers made directly accountable for their performance. Moreover, the traditional accountability for financial compliance is extended to accountability for efficiency and economy in operations and, in some cases, for outcomes. Agencies have their own accounts, on a quasi-commercial basis, are set financial targets and produce annual financial statements that disclose their financial performance, assets and liabilities. The development of accrual accounting and budgeting systems is another aspect of this enhanced focus on outputs and results.

"Output-budgeting", which has been adopted in New Zealand is the most comprehensive application of the NPM principles and doctrines. The ministers are seen as "principals" and the "chief executives" of the executive agencies as their "agents". Contracts between the ministers and chief executives are based on outputs, not on outcomes since the outcomes are affected by many variables beyond the control of the agents. "For example, the police commissioner contracts with the minister of police to provide a certain level of policing services, patrols, community security programmes, road safety commercials, etc. The commissioner does not contract to lower the crime rate. The crime rate is affected by many variables beyond the control of the commissioner." (Bale and Dale, 1998). Budgetary appropriations for outputs are on an accrual basis and defined by class of output.[12] At present, the costs of outputs are determined on the basis of the costs of inputs. Therefore, in fact, the budgeting processes are not yet fully output-oriented.[13]

2. Relevance of the managerialism model for transition countries[14]

Should transition countries consider adopting the managerialism approach? Scientific methods are required in order to evaluate the effects of some NPM experiments on the behaviour of public servants and the efficiency and effectiveness with which public services are delivered. Insufficient evidence has been collected to date. Too little time has elapsed to assess whether the experiment has been a complete or partial success. This fact alone should be warning to transition countries not to proceed down this road without considerable caution. Schick (1998) makes several powerful arguments about the dangers of replicating the New Zealand approach in countries that have still to build up the basics of a budget system and other essential pre-conditions.

Many of the contracts into which governments enter under the reformed New Zealand model are not real contracts in the commercial sense, that is, they are not governed by arms-length relationships and do no allow the "buyer" of services to terminate the contract and seek redress through the courts if the "seller" fails to deliver. Contracts where the "buyer" of services is a minister and the "seller" is an official in the ministry or agency concerned are particularly unreal in this sense. In any case, not all activities can be easily contracted. Only activities that are easily quantifiable and predictable, low on political sensitivity and the need for discretion can be well specified under contracts.

The idea that it is possible to write complete purchaser-provider agreements that define clear and unambiguous incentives and performance standards for most government has to be dealt with very carefully. In Western countries, extensive use of such contracts may weaken the traditional values of public service, personal responsibility and professionalism, and information and feedback mechanisms between policy and delivery. An element of informality is an essential lubricant to oil the wheels of a public administration machine in which formal procedures and rules govern all significant government activities. Reducing informal communications and interchange can leave both sides impoverished. This was well recognised by the New Zealand Department of Labour, which resisted separation of policy and service delivery for some years.

In transition countries, such use of contracts may make it more difficult to build a modern system of public administration that incorporates the essential qualities and ethical standards consisting of the traditional values of public service in western democracies. Where rules to govern public administration are lacking, the costs of informality will be high. Time and resources will be spent in beating the system, without paying real attention to the results of programmes. In a financially and politically uncertain context, funds voted to a contractor are likely to be related to the amount of leverage the agent can exert over the contracting principal, and to the amount of ignorance of the principal about what the service costs.

Process standards — competitive recruitment and promotion, ethnic and gender fairness, honesty and transparency, impartiality in the use of control rights conferred by regulatory power, exercising the State's monopoly of coercion with restraint and decency — are an important part of what governments should deliver. Reducing this complexity to a line-item — in both financial and service terms — can open government activity to abuse and corruption and leave the public vulnerable.

Negotiating and enforcing contracts entails substantial transaction costs. Capacity constraints are also likely to be important. Managing contracts requires defining performance ex ante, measuring it ex post, calibrating rewards accordingly and in ways perceived to be fair. It is difficult and potentially risky to apply a contract management approach in countries that have traditionally functioned on the basis of command rather than collaborative and consultative behaviour.

Creating separate agencies for public service delivery can improve operational efficiency, and can be desirable in transition countries for certain functions. Nevertheless, caution is required. In a number of transition countries, the "separate entity" can easily in practice degrade into "extra-budgetary fund" with consequences that have already been discussed in this book. It is also questionable whether an organisational reform is really needed to clarify mandates (e.g. compared to appropriate delegations of authority). Moreover, in many countries, decoupling policy advice from service delivery, without giving increased resources to the central departments responsible for policy advice, tends to result in fragmentation and inconsistency in the formulation of sector policies, since in effect these policies end up being formulated by the entities responsible for delivering the services. The typical outcome is a different variant of "capture". The ministry of finance deals directly with the service delivery entities when preparing the budget whilst the line ministries are little involved. For example, in transition countries, the budget of the transport sector is often negotiated between the ministry of finance and the relevant agencies, with weak co-ordination at the sectoral level.

Accountability requires developing proper accounting and financial reporting systems. However, it must be stressed, that for purposes of policy formulation and implementation, it is the line ministry that represents the hub of operations. Transition economies should not make financial reporting a substitute for efficient budget implementation and fragment political responsibilities, as could happen if subordinate agencies become the entities that report to parliament and the general public. As Premchand (1998) noted, the focus on agencies or reporting entities could contribute to avoidable fragmentation.

In reality, some of the early enthusiasm for the NPM model of separating policy and delivery, purchasers and providers, and writing contracts between them, has been moderated by experience. This experience includes the discovery that the government would not be exonerated by the electorate for responsibility for outcomes because it had written a contract and had put an activity at arm's length. Indeed, governments could get the worst of both worlds in the sense that they lose immediate control over outcomes while still being held responsible in the public eye for failures to deliver their policy pledges and loss of fiscal control. The UK government recently questioned the extent to which it had placed the great bulk of government activity under agency contracts.

There seem to be difficulties for countries that try to apply New Zealand type reforms in an environment that does not share similar legal and cultural characteristics. Some continental European countries have faced serious difficulties in attempting to import NPM solutions, and partly for that reason, such reforms have seldom been pushed very far. In general, countries in transition should be cautious in moving towards NPM solutions without ensuring that certain pre-conditions are in place, e.g. strong central cash management and control mechanisms.

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1. The Statistics Department of the IMF is revising the 1986 edition of *A Manual on Government Finance Statistics*. The new manual will describe an integrated Government Finance Statistics (GFS) system that is harmonised, to the extent possible, with the *System of National Accounts, 1993*. Unless otherwise noted, this book refers to the January 2000 draft version of GFS which is given the shorthand title "GFS 2000". The revised GFS will be published in late 2000 or in 2001. For more information, see http://www.imf.org/external/pubs/ft/gfs/manual.

2. See detailed explanations on the differences between the requirements of a budget/accounting classification and the GFS reporting classification in Allan (1998).

3. Both the term "depreciation" used in business accounting and the SNA concept of "consumption of fixed capital" refer to the allocation of the costs of fixed assets over accounting periods. However, the value of the consumption of fixed assets estimated in the national accounts may deviate considerably from depreciation as recorded in business accounting or as allowed for tax purposes, especially where there is inflation. According to the SNA methodology, the consumption of fixed assets is calculated using the prices prevailing at the time production takes place, not at the time the assets were originally acquired.

4. In discussing the GFS, the IMF (1986) notes: "There is a great deal of latitude for decisions as to the functions to be isolated and the way in which they should be grouped. Decisions made are never final but need to be reviewed periodically [to determine] whether public demand and government priorities should be reflected in a changed classification. For example, the present concern (in the early 1980s) with energy supply and conservation was the main motivation for creating a major category for fuel and energy. On the other hand, the classification does not yet contain a category relating to the protection of the environment since at the present time it does not seem possible to define and measure such a group".

5. In addition to the term "current expenditure" as defined in the glossary (i.e. all expenditure other than that for capital projects and capital transfers), this book uses two other related concepts. "Recurrent costs" are the forward costs (capital and current) generated by investment projects; "operating expenditures" or "running costs" are the administrative expenditures incurred by ministries and agencies in managing their operations, i.e. salary and non-salary personnel costs, furniture and equipment, heating and lighting, office rent, routine maintenance, etc.

6. "For most other outlays [other than transfers and lending minus than repayment], it will generally not be possible to use transactions as units of classification. Instead, COFOG codes will have to be assigned to agencies, programme units, bureaus and similar units within government departments", IMF (1986), page 143. A similar recommendation is made in Chapter 2 of United Nations (2000).

7 . Some countries that have not traditionally made a clear separation between capital and current expenditure in the presentation of the budget are discussing the possibility of creating a separate "capital account". For the US, see GAO (1993); for Canada, see Auld (1985).

8. This includes, in the context of the European Union, candidate countries that benefit from flows of EU pre-accession aid for agriculture, regional development, etc.

9. The United Nations' *A Manual for Programme and Performance Budgeting* (1965) gave a definition of performance budgeting that embodied programme formulation as well as the measurement of performance in accomplishing programme objectives.

10. See "Application of Modern Budgeting Techniques: Variations on a Theme" in Premchand (1983), Table 23.

11. The reader can find descriptions of the NPM model and a discussion of its relevance in Christopher Hood (1991), Savoie (1995) and Borins (1995).

12. The New Zealand budget distinguishes the following categories of appropriation: "(i) output classes, e.g. policy advice, management of contracts, policing, custodial services, etc.; (ii) benefits, e.g. unemployment, domestic purposes, scholarships; (iii) borrowing expenses, e.g. interest expenses, premiums, borrowing, other finance costs; (iv) other expenses (e.g. restructuring costs, litigation costs, loss on sale of fixed assets, overseas development aid); (v) capital contributions, increase in investment in a department or SOE to increase its output capacity or improve its efficiency; (vi) purchase and development e.g. state highways, national parks, Parliament Buildings of capital assets and; (vii) repayment of debt e.g. foreign currency debt repayment". Benefits and capital contributions to departments are appropriated on a cash basis. (New Zealand, The Treasury, 1996).

13. "More consideration is given to line-items in preparing and reviewing budgets than is commonly thought to be the case. Certain outputs, such as policy advice, are budgeted in input terms, and managers indicated in interviews that their departmental budgets often are examined by Treasury Vote analysts in these terms... Moving from input to output prices would require major improvements in cost accounting, allocation and analysis" (Schick, 1996).

14. Partly drawn from Allen (1999) and Sutch (1999).

CHAPTER 5

POLICY FORMULATION AND BUDGET PREPARATION

This chapter deals with the core processes necessary to ensure aggregate fiscal discipline and an efficient allocation of resources in line with the government's policy goals and fiscal targets. These processes consist of:

1. Setting fiscal targets and levels of expenditure compatible with them.

2. Preparing a medium-term macroeconomic and fiscal framework.

3. Co-ordination mechanisms for policy decision-making.

4. Preparing the budget itself.

A. The Macroeconomic and Policy Context

1. The importance of a medium-term perspective for budgeting

a. General issues

Although in almost all countries government budgets are prepared on an annual cycle, they must take into account events outside the annual cycle, in particular the expected revenues, the longer-term costs of programmes and government policies, and the sustainability of government fiscal policies, notably their impact on the national debt. A medium-term outlook is also necessary because the time span of an annual budget is too short for the purpose of adjusting expenditure priorities. At the time the budget is formulated, most of the expenditures of the budget year have already been committed. For example, the salaries of permanent civil servants, the pensions to be paid to retirees, and debt service costs, are not variable in the short-term. Other costs can be adjusted, but often only marginally. The margin of manoeuvre is typically around 5 to 10% of total expenditure. This means that any real adjustment of expenditure priorities, if it is to be successful, has to take place over a time span of several years. For instance, the government may wish to switch from blanket provision of welfare services to targeted provision designed for those citizens most in need. The expenditure implications of such a policy change stretch over several years, and the policy therefore can hardly be implemented through a focus on the annual budget alone. Medium-term fiscal projections are also necessary to demonstrate to the administration and the public the desired direction of change. In their absence, rapid spending adjustments to reflect changing circumstances will tend to be across-the-board and ad hoc, focused on inputs and activities that can be cut in the short-term.

To frame the formulation of the annual budget, assess whether the budget policies are sustainable, and identify desirable policy changes, the preparation of a medium-term macroeconomic framework is essential.

Macroeconomic projections are not simple forecasts of trends in macroeconomic variables. Projections are based on a definition of targets and instruments, in areas such as monetary policy, fiscal policy, exchange rate and trade policy, external debt management, regulation and promotion of private sector activities and reform of public enterprises. For example, the policy objective of reducing inflation normally corresponds to targets such as the level of the deficit and the debt/GDP ratio, and the specific instruments can include changes in the balance of direct and indirect taxes and credit policy measures.[1] The macroeconomic framework should include the projections of the government accounts, which form a medium-term fiscal (or financial) framework (MTFF). Projections should cover the current year and a forward period of 3-4 years. The MTFF should detail the broad economic categories of revenue and expenditure. Moreover, as discussed below, it should be preferably supplemented with expenditure estimates by main function or sector.

Starting points for the preparation of the annual budget are a clear definition of fiscal targets and a strategic framework consisting of a comprehensive set of objectives and priorities. The capacity to translate policy priorities into the budget, and then to ensure conformity of actual expenditures with the budget allocations, depends in large part on the soundness of medium-term macroeconomic and fiscal projections and revenue forecasts.

In addition, when preparing the budget the following important multi-annual factors should be taken into account:

- The forward costs of ongoing investment projects/programmes, including their recurrent costs.
- The future funding needs of entitlement programmes where expenditure levels may change, even though the basic rules and procedures that determine an individual's eligibility and level of benefit remain the same.
- Contingencies and other implicit or explicit policy commitments which may result in future spending requirements.
- The impact of the fiscal deficit on the costs of servicing the public debt.

b. EU Convergence and Stability Programmes

Preparing a medium-term macroeconomic framework and a MTFF is a general condition for sound budgeting. In addition, it is a specific requirement for EU Member States (see Chapter 3). Since July 1997, according to the Stability and Growth Pact, EU Member States are required to formulate and submit stability programmes, if they have adopted the euro, and convergence programmes, if otherwise.

These stability and convergence programmes must provide the following information:

- Medium-term budgetary objectives, which should be close to balance or in surplus, and gradual path adjustments in the general government deficit and debt ratio deficit to GDP. Budgetary programmes must be credible and sustainable, and the burden of adjustment should be allocated in a fair and just way.
- Main assumptions about the expected developments of economic variables relevant to the convergence programmes (i.e. public investment, real GDP growth, employment and inflation).
- Budgetary and economic policy measures, taken and/or proposed to achieve the budget objectives, including an assessment of their quantitative effect on the budget.

- A sensitivity analysis of how changes in the main economic assumptions would affect budget and debt positions.

Medium-term fiscal objectives need to be stringent in order to ensure convergence, but must be realistic and prepared according to a sound methodology. Thorough analyses of explicit or implicit existing policy commitments, identification and assessment of policy changes and associated measures are necessary.

In addition to these stability or convergence programmes, several EU countries prepare indicative multi-year budgets. These approaches, which vary in scope and content from one country to another, are reviewed in Chapter 6. The present chapter focuses on the basic requirements to place the budget and policy formulation within a multi-year perspective.

2. Policy formulation

a. The budget-policy link

The budget preparation process is a powerful tool for achieving policy coherence. The budget is both an instrument of economic and financial management and an implicit policy statement, as it sets relative levels of spending for different programmes and activities. However, policy decision-making is complex and involves different actors inside and outside the government. It is a mistake to attempt to combine all the procedures of policy formulation and the budget process itself (as to some extent was the ambition of the PPBS). However, a coherent relationship needs to be established between the policy-making agenda (which should take into account economic and fiscal realities) and the budget (which should accurately reflect the government's policy priorities).

The budget process should both take into account policies already formulated and be the main instrument to make them explicit and "operational". However, policy proposals should be developed and reviewed outside the pressured environment of the budget process itself. Making policy through the annual budget would give undue prominence to short-term issues rather than longer-term, strategic issues, since the policy debate would be invariably dominated by immediate financial considerations.

An overall strategic framework should underpin the formulation of sectoral policies provided that it is a genuine and concrete strategy, based on a thorough analysis. Within this framework, line ministries and agencies should prepare their own strategic plans that include: (i) their mandate, consistent with statutory requirements; (ii) a set of desired policy goals (outcomes and objectives); (iii) the broad approaches to achieving these policy goals; (iv) a description of the concrete policy measures that will be used to achieve these goals, and (v) a broad cost estimate. Expenditure programmes and performance plans can be derived for these strategic plans, once the allocation of resources between different sectors is determined. Such strategic planning is not a static or occasional event, but a dynamic and inclusive process. If done well, strategic planning is continuous and provides the basis for the day-to-day operations of the organisations that manage the different expenditure programmes. Regrettably, in many cases, the exercise degenerates into bureaucratic formalism, where a long-term perspective, unrealistic assumptions and logical frameworks are used as a substitute for clear thinking about realistic policy options and instruments. A good practical rule for preparing (and evaluating) a strategic framework is: keep it simple.

A bridge between the policy-making process and the budget process is essential to make policy a breathing reality rather than a statement of wishes. For this purpose at least two clear rules should be established (see Allen, 1996):

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

- The ministry of finance should be consulted in good time about all proposals involving expenditure before they are reviewed by the council of ministers (or some other ministerial committee) and certainly before any public announcements are made.

Within the budget formulation process, close co-operation between the ministry of finance and the centre of government is required, at both the political and the technical level. The role of the centre is to ensure that the budget is prepared according to the principles previously defined; arbitrate or smooth over conflicts between the ministry of finance and line ministries; and ensure that the relevant stakeholders are appropriately involved in the budget process. An interministerial committee may be useful in tackling cross-cutting issues and reviewing especially sensitive issues. And, most important, each entity involved in the budget process must perform its own role in an informal and responsible fashion, and be given the means and capacity to do so.

b. Reaching out: the importance of listening

Consultations can strengthen the process of legislative scrutiny of government strategy and the budget. Legislative hearings through committees and subcommittees, particularly outside the pressured environment of the annual budget, can provide an effective mechanism to consult widely on the appropriateness of policies.

The government should try to get feedback on its policies and budget execution from outside organisations, including bodies representing employers and employees, professional institutes and academics, and NGOs. For example, consultative boards, grouping representatives from various sectors in society, may be a useful mechanism for discussing government expenditure policy. On crucial policy issues the government can set up ad hoc groups. Preparing and disseminating studies that evaluate the impact of government policy proposals, conducting surveys, etc. provides information to stakeholders and the civil society and helps the government receive reliable feedback. User surveys and/or meetings with stakeholders and users when preparing agencies' strategic plans can enhance their effectiveness. Finally, in countries with weak budget execution and monitoring procedures, only far-flung citizens' feedback mechanisms can be effective in revealing malpractices such as infrastructure projects that are not completed to specified material standards, cost restrictions or time limits, fraud, and waste. Such mechanisms are often resented by the executive branch, but should be seen by governments as cost-effective monitoring devices, and encouraged and supported as such.

However, there should be no direct linkages between these consultations and the budget process itself, which needs to be organised according to strict rules in order to prepare the budget in a timely manner and avoid excessive pressure from particular interests and lobby groups. Participation, like accountability, is a relative, not absolute, concept.

3. Consolidating fiscal commitments

The macroeconomic projections and policy objectives of the government must be made public. The legislature and the population at large have a right to know clearly the government's policy objectives and targets, not only in order to increase transparency and accountability, but also to reach a consensus within civil society. While such consensus building may take additional time, and require difficult debates, it

will also be an invaluable foundation for the robust and effective implementation of the government's policies and expenditure programmes.

In some countries, the government's macroeconomic projections are submitted to a panel of independent experts in order to evaluate their accuracy and reliability. In other countries, the projections are validated by the Auditor General (e.g. the UK, and the Canadian Province of Nova Scotia[2]). The independence of the Auditor General adds credibility to the projections. However, any other form of participation of audit offices in the budget formulation process is questionable.

Several countries have laws and rules that restrict the fiscal policy of government ("fiscal policy rules"[3]). For example, the so-called "golden rule" stipulates that public borrowing must not exceed spending on capital investment (thus mandating a current budget balance or surplus).[4] In some cases, the overall budget must be balanced by law. In many countries, the budgets of subnational governments must be balanced. Generally, in countries with fragile coalition governments, fragmented decision-making, and legislative committees acting as a focus for periodical bargaining, setting up legally binding targets may be appropriate. However, one frequent criticism of such rules is that they favour "creative accounting" and encourage non-transparent fiscal practices. Accounting methods and standards should be publicly disclosed in order to limit such opportunities. Another criticism is that non-discretionary rules can prevent governments from adjusting their budgets to the economic cycle, assuming that these rules are effectively enforced.[5]

In the European Union, the Maastricht Treaty stipulates specific fiscal convergence criteria, concerning both the ratio of the fiscal deficit to GDP and the debt/GDP ratio (see Chapter 3). These criteria are very important for candidate countries in the context of European integration, and many of these countries have already established programmes of fiscal convergence.

In 1992, a study for the European Union found that fiscal performance depends more on institutional issues, such as the distribution of powers in budgeting, than on the application of long-term fiscal limits.[6] It is, therefore, crucial to ensure that the institutional arrangements discussed earlier are in place.

Some countries (for example, the New Zealand "Fiscal Responsibility Act") do not mandate specific fiscal targets, but refer to criteria such as "prudent levels" and "reasonable degrees" of government borrowing, debt, etc. In the New Zealand case, it is left to the government to specify the targets in a Budget Policy Statement, which presents total revenues and expenses and projections for several years. This statement is published at least three months prior to the budget being presented to parliament, and is reviewed by a parliamentary committee but not formally voted by the parliament (see OECD, 1997b). Similarly, the British government adopted, in 1998, a Code for Fiscal Stability designed to "strengthen the openness, transparency and accountability of fiscal policy". Details are shown in Box 5.1 below.

B. Preparing the Macroeconomic Framework

1. Fiscal targets and indicators

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

Box 5.1. THE UK CODE FOR FISCAL STABILITY

Under the Code, the government makes the following commitments. It will:

- Conduct fiscal and debt management policy in accordance with a specific set of principles.
- State explicitly its fiscal policy objectives and operating rules, and justify any changes to them.
- Operate debt management policy to achieve a specific primary objective.
- Disclose, and quantify where possible, all decisions and circumstances that may have a material impact on the economic and fiscal outlook.
- Ensure that best-practice accounting methods are used to construct the public accounts.
- Publish a Pre-Budget Report to encourage debate on the proposals under consideration for the budget.
- Publish a Financial Statement and Budget Report to discuss the key budget decisions and the short-term economic and fiscal outlook.
- Publish an Economic and Fiscal Strategy Report outlining the government's long-term goals and strategy for the future.
- Publish a specific range of information from its economic and fiscal projections, including estimates of the cyclically-adjusted fiscal position.
- Invite the National Audit Office (NAO) to audit changes in the key assumptions and conventions underpinning the fiscal projections.
- Produce a Debt Management Report outlining the government's debt management plans.
- Refer all reports issued under the Code to the House of Commons Treasury Committee; and
- Ensure the public have full access to the reports issued under the Code.

Source: United Kingdom, HM Treasury (1998a).

The concept of "general government", defined according to GFS and ESA95 standards, should be used when preparing the fiscal projections and defining the fiscal targets, but these targets should also be broken down between central and local government. Fiscal projections should cover the consolidated account of the general government and quasi-fiscal operations by the banking system. Future expenditures related to contingent liabilities as a result of government guarantees and other sources should be assessed. Sometimes, only the central government is included in the fiscal projections, but this tends to give a misleading fiscal picture and creates a temptation to "download" the fiscal deficit onto local government

entities. It is often desirable to prepare also "consolidated accounts of the public sector", in order to identify financing requirements for the public sector as a whole.

The government operations table prepared according to the GFS methodology is a key instrument to assess the government's fiscal position, since it summarises all revenues, expenditures or expenses, and financing transactions, and shows the key fiscal balances. The government's medium-term projections form the medium-term fiscal framework, which is a major component of the macroeconomic framework. The GFS 2000 is accrual-based, but with the exception of consumption of fixed capital, all items in this table apply equally to the cash and accrual bases of accounting. Figure 5.1 below compares a cash-based government operation table with an accrual-based table.

The summary indicator of fiscal position used most commonly is the budget deficit/surplus. It is a major policy objective to ensure that the budget is financed in a non-inflationary way and without crowding out private investment, while keeping the growth of public debt under control.

In the European Union, within the context of the Maastricht/Amsterdam Treaties, the deficit is the net borrowing of the general government, as defined in ESA95. This measure of the deficit is equal to total expense transactions plus the net acquisition of capital assets less total revenue transactions. According to the SNA93 and ESA95 methodology, financing transactions such as the sale (or acquisition) of shares and equity are not included in revenues (or expenditures) when calculating the deficit. Interest must be calculated on an accrual basis and liabilities must be registered properly.

The budget deficit/surplus on a cash basis (or cash balance), as defined in the 1986 version of GFS, is equal to expenditure payments plus net lending/borrowing for policy purposes ("lending minus repayments") less collected revenues (on a cash basis). In contrast to the Maastricht/Amsterdam definition, this definition of the deficit comprises only cash transactions and includes "above the line" financing transactions for policy purposes, such as the sale of shares and equity related to privatisation programmes. Because it does not take into account payments' arrears and floating debt, a number of countries also calculate a measure of the deficit that is called "the deficit on a commitment basis". This should be defined as the difference between expenditures at the verification stage and collected revenues (on a cash basis). Commitments, when they are properly registered, include orders not yet delivered and multi-year contracts not yet completed. To estimate arrears accurately, orders not yet delivered must be separated from actual expenditures. In order to calculate the deficit on a commitment basis, a number of countries have put in place special systems for reporting arrears. But such systems are no substitute for proper accounting for liabilities.

Under the GFS 2000 methodology, the government operations table includes three key balances:

- The *net operating balance* is revenues less expenses, that is the change in net worth resulting from transactions. This provides a measure of the sustainability of fiscal policies. In practice, however, because consumption of fixed capital is difficult to measure, the *gross operating balance* will be more frequently estimated.

- *Net lending/borrowing* measures the *financing* requirement of government. As noted above, net borrowing corresponds to the deficit calculated according to the requirements of the Maastricht/Amsterdam Treaties.

- The *policy balance* is equal to the difference between revenues and expenses, other than consumption of fixed assets, plus the net acquisition of non-financial assets (capital assets) for policy purposes. It is the accrual equivalent of the deficit/surplus on a cash basis.

Different definitions of the deficit meet different purposes. The deficit on a cash basis provides a direct link with the money supply and thus monetary policy objectives and targets. But the deficit defined according to ESA95 methodology gives a more meaningful assessment of the fiscal position of the government, because it comprises also non-cash transactions that increase liabilities. It defines properly the financing transactions of government. However, separating financial transactions for policy purposes in order to calculate the policy balance as defined in the 2000 version of GFS is also useful for analysing the impact of policy decisions. Thus, a country may need to calculate several deficits, corresponding to different definitions. This should not create any difficulties provided that expenditures, revenues and financing classifications are properly defined and sufficiently detailed. However, countries that are candidates for membership of the European Union should preferably adopt in their financial regulations a definition of the deficit in conformity with ESA95, in order to ensure that their fiscal reporting system will fit EU requirements.

The ESA95 and the GFS 2000 methodologies are on an accrual basis. However, the consumption of fixed capital assets does not affect the deficit as calculated on an accrual basis (the consumption of fixed capital is included as an expense, but this is balanced by the fact that it is deducted from the transactions in capital assets). Assessing the consumption of fixed capital is not necessary in order to calculate fiscal balances that satisfy the ESA95 and GFS 2000 definitions.

Figure 5.1 shows the main elements included in the different definitions of the deficit and the fiscal balance on both a cash and an accrual basis.

Depending on the objectives of the analysis and the country context a number of other balances are useful for fiscal analysis. The *primary balance* is the difference between the policy balance and non-interest expenditures and revenues and grants. As a target for budget policy, it does not depend on the vagaries of interest rates and exchange rates, and is therefore under some circumstances a better measure of the government's fiscal adjustment effort.

The government's *net (gross) saving* is equal to the net (gross) operating balance less capital transfers receivable plus capital transfers payables. It measures in theory the contribution of government to investible resources and economic growth. However, since the current spending of a government may be as important for growth as capital spending, the macroeconomic meaning of this indicator should be interpreted with care.

In high-inflation countries, in order to take into account the impact of inflation on the stock of debt, a frequent indicator is the *operational deficit*, which is equal to the deficit on a cash basis less the inflationary portion of interest payments.[7] Depending on circumstances it may also be necessary to isolate on a once-and-for-all basis the fiscal effects of other operations, for instance the sale of public assets, or a special recovery of tax arrears.

Indicators of the fiscal sustainability of government policies include the ratios of *debt to GDP*, *total tax revenues to GDP*, *net unfunded social security liabilities*, etc.

The ratios of *tax revenues to GDP* and *public expenditure to GDP* are important indicators of the weight of the government in the economy. Many countries have established a policy objective to diminish these ratios, in order to encourage the expansion of private sector activities.

Accrual accounting allows the government to better assess the value of its assets and liabilities, and net worth, and their impact on the sustainability of fiscal policy. The net operating balance defined above

Figure 5.1. GOVERNMENT OPERATIONS TABLE: DEFINITIONS OF THE FISCAL BALANCES

Cash basis (GFS 1986)

Revenue and grants
- Revenue
  - Tax revenue (incl. social contributions)
  - Non-tax current revenue
  - Capital revenue (incl. sales of fixed assets)
- Grants

Expenditures and lending minus repayments
- Current expenditures
  - Goods and services
    - Wages and salaries
    - Employer contributions
    - Other goods and services
  - Interest payments
  - Subsidies
  - Transfers
- Capital expenditures and transfers
- Lending *minus* repayments

Deficit (-)/Surplus (+) on a cash basis

Financing
- Domestic
  - Banking Sector
  - Other
- Abroad

Memo item: Variation of Arrears
- Arrears paid
- New arrears

Accrual basis (GFS 2000)

Current transactions and capital transfers

Revenue
- Taxes
- Social contributions
- Grant
- Other revenue

Expense
- Compensation of employees
- Use of goods and services
- Interest
- Subsidies
- Grants
- Social benefits
- Transfers and other expenses

Gross operating balance (revenues *less* expenses - excluding consumption of fixed assets)

Consumption of fixed capital assets

Net operating balance (revenues *less* expenses - including consumption of fixed capital)

Transactions in capital assets

Net acquisitions of fixed capital assets
- Acquisitions of fixed capital
- *less* Disposals of fixed capital
- *less* Consumption of fixed capital

Change in inventories

Net acquisition of other non-financial assets

Net lending/borrowing (1) *(revenues less expenses less net transactions in capital assets)*

Transactions in financial assets and liabilities (financing)

Net acquisition of financial assets for policy purposes

Policy balance *(net lending/borrowing less thenet acquisition of financial assets for policy purposes)*

Net acquisition of financial assets for liquidity management
- Domestic
  - Central Bank and financial corporations
  - Other
- Abroad

Net incurrence of liabilities
- Domestic
  - Central Bank and financial corporations
  - Other
- Abroad

(1) Equals gross operating balance plus gross acquisitions of capital assets. Net lending/borrowing is the general government deficit as defined in the European Council regulation (EC 475/2000).

Source: GFS (1986 and 2000).

includes changes in assets and liabilities related to transactions only. Such changes depend directly on government policy. However, *changes in net worth* come also from other economic factors. Large movements in net worth can be occasioned by valuation changes in assets, such as land, that the government has no immediate intention of liquidating. Hence, "net worth measures could be dangerous if used as indicators for near-term fiscal policy".[8]

An assessment of *fiscal vulnerability* is also needed, especially in countries that benefit from short-term capital inflows. Such an assessment could be based on the analysis of the maturity of government debt, the volume of usable foreign exchange reserves, etc.

2. Methodological issues

a. The analytical framework

The government's fiscal objectives should be defined within a consistent and comprehensive medium-term macroeconomic framework. A medium-term macroeconomic framework typically includes projections of the balance of payments, the real sector (or production sector), the fiscal accounts and the monetary sector. It is a tool to check the consistency of assumptions or projections concerning economic growth, the fiscal surplus or deficit, the balance of payments, the exchange rate, inflation, credit growth and its distribution between the private sector and the public sector, policies on external borrowing, etc.

The macroeconomic projections should be based on a consistent description of the relationships between the economic agents. For this purpose, the EU Member States use a common framework and methodology of national accounts (ESA95).

The projections of public sector transactions and balances, on the other hand, should be presented on a basis that is compatible with the national budget and fiscal statistics, while the external sector projections should be presented according to the internationally recognised (IMF) balance of payments format. Therefore, when setting up the analytical framework for the macroeconomic projections it is necessary to take ionto account the methodological differences between the SNA standards, a country's government accounting system and the IMF's balance of payments manual. This does not pose major problems provided that forecasters are aware of these methodological problems and work closely with national accounts specialists, in order to reconcile the projections of the national accounts with the fiscal and balance of payments projections.

In most countries, the main differences between the government financial reporting system and the national accounts concern the basis of accounting and the definition of the government sector. The SNA is on an accrual basis, while the government financial reporting system, which generally follows the methodology of GFS 1986, is on a cash basis. Moreover, the coverage of the government sector is frequently more comprehensive in the national accounts than in the government's financial reports, which often omit some government entities (such as low level subnational authorities or certain autonomous funds and agencies). Therefore, to prepare a macroeconomic framework in conformity with SNA93 and ESA95 standards the forecaster should know how the national accounts have estimated government consumption and gross investment. The fact that many macroeconomic projections are prepared in ignorance of these methodological problems generates avoidable inconsistencies between the projected and the actual data.

Moreover, while the macroeconomic framework should be based on a definition of the government consistent with SNA93 and ESA95, the fiscal projections are also an important source of information for budget preparation. The projections must therefore distinguish the central government from other government entities.

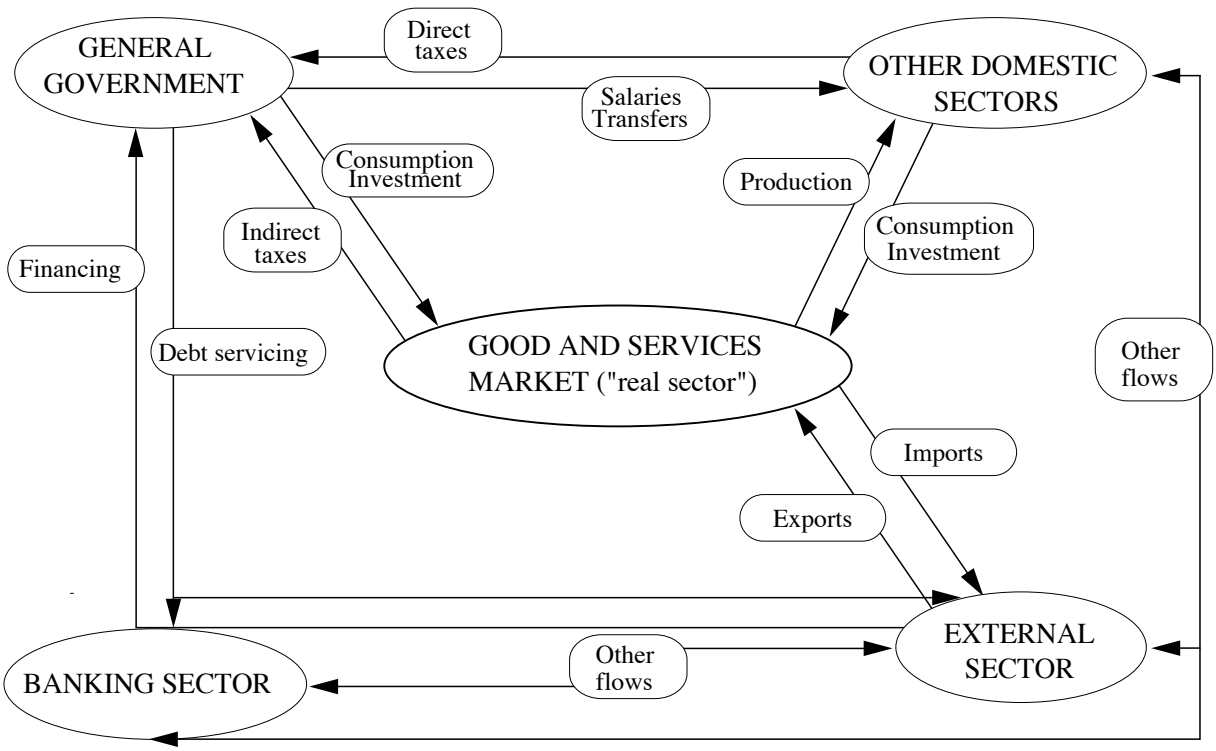
b. Modelling

Any projection needs to be based on a formal model of the economy, which consists of both setting up an analytical framework based on the national accounts, and a description of the behaviour of economic agents. The degree of sophistication of the model depends not only on the technical capacities within the country, the availability of appropriate tools, and the quality of the national accounts and other relevant statistical data, but also on the purpose and scope of the projections.

Macroeconomic models can be relatively simple. The major goal of the government in preparing macroeconomic projections is to set a general frame to formulate macroeconomic objectives and check their consistency. Sophisticated econometric models and detailed descriptions of the analytical framework are useful, but not essential in preparing macroeconomic projections. Indeed, in this context, such models have certain disadvantages. Operating elaborate models needs time, and a strong technical support team, while the budget is usually prepared to a tight deadline. Advanced econometric techniques may give rise to a sense of misplaced concreteness and a "forecast illusion" which may reduce their practical value. Simpler models are also easier to use in debates on fiscal policy, whereas the outputs of a sophisticated econometric model depend on the approach adopted by the modeller, and the process is often more opaque.

The simplest macroeconomic models usually contain four principal economic agents: the general government, the banking sector, the external sector, and a "residual" sector (named often the "private" sector): see Figure 5.2. These agents trade both financial assets, and goods and services. The market for

Figure 5.2. **RELATIONSHIPS BETWEEN MAIN MACROECONOMIC ACCOUNTS**



N.B. The arrows show the directions of financial flows

goods and services is the "real sector" (or "production sector") derived from the national accounts. The simplest models are generally "quasi-accounting" models. Such models include mainly accounting relations to balance the accounts of each sector and an analysis of the flows of funds, and only a limited number of behavioural relations, which are often defined by simple ratios without resorting to econometric techniques.[9] An example of an accounting relation is the familiar GDP identity (GDP plus net imports equals consumption plus gross domestic investment). An example of a behavioural relationship is between the change in a country's fiscal deficit or its money supply (which may be defined in various ways) and the change in its GDP or national income.

A model contains both exogenous variables (i.e. assumptions and relationships determined outside the model) and endogenous variables that are calculated by the model. Many solution procedures or "closures" can be considered. For example, the model can be designed to calculate the borrowing requirement of the government, for a given set of exogenous assumptions for GDP and government expenditure; or alternatively, the impact on GDP growth of exogenous financing and monetary policy assumptions can be estimated. In theory, the closure of a model is determined by the underlying macroeconomic approach (e.g. monetarist, Keynesian, etc.). In practice, however, the manner of operating a model is more important than the closure of the model itself. To get satisfactory results from a model, many iterations are needed, various values of exogenous variables must be tested, and the relevance of the results must be assessed at each iteration. What is exogenous in the model is in fact, often, endogenous in this iterative process. In reality, the closure should be defined in the way that is most convenient for operating the model and creting an effective dialogue with senior officials and ministers. In this respect, starting from GDP projections and fiscal projections in order to calculate different scenarios for the government's borrowing requirement is often a convenient procedure for operating a simple medium-term macroeconomic model (while the monetary policy closure procedure is often used for short-term models).

In addition to the macroeconomic model, specific analyses are also needed to prepare the MTFF. For example, forecasting revenues should be based on detailed analyses and forecasts of individual taxes rather than relying on the aggregate outputs of a macroeconomic model, whatever its degree of sophistication.

c. Importance of data

The macroeconomic projections must be based on accurate and timely national accounts data, and statistics of a similar quality for the government sector and balance of payments. In addition, data from economic surveys undertaken by the national statistics office, the private sector or the central bank should be collected. Projections from government bodies or private sector organisations should be compiled at an early stage when preparing the macroeconomic framework. They should be used for both establishing the major assumptions and assessing the relevance of the preliminary results. Preparing the fiscal projections requires considering changes in laws and regulations that affect revenue, expenditure, financing and other financial operations of the government.

3. The need to assess fiscal risks

Governments face many fiscal risks related to natural disasters; guarantees, implicit or explicit, that they enter into; changes in the external economic environment; and events or "shocks" that are outside the government's control. Major economic external shocks, such as the impact of the Russian and Asian crises of 1998-99 on neighbouring countries, and natural catastrophes are difficult or impossible to forecast in advance. Such events call for exceptional measures, such as revising in depth the entire budget

and sequestering appropriations. But many fiscal risks are easier to assess, and should be managed within the usual budget processes. Standard tools of risk assessment and risk management can be used in such circumstances.

To decide on the fiscal targets and budget aggregates that are appropriate, policy decision-makers must be aware of the fiscal and economic risks, and of their possible fiscal impact. In addition, it is necessary to estimate the size of the contingency reserve to be included in the budget. Such a reserve should cover fiscal risks, such as those related to government guarantees and the impact of changes in exchange rates on debt servicing costs. However, the amount of the contingency reserve should be limited to no more than 1-3% of the total budget, otherwise political bargaining over the allocation of the reserve will dominate the budget execution phase.

The macroeconomic projections underlying the budget should include variants calculated on the basis of different assumptions, such as changes in world oil prices and developments in the world economy. The medium-term impact on debt servicing costs of changes in exchange rates and interest rates should also be systematically estimated. Assumptions of capital inflows and outflows must be carefully reviewed to take account of possible changes in the external environment. Fiscal risks related to contingent liabilities and policy commitments must also be assessed. In addition, when preparing their programmes and budgets, spending agencies should conduct an assessment of the economic and financial risks of implementing the various policies and projects for which they are responsible.

4. Aggregate expenditure estimates and the MTBF

Typically, the MTFF presents highly aggregated data on the expenditure side. It shows only total government wages, spending on other goods and services, interest payments, government transfers, and capital expenditures. However, more detailed analysis and discussions within the government are required to define the medium-term objectives. For example, to prepare the aggregated projections in the MTFF, transfers or entitlements must be reviewed in sufficient detail and assumptions on future developments must be compared to continuing commitments.

In practice, when preparing the MTFF on the basis of the overall macroeconomic framework, the impact of the assumptions and the aggregate fiscal targets on the composition of expenditure by sector or strategic area should be estimated in order to assess whether the fiscal targets are realistic and sustainable, and what conditions are required to meet them. The formulation of aggregate fiscal targets cannot be made in isolation from the formulation of budget policy changes.

Preparing aggregate multi-year expenditure estimates by broad function or strategic area will help both in formulating aggregate fiscal objectives and making strategic policy choices. These estimates should also specify the expenditure projections for the programmes that have the most significant forward fiscal impact (e.g. investment programmes of a significant size and entitlement programmes). The aggregate estimates form the expenditure framework component of a medium-term budget framework (MTBF) covering both revenue and expenditure projections of the central government (including EBFs), and, when it is feasible, the expenditure and revenue projections of other levels of government. Figure 6.1 in Chapter 6 describes the possible structure of an MTBF, the format of the aggregate multi-year expenditure estimates (or expenditure framework), and how the different frameworks needed to prepare the budget and formulate the budget medium-term policies are related to each other. The MTBF itself is a potentially effective instrument in the budget process. For example, it can be used to prepare initial ceilings at an early stage of the annual budget cycle, discussed below, and to support the process of policy formulation.

5. Preparing the macroeconomic framework

a. Steps in the preparation of the medium-term macroeconomic framework

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

The problems revealed by the projections (e.g. lack of consistency between economic growth targets and monetary policy) must be discussed among the agencies involved in macroeconomic management. The preliminary baseline scenario gives the essential macroeconomic information needed for preparing detailed projections, but these projections in turn usually lead to revisions in the baseline scenario. Such iterations should continue until overall consistency is achieved in the macroeconomic framework as a whole.

The preparation of a medium-term macroeconomic framework should be a continuing activity. The framework needs to be prepared at the beginning of each the budget cycle, in order to give adequate guidelines to the line ministries. It should then be updated during the further stages of budget preparation, in order to take into account intervening changes in the economic and fiscal environment. During the budget execution phase, macroeconomic projections require frequent updating in order to assess the impact of exogenous changes or of possible slippage in budget implementation.

In addition to preparing the baseline framework, it is important to formulate variants under different policy assumptions, such as changes in the world economy and international commodity prices. The risks related to unexpected changes in macroeconomic parameters must be assessed and policy responses identified in advance.

b. Distribution of responsibilities for the medium-term projections

Generally, preparing macroeconomic projections should involve directly the agencies responsible for the underlying policies and technical issues, normally the ministry of finance, the central bank, the treasury department, the ministry of economy, the national statistics office, and, as the occasion requires, sector ministries.

In many countries, a single ministry or agency, frequently the ministry of finance, has overall responsibility for the preparation of the macroeconomic framework and projections. In other countries, the responsibility for preparing macroeconomic projections is fragmented. For example, the ministry of finance may be responsible for fiscal projections, the ministry of economy for projections of the "real" sector, the central bank for monetary forecasts and the balance of payments. In such cases, the macroeconomic projections are simply the consolidated set of forecasts from different agencies. This approach tends to result in a lack of consistency of the projections and a poor dialogue within the government on policy issues. When responsibility is fragmented, therefore, it is essential to set up appropriate co-ordination committees and procedures in order to scrutinise the different sets of projections, assess their realism and consistency, and make the required changes. Since work on preparing macroeconomic projections requires the co-ordination of statistical data and specialised skills in several areas (national accounts, public finance, monetary policy, etc.), the functioning of an informal network of technicians dealing with macroeconomic and statistical issues is as important as the formal structure of official co-ordinating committees.

Other problems may arise when the agency responsible for the preparation of the macroeconomic framework is separated from the entity responsible for overall budget management. The argument in favour of such an arrangement is to relieve the agency responsible for preparing the macroeconomic framework from the pressures of day-to-day administration of the budget, thus allowing medium-term strategic issues to be better taken into account. In practice, however, this often disconnects the preparation of the macroeconomic framework from the ongoing policy dialogue, and transforms it into a mechanistic pro-forma exercise, while the real issues are addressed elsewhere (for example, during meetings between the ministry of finance, line ministries, the central bank and multilateral donor agencies).

Whatever the distribution of responsibilities for preparing macroeconomic forecasts, the ministry of finance must be responsible for preparing the MTFF, which is the most crucial component of the macroeconomic framework. It must have the internal capacity to review the macroeconomic projections, assess the risks associated with the different macroeconomic and fiscal scenarios, and prepare its own macroeconomic scenario to serve as a basis of comparison and a "reality check". Therefore, a macroeconomic and fiscal policy department or unit, staffed with competent technicians in macroeconomics and public finance, should be established within the ministry of finance.

C. Conditions for Sound Budget Preparation

During budget preparation, trade-offs and prioritisation among sectors and programmes must be made to ensure that the budget fits government policies and priorities. Next, the most cost-effective variants should be selected. Finally, spending agencies need to pay attention to increasing the technical efficiency of programme implementation, and the budget process itself should include incentives for spending agencies to improve their efficiency as programme managers. None of these objectives can be accomplished properly unless decision-making processes are unified; financial constraints built into the process from the start and enforced at each of its stages; and attention focused on major policy issues.

1. The need for unified processes

Expenditure programming and the preparation of resource allocation decisions is a continuing activity, but the budget is potentially a powerful tool of coherence. This calls for the institutional arrangements discussed earlier to ensure the budget fulfils effectively its primary function and goals. In addition to the issues reviewed in Chapter 1, another cause of fragmentation in the budget process comes from the organisational arrangements for the preparation of the capital budget. In a number of transition countries, the responsibility for preparing the investment budget[10] is assigned to an entity (the ministry of economy) different from the entity that prepares the budget for operational expenditures (the ministry of finance). Another complicating factor in many transition countries is the link between the capital budget and the preparation of a Public Investment Programme (PIP): see Chapter 6.

Such arrangements fitted the previous central planning paradigm, but impede the integrated review of current and investment expenditures that is a necessary in any good budgeting process. They are found also in developing and emerging countries, where they fitted the developmental approach of the 1960s and the 1970s, but not in most industrialised countries. The static and mechanistic view of the relationship between investment and growth (usually identified with the Harrod-Domar model[11]), has been shown long ago to be simplistic and often very misleading. Capital expenditures are not unique in contributing to future production. What is important for economic development is not only the volume of investment, but the efficiency of investment, as well as an adequate mix of both capital and current expenditures (e.g. teacher qualifications and wages can affect the quality of education, human capital and future economic growth

more than the number of new schools). Sometimes, the separation of procedures for preparing the capital budget and the operational budget has been justified by the fact that investment expenditures were financed by borrowing. However, government borrowing policy should not be related only to the desired capital stock. A commercial enterprise prepares its borrowing plans according to the stream of income and profits expected from new capital investment. But the government has to take into account the macroeconomic effects of policy; both current and capital expenditures affect aggregate demand; and borrowing policy must be established by reference to macroeconomic and fiscal targets in their entirety, and not only to investment considerations.

Where the capital investment budget is prepared by the ministry of economy, the ministry of finance generally establishes a global financial envelope for investment, within which the capital budget is prepared. In some countries, this leads both to under-investment and lack of resources for periodic maintenance, despite the important role of such expenditures for economic development. Thus, the resources allocated to capital spending are sometimes calculated as a residual by deducting operational expenditure needs from the expected total amount of budgetary resources, priority being granted to entitlement programmes and other current expenditures. In other cases, by comparison, this dual procedure generates excessive pressures to increase expenditures. For example, the ministry of education will put forward separate programmes for school construction and the ministry's operating expenditures and try to get the maximum resources for both, while not considering variants which might consist of building fewer schools and hiring more teachers. Or a decision to launch substantial capital investment project will be taken, without scrutinising its immediate and future fiscal impact.

To build a modern budget system, transition countries should unify their budget processes, and place their capital budget under the full supervision of the ministry of finance. The ministry of economy can provide advice on economic or social issues during budget preparation, but should not be directly involved in the preparation of the capital budget and investment programming. Such a transfer of authority is usually feasible at a technical level but sometimes difficult to implement for political reasaons.[12] In any case, adequate co-ordination mechanisms must be established to ensure an effective supervision of budget preparation by the ministry of finance (e.g. joint reviews by the ministry of finance and the ministry of economy of sectoral budget requests, placed under the authority of the ministry of finance).

Additionally, the creation of special mechanisms for preparing a multi-year investment programme that will fragment the expenditure programming processes should be avoided. In some transition countries, attempts have been made to create central investment programming units separate from the ministry of finance, despite the fact that the ministry of finance is fully responsible for the preparation of the capital budget[13]. These units are often established because of some request by donor agencies, or to create a mechanism for managing donor assistance, but this does not justify their establishment outside the organisation responsible for the preparation of the capital budget.

2. The need for early decisions

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

When revenues are overestimated and the impact of continuing commitments is underestimated, sharp cuts must be made in expenditure when executing the budget. Overestimation of revenue can come from technical factors (such as a bad appraisal of the impact of a change in tax policy or of increased tax expenditures), but more often from the desire of ministries to include or maintain in the budget an excessive number of programmes, while downplaying difficulties in financing them. Similarly, underestimation of expenditures can come from unrealistic assessments of the cost of unfunded liabilities (e.g. benefits granted outside the budget) or the impact of permanent obligations; it can sometimes be a deliberate tactic to launch new programmes, with the intention to request increased appropriations during budget execution. It is important not to assume that "technical" improvements can by themselves resolve institutional problems of this nature.

An over-optimistic budget leads to accumulation of payments' arrears and confuses rules for compliance. Clear signals on the amount of expenditure compatible with financial constraints should be given to spending agencies at the start of the budget preparation process. It is possible to execute badly a realistic budget, but it is impossible to execute well an unrealistic budget. There are no satisfactory mechanisms for correcting during budget execution the effects of an unrealistic budget. Thus, across-the-board appropriation "sequestering" leads to inefficiently disseminating scarce resources among an excessive number of activities. Selective cash rationing politicises budget execution, and often substitutes supplier priorities for programme priorities. Selective appropriation sequestering combined with a mechanism to regulate commitments partly avoids these problems, but still creates difficulties, since spending agencies lack the certainty and sufficient time to adjust their programmes and their commitments.

An initially higher, but more realistic, fiscal deficit target is far preferable to an optimistic target based on overestimated revenues, or underestimated existing expenditure commitments, which will lead to payments' delays and arrears and, therefore, create inefficiencies and reduce the government's credibility.

To alleviate problems generated by overoptimistic budgets, it is often suggested that a "core programme" within the budget should be isolated and given higher priority during budget implementation. In times of high uncertainty of available resources (e.g. very high inflation), this approach could possibly be considered as a second-best response to the situation. However, it has little to recommend as a general practice, and is vastly inferior to the obvious alternative of starting with a realistic budget. When applied to current expenditures, the "core programme" typically includes personnel expenditures, while the "non-core programme" includes a percentage of non-personnel goods and services. Cuts in the "non-core" programme during budget execution would tend to increase inefficiency, and reduce further the meagre operations and maintenance budget in most transition countries. The "core/non-core" approach is ineffective also when applied to investment expenditures, since it is difficult to halt a project that is already launched, even when it is "non-core". Indeed, depending on the strength of political support, non-core projects may in practice chase out core projects.

3. The need for a hard constraint

An open-ended budget preparation process starts with requests from spending agencies that are prepared without any clear indications from the ministry of finance of financial constraints. Since these requests express only "needs", in the aggregate they invariably exceed the ceiling of available resources. Spending agencies have no incentive to propose savings, since they have no guarantee that any such savings will give them additional financial room to undertake new activities. New programmes are included indiscriminately in sectoral budget requests as bargaining chips. Lacking information on the relative merits of proposed expenditures, the ministry of finance is led to making arbitrary cuts across the board among the request submitted by spending agencies, usually at the last minute when finalising the budget.

At best, a few days before the deadline for presenting the draft budget to the council of ministers, the ministry of finance gives firm directives to line ministries, which then redraft hastily their requests, themselves making across the board cuts in the programmes of their subordinate agencies. Of course, these cuts are also arbitrary, since the ministries have not had enough time to reconsider their previous budget requests. Further bargaining then takes place during the review of the budget by the council of ministers, or even during budget execution.

"Open ended" processes are sometimes justified as a "decentralised" approach to budgeting. Actually, they are the very opposite. Since the total demand by line ministries is inevitably in excess of available resources, the ministry of finance in practice has the last word in deciding where increments should be allocated and whether reallocations should be made. The less constrained the process, the greater is the excess of aggregate ministries' request over available resources, the stronger the role of the ministry of finance in deciding the composition of sectoral programmes, and the more illusory is the "ownership" of the budget by line ministries.

There is always an element of bargaining in any budget preparation process, as decisions must be made among conflicting interests. An "apolitical" budget process is an oxymoron. However, when bargaining drives the process, the only predictable result is inefficiency of resource allocation. Choices are based more on the political power of the different actors, than on facts, integrity or results. Instead of transparent budget appropriations, secret deals and false compromises are reached, such as increased tax expenditures, the creation of earmarked funds and unrecorded loan guarantees. A budget preparation process dominated by bargaining can also favour the emergence of various escape mechanisms described below and a shift of key programmes to special funds or agencies outside the budget.

A variety of undesirable political compromises and escape routes are used to avoid internal bureaucratic conflicts — dissemination of scarce funds among an excessive number of programmes in order to satisfy everybody, deliberate overestimation of revenues, underestimation of continuing commitments, postponing hard choices until budget execution, inflating expenditures in the second year of a multi-year expenditure programme, etc. These conflict-avoidance mechanisms are frequent in countries with weak cohesion within the government. Consequently, improved processes of policy formulation can have benefits for budget preparation as well, through the greater cohesion created within the government.

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

Notifying line ministries of their initial expenditure ceilings at the beginning of the budget preparation process encourages them to make an attitudinal shift from a "needs" mentality to an "availability" mentality. It can also help the ministries translate their strategic choices and policies into decisions about the allocation of resources at the programme level. Moreover, a hard budget constraint procedure of this kind increases the de facto authority and autonomy of the line ministries, weakening the claim of the "ministry of finance" to a role in determining the internal composition of the line ministry's budget. (A similar argument can be made about the relationship between a line ministry and its subordinate agencies.)

As noted earlier, the main starting points for budget preparation should be a clear definition of fiscal targets and the preparation of the macroeconomic framework and the MTFF. Thereafter, budget preparation

is an iterative process between the ministry of finance and spending ministries. Therefore, it should comprise a combination of the following three approaches:

- A *top-down approach*, consisting of: (i) establishing initial sectoral spending ceilings that fit government priorities (once aggregate resources available for public spending are defined); and (ii) notifying these spending limits and guidelines for the preparation of the sectoral budgets to line ministries. The role of the ministry of finance is dominant in this part of the process, but it should consult the council of ministers on key policy decisions.

- A *bottom-up approach*, consisting of formulating and costing sectoral spending programmes, and preparing sectoral budgets within the sectoral spending limits. This part of the budget process should be placed under the responsibility of line ministries.

- Iteration and reconciliation mechanisms.

Although the process must be tailored to each country, it is generally desirable to start with the top-down approach, before moving to the second and third approaches later in the budget cycle.

4. Focusing on policy changes

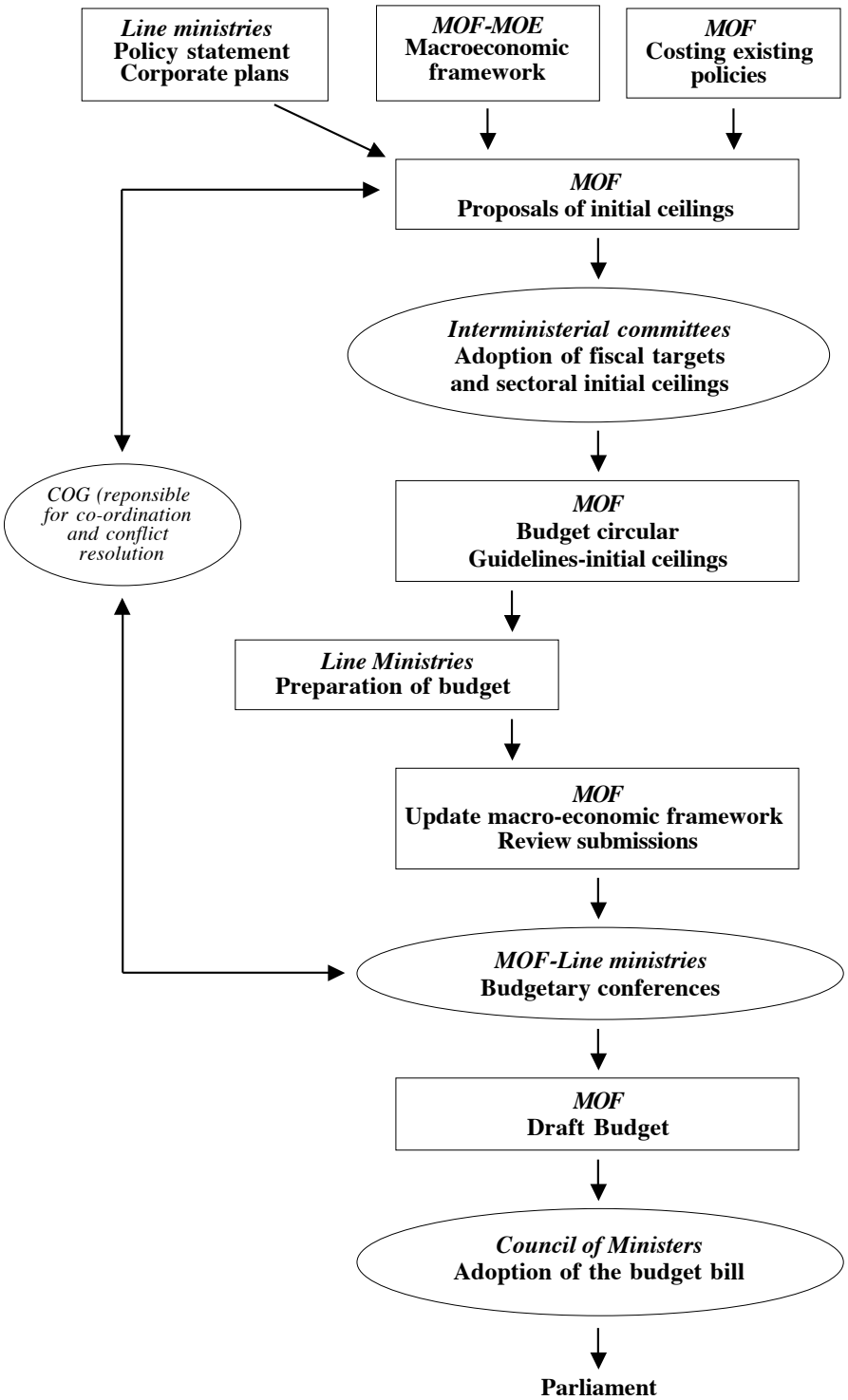
"Incremental budgeting", understood as a mechanical set of changes in a detailed line-item budget, leads to very poor results. The dialogue between the ministry of finance and line ministries is confined to a review of the different items and to bargaining decreases or increases — item by item. Discussions focus solely on inputs, without any reference to results, between a ministry of finance typically uninformed about sectoral realities and a sector ministry in a negotiating mode. Worse, the negotiation is seen as a zero-sum game, and is usually not approached by either party in good faith. Moreover, incremental budgeting of this sort is not even a good tool for expenditure control, although this was its initial aim. Line-item incremental budgeting focuses generally on non-personnel goods and services expenditures, whereas the "budget-busters" are normally entitlements (or "demand-led" programmes), subsidies and personnel expenditures.

Life itself is incremental, however. And so, in part, is the budget process, since it has to take into account the current economic and financial context, continuing policies and ongoing programmes. Budgets are never prepared from scratch. Debt servicing; multi-year commitments for investment; pensions and other entitlements; rigidities in civil service regulations; and the simple reality that government cannot stop at once all funding for its schools, health centres, military establishments, etc. limit possible annual changes to perhaps 5-10% of total expenditures. Re-assessing every year all programmes from scratch would be an expensive illusion. Capriciously large swings in budget allocations in response to changes in the balance of political power impede predictability and efficient programme implementation. If one excludes emergency or crisis situations, when preparing the budget the government should focus on new policies, savings on low priority programmes, and measures to increase the efficiency of other ongoing programmes.

Many budget formats present funding changes, increases and decreases, from a predetermined base level (actual expenditures, appropriations, current services, the costs of existing policies). This type of presentation should not be confused with "incremental budgeting", if the underlying analysis and policy formulation is comprehensive. Focusing on policy changes or on changes in the level of services delivered clarifies policy issues when scrutinising the budget.

In principle, the costs of existing policies are different from the costs of the present level of activity, that is the present cost of inputs to produce the present level of outputs. For example, for a given education

Figure 5.3. **BUDGET PREPARATION PROCESS**



COG = centre of government; MOF = ministry of finance; MOE = ministry of the economy

N.B. The COG could take a number of forms: office of the prime minister, office of the president, council of ministers, etc.

policy, an increase in the number of students calls for an increased number of teaching hours, and therefore for an increased level of outputs and expenditure. However, estimating the forward costs of existing policies is not easy. Moreover, in a situation of fiscal restraint, as faced by most transition countries, the costs of existing policies must be established in a very conservative manner. Therefore, the focus during the preparation of the annual budget will be placed in most cases on the expected changes in the level of activity (i.e. inputs and outputs), instead of on the desired policy changes. For entitlement programmes, however, estimates of the cost of existing policies are always required, since the level of these expenditures depends on external parameters that are not under the control of the government.

D. Budget Preparation Process

There needs to be a structured approach to preparing the budget that is described in the budget law and secondary law. This varies from country to country. Figure 5.3 illustrates the main steps in a typical budget preparation process. These steps are described in more detail below.

1. Top-down approach

a. The need for initial ceilings

The articulation of the top-down and bottom-up approach discussed earlier is crucial since it determines how policy priorities and fiscal targets will be taken into account during the budget preparation cycle. This calls for notifying in a timely manner to spending agencies initial budget ceilings. These ceilings may be defined either at the very beginning of the dialogue between the ministry of finance and the line ministries, or after a first iteration when line ministries communicate their preliminary requests. In practice, two main variants are found in countries that have good financial discipline. In some countries, line ministries are notified of the sectoral ceilings at the beginning of the budget preparation process. Other countries, where budget preparation may last more than ten months, establish ceilings in two steps. In the first step, some flexibility is left to line ministries to translate guidelines in terms of budget envelopes. Then, after a brief review and discussion of the preliminary requests, the ministry of finance notifies the line ministries of their binding ceilings.

In countries with strong government cohesion and stable and well-organised arrangements for budget preparation, these two variants are equally workable, since financial constraints are more or less taken into account by line ministries when preparing their preliminary request. Moreover, when budget preparation lasts nearly one year it would be very difficult to set definite ceilings at the beginning of the process.

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

Generally, the ministry of finance should be responsible for setting the sectoral ceilings, but it should of course co-ordinate with the centre of government, which must also review the ceilings in detail and approve them. With a view to reaching an agreement within the government and making the sectoral ceilings effective, the ceilings and the MTFF should be discussed by the council of ministers (or at least by a committee of senior ministers). In a few countries (e.g. Sweden), this information is voted on by the parliament and thus becomes legally binding.

b. Preparing the initial ceilings

Preparing initial ceilings is largely an incremental/decremental exercise. How this exercise should be carried out depends on the extent of adjustment that must be made, and the quality of information available at the central level. However, the approach should include, explicitly or implicitly, the following steps:

- First, assessing the overall expenditure ceilings that are compatible with the macroeconomic and fiscal outlook.

- Second, assessing the margin of manoeuvre for making desirable policy changes. This consists of estimating the impact of current policies on the next budget, or, more simply, the present level of activity (i.e. expenditure on government policies and programmes). This step can consist of preparing some form of baseline budget. The forecast level of total budgetary resources minus the costs of present activities gives the envelope for changing the level of activity.

- Third, identifying, by sector, possible savings and adjustments on low priority programmes (taking into account where appropriate the scope for efficiency improvements). The costs of the present level of activity minus the estimated savings gives a net baseline by sector. The forecast budgetary resources minus this net baseline gives a possible envelope for the increased level of activity.

- Fourth, distributing by sector the total envelope for increased activities according to government priorities.

The estimated sectoral envelope for increased activities by sector plus the net baseline gives the sectoral envelope, to be discussed within the council of ministers, then notified to line ministries by the ministry of finance. The enumeration of the different components of the ceilings defined above (present level of expenditure efficiency savings, etc.) defines the main steps in estimating the initial ceilings. Whether these components should be made explicit and discussed within the government depends on many factors, such as the quality of data and the degree of political cohesion of the government.

Work on the preparation of these initial ceilings must be co-ordinated properly with the underlying macroeconomic analysis, since the aggregate fiscal objective cannot be defined in isolation from the constraints that derive from ongoing policy commitments (this reinforces the suggestion made earlier to develop a macroeconomic analysis capacity within the ministry of finance).

c. Baseline budget

Several countries prepare a baseline or "current level of services" budget that provides the basis from which policy changes can be measured. The baseline budget is prepared by the ministry of finance, and can be used by this ministry to prepare the initial ceilings, then to negotiate sectoral budgets with line ministries on a clearly defined basis.

Ideally, the baseline budget should reflect the costs of existing policies, rather than only the costs of the present level of inputs and outputs. However, with the exception of entitlement programmes, it seems more realistic and simpler to focus on the present level of expenditure. Therefore, the baseline budget can consist of the following elements:

- For operating expenditures: (i) the budget of the current fiscal year adjusted for expected inflation; (ii) the recurrent costs of investment projects that are being completed; and (iii) the effect of

measures implemented in the course of the current fiscal year, whose impact has to be evaluated for a full year (for example, recruitment of civil servants in October, where the fiscal year runs from January-December).

- For entitlements and transfers, development of parameters such as the expected number of beneficiaries, the exchange rate (for transfers abroad), etc.

- For investment projects above a certain size, the forward costs of ongoing projects.

To prepare the baseline budget, the ministry of finance must keep data on the more substantial programmes (notably, entitlements and investment projects of a significant size).

The preparation of such information will provide the ministry of finance with an appropriate instrument both for preparing the initial ceilings and negotiating sectoral budgets with the line ministries.

Some countries, however, have set up more formal and systemic approaches to using a baseline budget in budget preparation. In France, for example, the procedure is formally structured in the organic budget law. In several other OECD countries, the baseline budget in effect is established through a rolling multi-year budgeting process. Such rolling processes, when they are properly designed, allow the ministry of finance to prepare the baseline budget from multi-year estimates prepared the previous year, which are updated at the start of the budget preparation cycle. Within a multi-year framework the costs of existing policies should not be confused with the costs of the current level of activities, since the gap between these two elements increases each year.

Such systemic approaches to preparing a baseline budget are a substantive administrative simplification and can be helpful in opening up a thorough policy debate, since budget preparation and budgetary negotiations can focus on desired policy changes. However, they may also rigidify budget preparation. If spending agencies have no guarantee that any savings they might make will provide them with additional room for manoeuvre to undertake additional activities, there will be little incentive for them to find savings on the baseline budget.[14] Moreover, when significant shifts must be made in the composition of the budget, a formal baseline budget, including the costs of continuing policies or programmes that should be eliminated, can increase difficulties in budgetary negotiations.

In many transition countries, a systemic approach as described above would present a number of difficulties. Nevertheless, the preparation of the initial ceilings and the budget negotiations should always attempt to distinguish the "baseline" from policy changes or at least from changes in the level of activity.

d. Subceilings for some categories of expenditure?

Depending on circumstances and fiscal policy issues, separate subceilings may be needed for broad economic categories of expenditures (e.g. personnel expenditures, subsidies, and capital investment programmes).

Concerning capital expenditures, if only a global ceiling is set, line ministries would be able to make trade-offs between their current spending and their capital spending. Line ministries presumably know better than the "ministry of finance" what would be the most efficient allocation of resources within their sector. Thus in certain sectors, such as primary education, it is generally preferable to leave the choice between current and capital spending to line ministries, since both types of expenditure are "developmental" and investment projects are generally of small size. However, in other cases, a ministry's budget may depend largely on the decision of whether about not to launch a large investment project. For example, the budget

of a ministry of higher education could be dominated by a decision to construct a new university. Because decisions about such large investment projects should be taken by the government as a whole, and are not only a sectoral policy issue, separate ceilings are appropriate in these cases.

e. Efficiency "dividends"

In recent years, Australia and Sweden[15] have demanded from each spending unit so-called "efficiency dividends", i.e. savings required in their ongoing activities (around 1.5% annually). At first sight, this practice may look like an example of (undesirable) across-the board cuts made by the ministry of finance when finalising the budget. However, there are two major differences: (i) efficiency dividends are notified early in the process and within a coherent multi-year budgeting system; and (ii) the allocation of savings among activities and expenditure items is entirely the responsibility of the spending agencies, which alleviates the arbitrary nature of the approach. "Savings measures are much more likely to be implemented within the ministry when the line ministry itself is arguing for them rather than when they are set by the central agencies, with the knowledge and skills of the programme agency being devoted to criticism and obfuscation." (Dixon, 1996). This approach appears to have achieved effective results in recent years.

In OECD countries, the potential for substantial fiscal savings and efficiency improvements exists. Before considering introducing efficiency dividends in transition countries, however, the country context must be carefully reviewed. In those countries where the current budget is insufficient to allow line ministries to function at an acceptable level, the real question is not to generate a gradual increase in efficiency, but to restructure public expenditure by eliminating questionable programmes altogether (and/or increase tax collection). Moreover, "efficiency dividends" differ from across-the-board cuts only if line ministries demonstrate a willingness to make their own hard choices. Certainly, in the long run, the savings from the efficiency dividends mechanism may be expected to decline. And, where the current budget is inadequate to satisfy essential needs, the risk that the efficiency dividends are achieved at the expense of diminishing service or programme quality is very real. However, efficiency dividends may be a useful tool to introduce greater performance-orientation in a complacent administrative system, and trigger desirable structural improvements.

f. Ministry of finance guidelines and budget circulars

In most countries, a "budget circular" is issued to spending agencies by the ministry of finance at the beginning of the budget preparation cycle. For a sound budget preparation process, the budget circular should state clearly the government's fiscal targets, and the policies proposed. It should also specify the guidelines for the preparation of the sectoral budget, pro-forma documents with which spending agencies submit their budgeting requests to the ministry of finance, and deadlines for receipt of this information. Thus, a budget circular should include most or all of the following elements:

- A statement of the macroeconomic and financial situation.
- The overall deficit target and other fiscal targets/objectives, and expected resources.
- Budget priorities.
- The sectoral budget ceilings. Depending on the quality of the estimates, the sectoral ceilings can be broken down, for information only, into an allocation of the present level of activity/outputs (or continuing policies), an indication of expected savings, and an allocation of increased activities (or new policies).

- A proforma of the line ministries' budget submissions.

- Specific guidelines for the presentation of major expenditure items and programmes, such as personnel expenditures, investment projects and entitlement programmes.

- Specific policy recommendations on the main programmes/projects.

- Key economic assumptions that enable line ministries to prepare their budget requests such as the expected inflation rate, exchange rate and level of unemployment.

2. Bottom-up approach

Line ministries are responsible for preparing their requests within the spending ceilings specified by the ministry of finance. Depending on the severity of the fiscal constraint and the organisation of the budget preparation process, additional requests from line ministries could be allowed for new programmes. However, the principal request should be consistent with the notified ceilings or guidelines, and the cost of programmes included in this submission should be sufficient for full implementation of the programmes concerned. Provided that their savings proposals are realistic, line ministries should be free to reallocate savings on ongoing programmes, within the limits of the sectoral ceilings.

Line ministries' budget requests should preferably distinguish between: (i) the amount necessary to maintain the current level of activity (or the costs of ongoing policies); and (ii) proposals for and costing of changes in the level of activity (or policy changes). As discussed earlier, at least for entitlements, the distinction between continuing policies and policy changes is more relevant than the distinction between the present level of activity and changes in the level of activity. But in both cases, the methodology should be defined in the budget circular.

Before deciding to include in the budget any new expenditure policies or programmes it is necessary to assess their budgetary impact in the medium-term. This is particularly important for investment projects and entitlement programmes, which may generate recurrent costs or increased expenditures in the future. Such an assessment is required whether or not a formal exercise of multi-year expenditure programming is carried out. For this purpose, line ministries' requests must show systematically the forward annual costs of multi-year or entitlement programmes, and the ministry of finance should take into account the forward fiscal impact of these programmes when scrutinising the budgetary requests from line ministries.

The submissions from line ministries should include:

- A brief policy statement describing the sector policies and expected outputs/outcomes, including some key indicators of these outputs and outcomes.

- If possible, performance indicators by programme and activity. These indicators can be defined according to the organisational structure of line ministries, or by a specific programme/activity classification. If the budget of the line ministry is presented by programme, a programme profile form should be prepared.

- A statement of how the policy and programme objectives will be achieved.

- Expenditure estimates for the budget under preparation. These estimates should fit within the sectoral ceiling notified by the ministry of finance (any additional requests being presented on a

separate list). They should be compared with actual data for the previous year and the current budget forecasts.

- Identification of the savings made on ongoing programmes (compared, for example, to the costs estimated by the ministry of finance when preparing the ceilings); and clear identification of measures needed to implement effectively the proposals.

- The number of staff positions (occupied and non-occupied) and of personnel expenditures. The methodology to calculate personnel expenditures must be clearly indicated (in particular, line ministries should indicate the number of full-time equivalent staff they have used in order to estimate total personnel expenditures). Overhead costs such as the social welfare and pension fund contributions paid by employers should be included. The forecasts for increases in salaries and benefits must be consistent with the ministry of finance guidelines. Estimated payments of bonuses and special allowances should be identified separately within the personnel costs subhead. In addition, ministries should include an estimate of the cost of casual staff and consultants.

- For capital investment projects/programmes above a specified size (as defined by the ministry of finance), and, for all such projects externally financed: (i) total costs, annual costs over a period of three to four years, and any balancing expenditure that is required to complete the project after this period; (ii) an estimate of the operational costs after completion of the project; (iii) a schedule of commitments (contracts to be engaged) over the project lifetime. The planning of commitments is required for an agency's internal management, and to prepare authorisations for forward commitments, if any. The ministry of finance should specify the rules to be adopted for making estimates of these forward costs (e.g. constant or current prices, and the assumed inflation rate) and for estimating the costs after the current fiscal year.

- Data on the nature of entitlement and subsidy programmes, such as the number of beneficiaries and the method of calculation, should be included in the budget requests of line ministries. The forward costs of entitlement programmes should be systematically assessed, by the agency responsible to manage them. This requires compiling all related regulations and laws, and evaluating the impact of factors such as economic growth and demographic influences.

- Estimates of acquisitions and disposals of state property assets. (Line ministries should be given incentives to sell such assets for which no future public use is expected).

Line ministries should co-ordinate the preparation of the budgets of their subordinate agencies and give them appropriate directives. The submission of budget requests from subordinate agencies, in general, should meet the same criteria as noted above for line ministries' requests to the ministry of finance.

Special issues related to screening and selecting investment projects are reviewed in Chapter 6.

3. Examination of the budget submissions and negotiations with line ministries

Once the requests of line ministries are received, the ministry of finance should review their conformity with overall government policy, legal requirements and compliance with the spending limits; and take into account any changes in the macroeconomic environment since the beginning of the budget preparation cycle.

To examine properly the budget requests it is necessary to:

- Scrutinise the spending ministry budget submission. Does the budget request reflect government policy? What policy issues does the programme intend to address? Are the objectives clearly identified? If relevant, are the programme's objectives and results measurable? Can they be monitored?

- Discuss the submission with officials of the spending ministry.

- Ideally, make field trips to see how the programme works at the operational level, and meet with programme managers and users/clients.

- Analyse the impact of recent policy decisions, significant changes in legislation or new government regulations in the field, and relevant litigation.

Almost always, the review of budget submissions leads the ministry of finance to suggest modifications in the line ministries' budget requests, and a subsequent period of negotiation. Formal negotiations between the ministry of finance and line ministries can take the form of a budgetary conference. Professional staff from the ministry of finance and line ministries should also hold informal meetings in order to avoid misunderstandings and minimise conflicts. Major differences of opinion will normally be referred upwards to the ministers concerned, ultimately to the prime minister or council of ministers for arbitration.

4. The budget timetable

Sufficient time needs to be allowed for iteration between the top-down and the bottom-up approaches described above, notably to allow line ministries to prepare their budgets and identify measures to comply with the ceilings. In several OECD countries, the budget circular for the next year is sent to spending agencies soon after the beginning of each fiscal year. Therefore, budget preparation starts nine to ten months before the budget is presented to the legislative branch. In the US, taking into account the special role of the Congress, the budget preparation cycle takes about 18 months. In some transition countries, budget preparation is sometimes started early in the year but the sectoral ceilings are notified much later, and as noted above across the board cuts, or other arbitrary adjustments in the budget, may then have to be made at the last minute.

The optimal length of the budget preparation cycle is difficult to establish, and depends on the country context. On the one hand, a relatively short calendar (or a short period between the notification of ceilings and the deadline for presentation of the budget requests) does not allow line ministries and subordinate agencies sufficient time to prepare properly their programmes, or to carry out the necessary negotiations with the ministry of finance and/or the centre of government. On the other hand, a procedure that is too long may lead to a budget based on out-of-date estimates of economic and fiscal parameters, which in addition may not take into account the results of the execution of the previous year's budget.

Unfortunately, countries with unstable and hard-to-forecast economic and fiscal parameters (such as high-inflation economies) generally need more time to make the hard choices among their programmes. In general, a budget preparation cycle that starts, with the issuance of the budget circular, about six months before the deadline for presentation of the budget to the legislature can be appropriate in many transition countries, but there is reliable rule of thumb, and no substitute for custom-tailoring the budget calendar to the needs of each country.

Figure 5.4 shows an example of an illustrative timetable for budget implementation.

Table 5.4. **POSSIBLE TIMETABLE FOR BUDGET IMPLEMENTATION**

The rectangles represent a process with a pre-determined beginning and end point.
The triangles represent pre-determined dates on which an event takes place.

	J	F	M	A	M	J	J	A	S	O
Preparation of macro-economic framework	▭	▭								
Ceilings by sector prepared by MOF		▭	▭							
Cabinet approves strategy and ceilings			▭	▭						
Budget circular is released				▲						
Line ministries submit budget requests				▭	▭	▭				
Budget requests reviewed by MOF/Negotiations						▭	▭			
Draft budget prepared by MOF								▭		
Draft budget reviewed by Council of Ministers									▭	
Budget submitted to legislature									▲	
Legislature scrutines and approves budget										▭

5. Distribution of responsibilities in annual budget preparation

Different institutions are involved in budget preparation: the centre of the government; the ministry of finance; central departments of line ministries; and, within line ministries, subordinate spending agencies (in some countries, the parliament and the supreme audit institution are also involved). The quality of the budget depends in a large part on the form and effectiveness of co-ordination that is established among these different institutional players.

The distribution of responsibilities in budget preparation should match the distribution of responsibilities within the government. There should be clear and indisputable rules for compliance and accountability in budget execution that are defined in primary legislation (e.g. the organic budget law) or secondary regulations. The organisation of the executive branch of government in most countries suggests a distribution of responsibilities according to the following lines:[16]

- The centre of government (i.e. the office of the prime minister or the council of ministers or some other group at the centre) is not directly involved in the practical aspects of budget preparation, but usually plays a key role in the budgetary process by ensuring that it is carried out according to the required procedures; arbitrating and smoothing over any conflicts that may appear among the institutional players; and ensuring the participation of the relevant stakeholders.

- The council of ministers plays a key role in discussing budget options and approving the draft budget before it is submitted to parliament.

- The ministry of finance has the leading role in budget preparation. It needs sufficient powers and technical capacity to ensure that, at every step, both fiscal targets and policy objectives are taken into due account. The ministry should prepare fiscal targets and strategic priorities among sectors; establish guidelines for preparing sector programmes and line ministries' requests; scrutinise these requests; and draft the budget. However, the ministry of finance does not carry out these functions

in isolation from other players in the budget process. Moreover, the budget procedure itself should not drive policy choices. The ministry of finance's role is to facilitate decisions on major policy choices and propose an allocation of resources among sectors based on its review of sectoral budget requests, not to make those decisions.

- Line ministries are responsible and accountable for defining and implementing government policies in their sector. Therefore, they should be responsible for developing sectoral policies and sectoral budgets, but within the framework established by the government. Moreover, they (and not the centre of government or the ministry of finance) should have the technical capacities and information needed to make informed trade-offs among ongoing policies and programmes and to appraise new programmes. In turn, line ministries are responsible for formulating guidelines for their subordinated agencies and scrutinising their draft budgets. Subordinated agencies should prepare their budgets within the guidelines provided by their immediate direct authority (i.e. the relevant line ministry). Often, powerful agencies prefer to deal directly with the ministry of finance; but this tends to impede the development of consistent sector policies.

NOTES

1. See Davis (1992) and Rajcoomar and Bell (1996).

2. National Audit Office, UK (1997). *Audit of Assumptions for the July 1997 Budget Projections*. Presented to Parliament by the Chancellor of the Exchequer, 19 June 1997. London: Her Majesty's Stationery Office. Auditor General of Nova Scotia, Canada (1997). *Report to the House of Assembly on the Estimates of Revenue for the Fiscal Year 1997-98 Used in the Preparation of the Budget Address*. Halifax: Auditor General Office.

3. Fiscal policy rules are discussed in Kopits and Symansky (1998).

4. The United Kingdom presently (2000) operates two fiscal rules: the golden rule and the sustainable investment rule under which public debt as a proportion of GDP is held over the economic cycle at a stable and prudent level.

5. See Bayoumi and Eichengreen (1994).

6. See Allan (1994) and Von Hagen (1992).

7. See Tanzi, Blejer and Teijero (1993).

8. Blejer and Cheasty in Blejer and Cheastery (1993).

9. For example: the RMSM-X model used by economists in the World Bank (case studies in Luc Everareart, Fernando Garcia-Pinto and Jaime Ventura (1990); the Polak model used by the IMF (Polack "The IMF Monetary Model: A Hardy Perennial" in *Finance Development*, December 1997); the Tommasi-Aerts-B.Leenhart-Olive (TABLO) model developed by the French Agency for Development (Leenhardt and Olive "An Example of Quasi-Accounting Model", Inter-Stat, 12 October, 1995, London), etc.

10. Or in developing countries the "development" budget, which includes both capital and current expenditures.

11. The Harrod-Domar model, which attracted much attention in the 1950s and 1960s and is described in most textbooks on economic development, attributed economic growth solely to capital formation and equated the growth rate to the ratio of the saving rate and the incremental capital-output rate. For further discussion, see, for example, Goode (1984).

12. This statement is true of most transition countries and middle income countries at least. In a number of developing countries, the technical capacity of the ministry of finance to analyse aid-financed projects, which constitute the higher share of the development budget, is usually very weak, though occasionally the ministry of economy (or planning) has some expertise in these areas.

13. For example, at the recommendation of IFIs, Romania attempted in 1993-1997 to set up an investment co-ordination unit outside the ministry of finance despite the fact that this ministry was already preparing the capital budget and screening projects through its own investment department.

14. See Hel-Thelier, Meny and Quinet (1996).

15. See Schick in OECD (1997h), page 100.

16. This scenario does not apply to countries that follow the US approach to budget preparation which is different in several respects, including the much stronger role of the legislature.

CHAPTER 6

MULTI-YEAR BUDGETING AND INVESTMENT PROGRAMMING

Looking beyond the broad principles and basic requirements reviewed in Chapter 5, this chapter discusses the techniques of medium-term budgeting and special issues related to investment budgeting and programming.

A. Multi-year Budgeting

1. Objectives and major features

Many OECD countries started preparing multi-year (or "medium-term") budgets in the 1970s and early 1980s and by the year 2000 this approach has become more or less universal. In some countries, the multi-year estimates are translated into detailed programmes. In other countries, they operate at a more aggregate level.

Generally, multi-year estimates are rolled over each year. The first year is fully consistent with the annual budget, while expenditure forecasts for the out-years are indicative. The planning period is usually three to five years. While in some countries the preparation of multi-year estimates has become an integral part of the formulation of the annual budget and is seen as a key instrument of expenditure control, in other countries the multi-year estimates provide only background information for policy decision-making.[1]

Budget literature describes these approaches under various terms such as "expenditure planning and forecasting"[2] and "multi-year budgeting"[3]. Forecasting involves estimating future budgetary resources and expenditure requirements, while planning implies the formulation of goals and policies.[4] Basically, the objective of medium-term "expenditure planning and forecasting" is to increase discipline over government expenditures. This involves an interplay of the following factors:[5]

- Setting overall fiscal policy targets and stating explicitly how the government will meet them over a number of years; these targets can then be translated into a ceiling for expenditures.

- Providing better information on the medium-term costs of existing expenditure policies. This frequently reveals that very limited, if any, additional resources are available if the government's fiscal policy targets are to be met. It serves to impose self-discipline on ministers in proposing new expenditures and to alert the government to policy decisions that may need to be made immediately in order to achieve the future fiscal targets.

- Giving greater scope to initiate changes in budget policy that will take more than one year to implement, and providing instruments to supervise their implementation.

- Illuminating the budget implications of recent policy decisions on future years' budgets, expenditure on which may not be fully reflected in the existing budget. This covers: (i) the future recurrent costs of government capital investment projects; (ii) programmes that come into effect late in the budget year thus not exposing their full costs initially; (iii) programmes whose impact on spending in future years will rise as take-up increases; and (iv) policy commitments whose fiscal impact is not immediate, but will be reflected in future budgets.

In addition, providing indicative funding to agencies can also contribute to improving operational performance, through increased predictability of funding and promoting clear indications of required future savings.

2. Experiences in multi-year budgeting

a. Past experiences

Multi-year budgeting was perceived in the 1970s mainly as an instrument to identify new programmes and allocate funds for them in future budgets. According to the OECD (1997b), two major problems were initially met by countries that prepared multi-year budgets: (i) the tendency to overestimate economic growth and resources available in the forecast period; and (ii) the tendency of spending agencies to view the medium-term forecast of expenditures as an entitlement. This made subsequent downward revisions in expenditures difficult, even when it became clear that the underlying economic assumptions were over-optimistic or that policy priorities had changed. Box 6.1 illustrates some of these problems.

Aside from technical deficiencies, the insufficient commitment of some governments to fiscal discipline explains why past experiences of multi-year budgeting did not always achieve the expected results. A frequent major weakness in budgeting is the "needs" approach, which leads to budgets that are not consistent with a country's financial constraints, and are characterised by excessive bargaining and the development of evasion strategy. These problems are aggravated when preparing multi-year programmes, since planning beyond the budget year is seen as less compelling than annual budgeting, and the temptation to prepare wish-lists instead of sound requests is greater.

Box 6.1. EXAMPLES OF MULTI-YEAR BUDGETING FROM THE 1970s AND EARLY 1980s

United Kingdom. In the 1970s, multi-year budgets were expressed in real terms rather than nominal terms. When economic growth fell and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically. This created further pressure on public finances. (1)

Multi-year budgeting in this period also produced "bow-waves" in expenditures implying higher expenditures for the immediate fiscal year and tapering outlays for future years. Spending units traded cuts in future years in order to maintain their existing budget allocations. (2)

Canada. The Policy and Expenditure Management System (PEMS) implemented in the early 1980s included the preparation of a five-year rolling fiscal programme. Results were disappointing.

(cont'd)

Box 6.1. **EXAMPLES OF MULTI-YEAR BUDGETING FROM THE 1970s AND EARLY 1980s** *(cont'd)*

One of the causes of the failure of the system was the incorporation of a "programming reserve" in the multi-year estimates. Spending ministries interpreted this policy as a signal that the government was willing to spend at levels above existing commitments. Thus, they were encouraged to bring forward new spending proposals to their respective policy committees in order to secure their "share" of the reserve. The PEMS system thus became transactional rather than allocational, driven by new spending proposals. (3)

Australia. In the 1970s and early 1980s, forward estimates were of little relevance to the annual budget preparation procedure and little attention was given to the estimates for the out-years, which were often "wish-lists". The different interpretations of what was a "continuing policy" produced time-consuming negotiations and disputes had to be brought to the Cabinet. (4)

Sources:

(1) A. Liekerman (1990).
(2) Premchand (1983).
(3) Sims (1996).
(4) Keating and Rosalky (1990).

b. Lessons to be learned

From about the mid-1980s, taking into account problems met in the past and the need to keep expenditure under control, multi-year budgeting systems shifted from an instrument for identifying new programmes to an instrument for expenditure control, and for the allocation of resources under a hard budget constraint. "Various OECD governments reoriented their multi-year budgets from plans to projections and from instruments of programme expansion to constraints on future spending. It was reflected (in a number of countries) in rules dictating that the projections be based on unchanged policy, that is, that they merely estimate the future cost of existing programmes." (OECD, 1995).

Multi-year estimates focusing on existing policy commitments provide a baseline for starting work on the budget. Even where they are only a background document, this baseline conveys a powerful message: "that the built-in momentum of existing programmers had already claimed all future resources and that there was no margin for new spending schemes" (OECD 1995).

However, in order to reinforce expenditure control, other OECD countries adopted a different approach. For example, in Canada, a two-year fiscal planning horizon replaced previous medium-terms plans, as authorities there concluded that a short-term focus would be more appropriate in dealing with fiscal consolidation. In the UK, as much expenditure as possible is fixed for a three-year period. A review of forward spending plans takes place every two years; the medium-term framework is then rolled forward (see Box 6.2 for further details of this innovative approach). A more common approach is to roll forward multi-year estimates every year. Box 6.3 illustrates how this is done in Denmark and Germany.

Box 6.2. MEDIUM-TERM BUDGETING IN THE UNITED KINGDOM

Planning and controlling public expenditure over the medium-term is subject to two strict fiscal rules: the golden rule (the government will borrow only to invest and not to fund current expenditure) and the sustainable investment rule (the ratio of net public debt to GDP will be held at a stable and prudent level).

The 1998 Comprehensive Spending Review (CSR) involved in-depth analysis of all spending programmes and their aims and objectives, covering the period 1999-2001.

The 2000 CSR repeated this exercise, using a new accrual budgeting system.

Spending plans are now set for three years, not just one.

Spending agencies can carry forward unspent funds from one year of their spending plans to the next year.

About half of total spending (e.g. entitlement programmes) is still managed annually because it is more volatile in nature.

The three-year plans are not affected by this spending on the more volatile expenditure items.

Capital investment is planned and managed separately from current spending to ensure that the fiscal rules are met, and to prevent capital spending being cut back to meet short-term pressures on current spending.

Spending agencies make Public Service Agreements (PSA) — agreed output targets detailing the exact outcomes agencies will deliver with the money provided — linked to their three-year spending allocations.

"Cross-cutting reviews" ensure that ministries/agencies work together to achieve the government's aims.

Source: HM Treasury. For more information: see *Modern Public Services for Britain*, CM4011, 1999; *Economic and Fiscal Strategy Report*, 1999; *Resource Accounting and Budgeting: A Short Guide to the Financial Reforms*, 1999.

3. Medium-term budget framework (MTBF)

As noted above, the definition and methodology of multi-year budgeting varies from one country to another, and in each country approaches have varied over time, depending on the policy concerns and priorities of the moment.

In relation to the balance between policy planning and expenditure programming aspects, the multi-year estimates can be either (i) aggregated by main function or strategic area, thus providing a framework

Box 6.3. ROLLING FORWARD MULTI-YEAR BUDGET ESTIMATES

Denmark. At the start of the budget preparation process, the Ministry of Finance adjusts the multi-year projections to reflect the pay and price assumptions that will be used in preparing the next budget. In February, it proposes to the Cabinet a set of spending ceilings, one for each minister, and the new aggregate expenditure target. These ceilings set the framework for the drafting of budget proposals in the various ministries. Negotiations on the budget focus on accommodating new expenditures and cut-back options for ministries that have difficulty keeping within the agreed limits.

Germany. Preparation of the annual budget is guided by a medium-term financial plan that is presented to Parliament each year. Both the plan and the budget are developed on the basis of fiscal proposals made the Financial Planning Council in which all tiers of government are represented. The plan indicates the government's overall fiscal policy and future expenditures in each of 40 large blocks. These blocks are aggregated from multi-year estimates prepared simultaneously with the annual budget for each of the expenditure items included in the budget. The multi-year estimates are consistent with the medium-term targets, but the sum of allocations to individual spending units is less than total budgeted expenditure because a general planning reserve is included for each of the future years to cover the additional costs of new programmes and possible price increases.

Source: OECD (1995).

for policy formulation and planning; or (ii) detailed by programme, thus providing an instrument for operational implementation of programmes.

In principle, to ensure predictability, multi-year estimates should be divided into spending agencies and programmes. Providing indicative funding levels at agency or programme level has the strong advantage of encouraging agencies over a multi-year period to adapt their programmes to the expenditure ceilings. However, to achieve these objectives, multi-year expenditure programmes must be based on sound revenue forecasts, which can be difficult to prepare in an unstable economic environment. In countries, where the ministry of finance systematically sequesters appropriations, because budgeted revenues are overestimated, priority should be given to improving the preparation of the annual budget.

In some transition countries, these requirements for a stable environment have not been achieved. In such a context, carrying out a detailed expenditure programming exercise is very difficult, since negotiations for future funding cut across the need for debate about the government's policy objectives and options. For example, what should be the ministry of health's approach in a country where a cost-recovery policy is being considered, but not yet decided by the council of ministers? Prepare its multi-year estimates on the basis of a cost-recovery policy still being debated within the government? Or prepare them on the basis of existing policies, according to which hospitals are totally funded by the government? In such circumstances, the preparation of multi-year expenditure estimates could become a source of delay in the implementation of important reforms. In practice, therefore, preparing a detailed expenditure programme requires, as a precondition, broad agreement by the government on its policy objectives and priorities.

It will be often more cost-effective than undertaking a comprehensive detailed expenditure programming exercise to supplement the medium-term fiscal framework (MTFF) by aggregate expenditure estimates, broken down by main function and/or strategic area.

The set of aggregate expenditure estimates comprises a medium-term expenditure framework (MTEF), which in turn constitutes part of a medium-term budget framework (MTBF) that will include:

- Revenue projections by broad economic categories (i.e. major items of the GFS classification).

- Expenditure estimates which should show, at least: (i) projections of expenditure by broad function and/or strategic area, distinguishing capital expenditures from current expenditures; (ii) projections of the more significant entitlement programmes; and (iii) projections of the forward costs of investment programmes/projects of a significant size. These expenditure estimates should cover all government expenditures, but low priority activities can be aggregated if required.

- Projections of other fiscal aggregates (e.g. interest and financing items).

The medium-term fiscal framework (MTFF) should cover the general government sector as defined according to the GFS 2000 and ESA95 standards. Ideally, the MTBF should have the same coverage as the MTFF. However, this depends on the country's institutional context, particularly on the arrangements for managing expenditures among the different levels of government. In every case, however, the MTBF should cover at least all central government financial operations, including those of extra-budgetary funds. Agreement by the council of ministers to these estimates, and the initial annual sector ceilings, will help to provide a framework for the formulation of budget policies.

Figure 6.1 illustrates the structure of a medium-term budget framework.

In parallel, or as a second stage exercise, detailed forecasts of the forward costs of the programmes authorised by parliament should be compiled once the budget is finalised. During budget preparation, information on the forward costs of programmes can be collected, and used to assess the forward fiscal impact of policy proposals. As noted earlier, such forecasts convey a powerful message, since they generally show that there is little or no fiscal room for manoeuvre. They provide valuable information for the preparation of the next budget.

The delicate fiscal situation faced by most transition countries, and the need to manage uncertainty suggest that many countries will want to focus initially on the MTFF and the MTBF, supplemented with preparing forecasts of the costs of ongoing programmes, rather than prepare a detailed multi-year budget. However, in some sectors, or in the case of special purpose budgets, multi-year programming exercises can be desirable and necessary (for example, those related to the use of EU pre-accession funds or other multi-annual aid programmes designed to promote economic development). Moreover, the MTBF can become progressively the basis of a rolling multi-year budgeting system, through which resources are allocated among programmes. We shall therefore review in the following sections other key issues related to multi-year budgeting.

4. Key issues in multi-year budgeting

a. The policy basis of expenditure

In principle, multi-year estimates should show: (i) the present level of expenditure; (ii) additional expenditure needed to provide the same level and quality of service in the future (for example, to maintain

Figure 6.1. **MEDIUM-TERM BUDGET FRAMEWORK**

Medium-Term Macro-economic Framework

Medium-Term Fiscal Famework

General government (including funds and subnational governments)

Medium-Term Budget Framework

	1999 Actual	2000 Budget	2001 Proj.	2002 Proj.	2003 Proj.
Revenue projections					
Expenditure framework by broad function					
Key sectors/areas					
Defence and security					
current					
capital					
Education					
current					
capital					
Transport					
current					
capital					
of which major ongoing projects:					
Motorway E76					
Major entitlement programmes					
Social welfare					
current policies					
plus/minus policy change					
Other expenditures					
current					
capital					
Grants subnational to government non included above					
Reserve					
Memo: uses of EU pre-accession funds included above					
EU					
Domestic counterpart					
Interest					
Financing					
Memo: *Superannuation liabilities/Contingent liabilities*					
Other fiscal risks/Tax expenditures					

a given pupil/teacher ratio in educational institutions); and (iii) additional expenditure or savings, if the level or type of service is to be changed. Elements (i) and (ii) can be described as existing/continuing policies and element (iii) as new policies or a policy change.[6]

The costs of existing policies include, in particular: (i) the costs of maintaining the current level of service, taking into account expected changes in the number of users or beneficiaries; (ii) the recurrent costs of investment projects that will be completed over the planned period; (iii) the forward costs of ongoing investment programmes; and (iv) the future costs of entitlement programmes based on decisions already taken and the influence of exogenous factors such as demographic trends.

Estimating the costs of existing policies over a multi-year period needs adequate information. For instance, determining the forward costs of primary education requires data on the numbers of children in the relevant age groups, participation rates and standards of provision.

This exercise is similar to the preparation of the budget baseline described in Chapter 5. Nevertheless, whereas in an annual budget framework, the scope of the baseline budget can be limited to the present level of expenditure, over a multi-year period, the cost estimates must also take into account the additional expenditure necessary to provide the same services. This is a difficult part of the exercise, since in a number of cases, the distinction between existing and new policies may not be clear. The inherent lack of clarity in the term "continuing policies" may lead to political disputes and bargaining, when detailed expenditure programmes are prepared. Making a distinction between ongoing programmes and new programmes is often less open to misinterpretation and should be preferred in certain cases. When significant adjustments in an investment programme are proposed, the approach should be even more restrictive and based on the existing legal commitments rather than existing programmes and projects.

b. Planning new policies and programmes

Concerning the planning and forecasting aspects of the multi-year estimates, three different approaches can be considered:

- A "technical" forecast of the forward costs of ongoing programmes (including the recurrent cost of investment projects).

- A "stringent" planning-programming approach, consisting of: (i) planned savings in non-priority sectors over the planning period, in order to leave room for higher priority programmes; but (ii) including in the expenditure plan only the cost of ongoing programmes and those new programmes which are included in the annual budget currently under preparation or for which financing is certain.

- A "full-fledged" planning-programming approach, which identifies explicitly new policies and programmes, and their costs, over the entire period.

Avoiding distortions in the annual distribution of expenditures is a difficult challenge when preparing multi-year expenditure programmes. Sometimes, in order to exclude certain programmes or projects from the annual budget under preparation, the ministry of finance attempts to compromise with the line ministries by including such projects in the out-years of the multi-year programme. However, this tends to result in spending agencies claiming "ownership" of these funds in the following year, thus making annual budget preparation increasingly difficult. Sometimes, indeed, spending agencies will commit the expenditure, before the budget has been approved by the parliament, on the pretext that it is included in

the out-years of the multi-year estimates, despite the fact that there is no legal base for such expenditure. In other cases, the spending units trade expenditure cuts in future years in order to maintain the present amounts of expenditure (see the UK example in Box 6.1). These future cuts can be purely hypothetical, since spending agencies may bargain later to preserve the current level of their programmes.

Care must be exercised to ensure that the multi-year estimates are based only on existing policy commitments of the government and do not provide a basis for increased spending claims by line ministries. This is an argument for adopting the stringent approach described above. Such an approach should be applied to special programme laws, public investment programmes and sectoral programmes, as well as detailed multi-year estimates.

c. Planning assumptions and contingency reserves

Multi-year estimates should be based on conservative assumptions in order to avoid future disruptive changes. The exercise loses credibility if the estimates prepared the previous year need frequent downward revision when preparing the annual budget. In practice, expenditure estimates should be equal to the budget forecasts for the first year of the planned multi-year period; and lower than the level of expenditures projected in the macroeconomic scenario for the out-years. An explicit or implicit contingency reserve should be included in the multi-year estimates. Two types of contingencies can be distinguished when estimating the required level of this reserve: (i) technical contingencies that take into account changes in key economic parameters (for example, the inflation rate) and the actual implementation of programmes (for example, unexpected increases in the costs of a construction project); and (ii) a policy reserve, for future new programmes not yet defined explicitly. These reserves should be purely indicative and should not create any "rights" over future spending allocations.

d. Linking annual budgeting and multi-year budgeting

In several OECD countries, disciplined rolling budgeting processes have been set up to integrate annual budgeting and multi-year budgeting. Ideally, such procedures should include the following features:

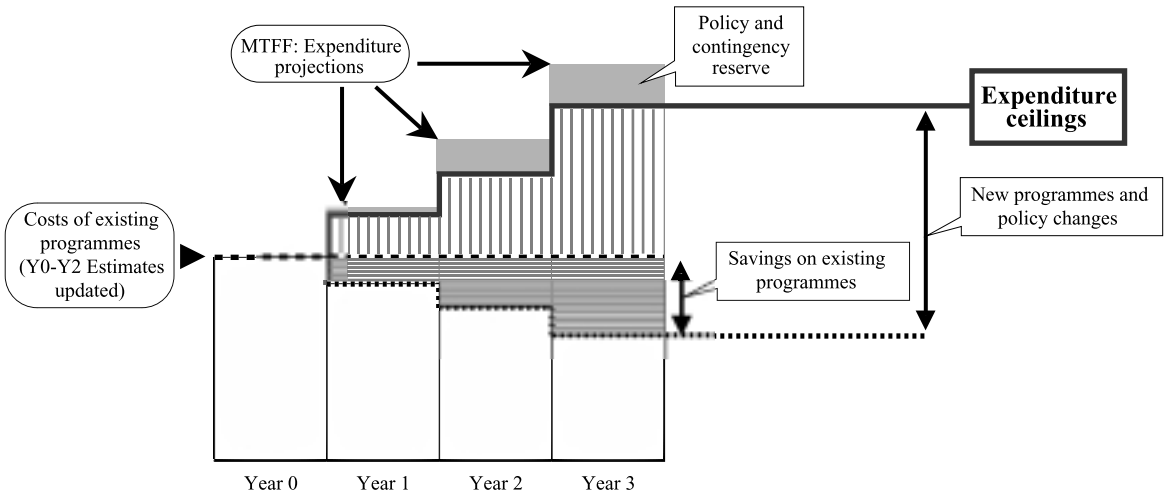
- Multi-year estimates prepared the previous year are the starting point of the budget preparation process. The ministry of finance updates the costs of the multi-year estimates prepared the previous year, taking into account expected developments of economic parameters, budget execution and expenditure reviews. It should make a preliminary estimate of savings that can be achieved in ongoing programmes over the planned period.

- Sectoral ceilings should be established for each year of the multi-year budget, on the basis of existing government policies and proposed policy changes. The annual budget and the multi-year estimates are prepared under these hard budget constraints.

- Continuing policies are clearly separated from proposed new policies and policy changes. Negotiations in respect of the annual budget and the multi-year estimates should focus on policy changes to be implemented in the forthcoming year.

Figure 6.2 illustrates some of the main tasks in preparing the multi-year estimates: (i) updating the costs of the estimates prepared the previous year; (ii) preparing the medium-term fiscal framework and expenditure projections; (iii) establishing expenditure ceilings below the projected level of total expenditure, in order to set aside a contingency reserve for the first year of the forward planning period and a policy and contingency reserve for the following years; (iv) identifying savings on ongoing programmes; and

Figure 6.2. **PREPARING MULTI-YEAR EXPENDITURE ESTIMATES**



(v) programming and budgeting under the double constraint resulting from the expenditure ceilings and the cost of existing policies.

Such rolling multi-year budgeting processes have several advantages, including bringing together the assessment of the forward fiscal impact of proposed policies and the preparation of the annual budget ceilings. However, setting up a disciplined rolling multi-year budgeting process needs time, and has proved to be difficult in many countries.

To ease the practical problems of implementation, the process of rolling forward the estimates could be restricted to the MTBF itself, including aggregate expenditure estimates by line ministry and main function. However, the ministry of finance will need more detailed data to update the MTBF at the starting of the budget process, and caution is still required to avoid the upward ratchet effect of increased claims from line ministries over future spending.

e. Other issues

Two other important issues in the design of the multi-year estimates concern the length of the forward planning horizon and the price basis of the estimates. On the one hand, uncertainty makes it difficult to prepare forward estimates over an excessively long period. On the other hand, the planning period must be sufficiently long in order to make a meaningful assessment of the government's policy priorities and to assess the recurrent costs of investment. If processes are disciplined and there is reasonable stability in the macroeconomic position and the government's policy priorities, a period of three or four years is an acceptable compromise.[7]

Multi-year estimates are either prepared in nominal terms or in constant prices. If the multi-year estimates are prepared in constant prices, the ministry of finance should define clear rules for updating the price projections. Preparing multi-year estimates in current prices ensures that they are consistent with the financial projections in the government accounts (which are also prepared in current prices). In a country with high inflation, it may seem more sensible to prepare multi-year estimates in real rather than nominal terms.

However, if inflation is higher than the forecast level, this will require additional cuts in expenditure in real terms. Conversely, estimates prepared in nominal terms give an added incentive for prudent management and thus may contribute to keeping down pressure on costs. Lessons drawn from UK experience in the 1970s show that multi-year budgeting in real terms and in an inflationary environment puts upward pressure on the budget. In any case, it is uncertain whether in practice multi-year estimates are useful in a country that lacks a minimum level of fiscal discipline and where budget predictability is not ensured, as is generally the case in high inflation countries.

As discussed in Chapter 5, announcing the government's fiscal objectives and targets, and presenting them to parliament with the budget is important both for fiscal discipline and accountability. However, committing the government on the basis of detailed expenditure programmes that are poorly prepared will impede the attainment of these fiscal objectives. Similarly, presenting to parliament detailed "programme laws" has led in some countries to rigidities and inefficiencies.[8] Caution is required before making public detailed multi-year estimates, and these figures should not be released before close internal review by the government.

In some countries, multi-year estimates are used to manage forward commitments. This requires highly disciplined multi-year budgeting processes. Otherwise, it is preferable to manage and authorise multi-year commitments through separate processes, for example by introducing an "authorisation for forward commitments" procedure in the budget.

B. Other Expenditure Planning and Forecasting Exercises

Earlier discussions focused on the preparation of expenditure estimates covering the medium-term, i.e. a period of three to five years, and all sector and categories of expenditures. In practice, a variety of expenditure planning and forecasting exercises can be considered, depending on the economic context and the government's policy priorities.

1. Sectoral programmes

Preparing expenditure programmes with a sectoral coverage has the advantage of focusing on the areas in which multi-year expenditure programming is most crucially needed. Countries that want to downsize significantly their civil service may need to focus first on personnel expenditure plans. Developing sectoral strategies and sectoral expenditure programmes covering, say, all categories of expenditures in the social sectors, or preparing a sectoral investment programme for the energy sector, is much more important than preparing detailed expenditure estimates for administrative sectors.

Aid or externally financed projects should be programmed in advance. Many aid-dependent countries have prepared since the 1980s rolling public investment programmes (PIPs). In the beginning of the 1990s, with the assistance of the World Bank and the European Union, PIPs were introduced in a number of transition countries. Similarly, sectoral expenditure or investment programmes are being implemented in several developing countries in order to co-ordinate donors' aid in priority sectors.

Programming donors' aid often leads to the inclusion of new programmes in the out-years of a multi-year budget. However, the qualifications made above must be kept in mind. Multi-year expenditure programming exercises must not open the door to bypassing essential fiscal constraints. Including a new project in an expenditure programme should be considered only if its financing is certain, and if it complies with the government's existing policies and the MTFF.[9]

When they are not properly framed and linked with the budget process, sectoral or investment programmes do not allow trade-offs among sectors or categories of expenditures to be made in a consistent manner and may reduce fiscal discipline. Sector budget-programmes and medium-term expenditure programmes should not be prepared through open-ended processes.

The *Public Expenditure Management Handbook* of the World Bank (1998) provides a consistent approach to linking budgeting, policy planning and the preparation of strategic sector reviews or programmes. It stresses the necessity of including the sector programmes within an MTEF prepared under hard constraints, which should, therefore, be consistent with the medium-term fiscal framework.

In a similar way, three broad principles should be adopted for the establishment of the National Fund through which EU structural aid to candidate countries is channelled: (i) expenditures financed by the National Fund must be integrated into the budget; (ii) the expenditure programmes submitted for EU financing must compete against all other expenditure programmes in the national budget; and (iii) the sources and uses of funds flowing through the National Fund must be included in the medium-term budget framework.

2. Long-term term budget frameworks

Long-term expenditure frameworks may be needed to assess the forward impact of current policies or to examine new policy options. Long-term frameworks are generally formulated on the assumption of a continuation of existing policies as the baseline scenario. Alternative scenarios may also be presented, however, incorporating the impact of specific policy changes being proposed or under consideration.

These long-term budget frameworks can identify adverse expenditure trends and assess the sustainability of current policies.[10] They are useful in analysing the impact of changing demography (e.g. the budgetary impact of an ageing population) or of the growing burden of fiscal debt. In such long term expenditure frameworks, government expenditure is generally divided into three groups: (i) expenditures directly affected by changes in demography; (ii) expenditures not directly affected by changes in demography, which are presented generally in an aggregated manner; and (iii) payments of debt interest. As reviewed in more detail in Chapter 11, several countries prepare generational accounts to assess the long-term implications of current policies and their effect on the distribution of costs and benefits across generations.

In fact, a variety of long-term planning and analysis is required for policy and budget formulation. For example, the fiscal impact of an investment programme can continue well beyond the period of the multi-year estimates, especially if there are heavy periodic maintenance costs (e.g. a road construction programme). Similarly, defining objectives such as an increase in the percentage of children in full-time education requires assessing their impact on the budget over a long-term period and reviewing different policy options and variants.

C. Budgeting and Programming Investment

1. Projects and programmes

Programming and budgeting investment is part of an overall expenditure management process, and requires the interplay of the following procedures:

- Project preparation, appraisal and screening.

- Investment programming and budgeting. Once the policy priorities among strategic areas are established, investment programming and budgeting consists of: (i) within strategic areas, balancing requirements for investment expenditure against those for current expenditure, and identifying investment projects and programmes; and (ii) within investment programmes, making choices among projects already identified, and reviewing ongoing projects.

These two processes are interdependent. At different stages of the project cycle choices between projects must be made (when launching studies on identified projects, when appraising studies, and when making the final "go/no go" decision). Sound budgets require good projects, but programming and selecting projects must be set in a broader framework than the analysis of individual projects. The sequencing of decision-making and an appropriate design of linkages between the project preparation process and the budgeting-programming process are essential, in order to ensure that policies drive programmes; programmes fit the financial constraints; and programmes drive projects.

2. Managing the projects

a. What is a project?

According to the definition given by Gittinger (1982), the project is a specific activity, with a specific starting point and a specific ending point, intended to accomplish specific objectives. Usually, it is a unique activity noticeably different from preceding activities and likely to be different from succeeding ones, not a mere "segment" of an ongoing programme. Sometimes investment spending is a routine activity (e.g. the acquisition of administrative equipment), but most investment spending consists of projects.

For efficient implementation, it is often necessary to set up special arrangements for administering projects. The project management model consists of project planning, accounting, systems for progress monitoring and reporting, and appointment of a project manager and a project team.[11] Such organisational models distinguish investment projects, as well as a variety of non-investment projects, e.g. aid financed projects.

Generally, in industrialised countries, special arrangements for administering projects are set up within spending agencies and do not affect the budgetary processes. In a number of developing countries, however, such projects are managed through a parallel administration, and contribute to increased fragmentation rather than to efficient government expenditure management.[12] Transition countries must avoid such fragmentation in budget management. Responsibility for day-to-day administration of projects should be granted to project managers, and projects should be firmly placed under the responsibility of line ministries.

Smaller countries may want to show individual projects, particularly those of strategic importance, in the presentation of the budget. Generally, however, the budget should group small or medium-size projects into programmes, and present details only of larger projects and projects financed from external sources. A budget with hundreds of small projects is difficult to analyse and scrutinise. The reviews of the budget proposals by the ministry of finance and the council of ministers, and the subsequent scrutiny by parliament of the draft budget, should focus on policies and programmes rather individual projects.

b. The project cycle

A typical project passes through successive stages, from the initial analysis of objectives and needs to project completion. Although each project has its own characteristics, projects usually have a common life cycle, called "the project cycle."

The number of stages into which a project cycle is divided, and the relative importance of each phase depends on the purpose for which this framework is used. A typical project cycle consists of the following phases:

- Definition of sectoral policies, analysis of objectives and determination of needs.

- Identification of potential projects and the formulation of project proposals.

(At this stage, a decision must be made on whether or not to allocate budgeted funds to the pre-feasibility studies.)

- Pre-feasibility studies and preliminary selection of the projects.

(At this stage, a decision must be made on whether or not to allocate budgeted funds to the feasibility studies.)

- Feasibility studies and detailed formulation of the projects.

- Technical appraisal of the projects and investment decisions.

(At this stage, a decision must be made on whether or not to include the projects in the budget.)

- Implementation of the projects (appointment of the project teams, project planning regularly updated, and project monitoring and accounting).

- Evaluation during project implementation, and evaluation ex post of the performance and results of the project.

The logical framework approach developed in the "Project Cycle Management" manual published by the European Commission (1993) is a useful tool to ensure that proper linkages are established between government policies and project preparation.

Since at each stage in the preparation of a project, a decision must be made about whether or not to proceed to the next stage, pre-feasibility studies and feasibility studies should include all the technical elements necessary to analyse the project and assist in making such decisions.

3. Appraising and screening projects

a. The appraisal and screening phases

Before examining whether a project should be included in the budget, it is important to:

- Assess the "quality" of projects: a full identification of costs and benefits is needed, whether they are tangible or intangible. Externalities (which may be negative, for example, in the case of the impact of pollution or positive in the case of flood protection) should be reviewed. A poverty or environmental assessment may also be needed for some projects. Tangible costs and benefits should be quantified and intangible ones assessed in qualitative terms. The methods of economic analysis reviewed below provide a framework for assessing the quality of a project. The degree of sophistication of the

techniques depends on the sector and the size of the project (for small projects a simple criteria "grid" can be sufficient).

- Verify that the best options have been defined for achieving project objectives: for projects of a significant size, this assessment should be the result of a cost-benefit analysis, or a cost-effectiveness or least cost analysis.

- Eliminate poor projects through a screening exercise that should be based on various criteria.

b. Economic analysis of projects

In relation to analysing a difficult decision about a public works project, Benjamin Franklin listed all the pros (i.e. benefits) and cons (i.e. costs) and weighted them separately, giving them numerical grades of importance (Sang, 1988). This procedure — "Moral and Prudential Algebra" — prefigured modern methods of project economic analysis. Indeed, it remains relevant for appraising smaller projects for which it would not be cost-effective to carry out sophisticated analyses.

An economic analysis of a project includes the following elements: (i) financial analysis; (ii) economic analysis; (iii) fiscal impact analysis; and (iv) social efficiency analysis (when relevant). Economic analysis can be used for evaluating the impact of policies and programmes as well as projects, but its application to policies and programmes is generally more difficult than to projects, since policies and programmes have a wider range of impacts.

Cost-benefit analysis (CBA) involves the application of three logical steps (Ward, 1994): (i) defining the objectives of the project or the programme and the alternative means of accomplishing those objectives; (ii) analysing the marginal (or incremental) impact of each of these alternative approaches; and (iii) comparing these incremental costs and benefits. CBA requires compiling and valuing the direct and indirect costs and benefits of the project, using an appropriate discount rate (see below) to calculate the value of benefits and costs that arise at different times in the future. When the effects of the project are partly intangible (e.g. in the health and education sectors) or when the impacts of the alternatives in term of quantity, quality and timing are similar, analysts use least-cost and cost-effectiveness analyses. Least-cost analyses compare the costs of different alternatives. Cost-effectiveness analyses compare alternative approaches that have different impacts and calculate cost-effectiveness ratios (e.g. cost per unit of output).

In the post World War II period, theoretical and methodological developments in the economic analysis of projects[13] were developed in order to design methods that calculate the social return of different projects, including their distributional effects and the correction of market distortions through estimates of shadow prices. The use of such techniques is now less necessary. Economies are now generally more open, and market distortions are diminishing. Moreover, the role of government as an investor is declining, public enterprises are being privatised, and for those enterprises remaining in the public sector, increasing emphasis is given to regulatory mechanisms that promote solutions similar to those in competitive markets. However, in transition economies where certain market distortions remain, the use of shadow prices remains relevant (e.g. in the energy sector).

In the past, excessive expectations were placed on techniques for analysing the economic impact of projects. CBA provides an analytical framework for organising facts and data, identifying project costs and impacts, quantifying them, and focusing attention on the essential aspects of proposed project variants. However, "at every step of the evaluation work, competent judgement is essential for fruitful results" (Sang, 1988). Calculating an internal rate of return (IRR) required the project analyst to compile the elements

needed for a judgmental assessment of the project, but the resulting calculation itself is less important. Undoubtedly, a low IRR shows that the project should not be launched. But, a relatively high IRR may only indicate that the numbers have been manipulated to meet an IRR target.

Economic analysis methods are required for analysing projects in a number of sectors (e.g. in the production and infrastructure sectors, CBA should be systematically undertaken for every project of a significant size). In other sectors, least cost or cost-effectiveness analyses of projects are generally desirable, but their degree of sophistication will depend on the size of the project.

In appraising and evaluating investment projects, through CBA or other techniques, and in the setting of charges to recover the cost of capital, it is important for the government to decide what discount rate to use. This raises complex economic (and political) issues that are not fully resolved in the literature.[14] The governments of most OECD countries set the public discount rate (or rates) either at a value similar to the real interest rate of government borrowing, or at a level that is believed to be similar to a real rate of return obtained in the private sector. These arguments generally lead to numbers between 3% and 10% in real terms.

Discount rates in the public sector serve two main purposes. In many applications (including CBA and cost-effectiveness analysis) they are used as a time preference rate, to reflect the extent to which the nation is concerned about the marginal income of future populations relative to the present population. In other applications (including commercial appraisal of costs against sales revenue, and costing government outputs) they are being used as a cost of capital, to cost public sector outputs in ways that can be efficiently compared with the prices of private sector outputs. In practice, however, many countries use the same number for both of these purposes. This is administratively much simpler. (See, Spackman, 2000).

Many transition countries have good capacity for preparing the technical design of projects, but lack experience in the economic analysis of projects. Weaknesses in these areas are currently being addressed in many countries, but sometimes only in a formal way, such as making compulsory the presentation of the IRR in the project profile forms. Further progress is generally needed in developing an analytical approach to evaluating projects.

In the 1970s, it was often stated that projects could be ranked by an indicator, such as the benefit-cost ratio, and the highest ranked "projects" selected in turn until the available financial "envelope" was filled. One transition country attempted unsuccessfully to carry out such an exercise in the 1990s. Comparing projects from different sectors according to such financial criteria is always hazardous, and in fact impossible. Moreover, ranking a set of projects depends on the total financial envelope granted to the set of projects and not vice versa.[15] The economic analysis of projects is useful in this respect, but cannot be relied upon to achieve the optimal balance of objectives. In the same way, multi-criteria analysis can be useful in comparing multi-purpose projects within a subsector or a programme. However, multi-criteria analyses may lead to absurd results if used to calculate the intersectoral distribution of investment, or to allocate resources among different programmes. Even to compare projects within a programme, multi-criteria analysis must be used with caution. Multi-purpose projects may be improperly favoured by multi-criteria analyses, while the "specificity rule" teaches that, in many cases, it may be more efficient to choose targeted projects to reach the required objectives.[16]

c. Project screening

Screening involves eliminating poor cases from the portfolio of projects being considered for inclusion in the sectoral budgets. Line ministries should verify that the projects prepared by their

subordinate agencies are compatible with the sector strategy, correspond to the most cost-effective means of reaching the programme objectives and that, where applicable, the results of cost-benefit (or cost effectiveness) analyses are acceptable. They should also verify that the projects are in conformity with the broad policy goals of the ministry (e.g. the sectoral strategic plan and the business plans of public enterprises).

In screening projects, information needs to be collected and assessments made in the following areas:

- Conformity of the project with sector and government strategies (an assessment should be carried out as soon as the project is identified).

- A cost-benefit or cost effectiveness analysis, if appropriate. For smaller projects, simple ratios can be used (for example, the costs of a classroom per student). The acquisition or construction of new facilities should be systematically compared with the cost of rehabilitating existing facilities.

- The fiscal impact of the project. Incremental recurrent costs, including forecasts of staff recruitment, should be estimated. For some programmes or agencies (e.g. road construction), assessing the recurrent costs requires making forecasts of both the capital and the recurrent budget, in order to take into account acquisitions of equipment needed for periodic maintenance.

- The policy on setting user charges or fees, when the project is aimed at delivering goods or services to the public.

- The environmental impact, when relevant.

- The poverty impact, when relevant (e.g. for certain projects in the social sector).

- Organisational arrangements for implementing and running the project, in order to strengthen their effectiveness.

Screening can be formalised in a series of "yes/no" questions and only projects that satisfy all the requirements should be selected.

4. Budgeting

a. Project selection

Appraisal and screening are not sufficient to decide whether or not to include a project in the budget. As discussed in Chapter 5, line ministries' budgets and programmes must be prepared under hard constraints. For a given sectoral envelope, project selection involves the interplay of the two following activities: (i) the allocation of resources among programmes or subsectors; and (ii) the selection of projects within a programme or subsector.

If the screening process leads to the elimination of several projects, the corresponding programmes should often be scaled down. The degree of the interaction between project screening and resource allocation varies from one sector to another. Rejecting or terminating a railway project, for example, can lead either to more resources being allocated to the road sector or a reduction in the budget of the ministry of transport. But eliminating a school construction project may create an incentive to increase the budget for buying schoolbooks, assuming that the budgetary envelope for primary education remains unchanged.

Within a programme or a subsector, investment projects must be balanced against current spending. As noted, a new construction project should be systematically compared to the cost of rehabilitating existing facilities. However, the optimal composition of a programme depends also on the overall policy in that sector (for example, balancing a school construction project against a programme for buying schoolbooks is essentially a matter of education policy).

Within certain programmes or subsectors, ranking projects according to certain criteria may help in the project selection process. But generally, selecting projects requires a variety of approaches, which depend on the sector. If, for instance, line ministries have prepared detailed programmes and verified the economic effectiveness of these programmes, the selection of projects should be made according to the policy priorities and time schedules defined within these programmes (e.g. the business plan in the telecommunications sector, the road transportation plan, the energy plan, etc.). Preparing a budget for the capital subsidies to public enterprises (or financing projects of public enterprises) requires reviewing the business plans of these enterprises. The financial viability of the projects of a public enterprise or an autonomous agency must always be assessed within the framework of the entity's financial viability, and its policy priorities, not only within the framework of the government budget or multi-year estimates.

b. Forecasting the forward fiscal impact of capital spending

To prepare capital investment budgets, some form of expenditure forecasting exercise is always required. As mentioned earlier, the forward costs of investment projects (including their recurrent costs) must be systematically reviewed when preparing the budget. The forward costs of projects of a significant size should be reviewed systematically by both the relevant line ministries and the ministry of finance. Smaller projects are generally grouped together (e.g. as part of a programme), but the line ministries should always review their forward costs and compare them with the current level of their budget.

One frequent cause of arrears and/or project implementation problems comes from the fact that the annual budget includes only a small share of the total costs of a new project, which may run over several years. Projects of a significant size must be sufficiently funded when they are launched, in order to meet all the forward costs of their completion and implementation. Otherwise, it is better not to include them in the budget. Even when multi-year estimates are not prepared, the fiscal sustainability of the forward costs of investment projects should be assessed and, where appropriate, offsetting savings in other programmes or sectors should be identified.

As noted earlier, the budget should show in an annex the total costs of investment projects/programmes and their planned implementation schedule. Including authorisations for forward commitments in the budget provides an effective instrument to control future investment expenditures. When forward commitments are not managed, a rule of thumb should be applied: the total amount of the (multi-year) contracts related to a project should not exceed the annual budget forecasts multiplied by the number of years needed to complete these contracts.

c. Multi-year programming

Projects must be prepared in advance, and some form of multi-year investment programming is always required. In most sectors, and particularly in the sectors responsible for public infrastructure programmes, line ministries should prepare internal multi-year investment programmes as a framework for preparing proposals on individual investment projects. To avoid wasting their efforts in preparing an excessive number of proposals for project financing, line ministries should assume that in most cases their

current level of resources will not be increased in the future. Preparing internal working documents of this kind does not necessarily require a government-wide multi-year budgeting exercise.

The preparation of projects involving lengthy technical studies, or using contracting-out or cost-sharing arrangements with local governments or public enterprises, often takes several years. In many EU Member States, for example, the preparation of large infrastructure projects may stretch over a decade. This preparatory work is sometimes supported by different programming documents, such as space plans and infrastructure plans, but also by government decisions of various kinds. Caution is required before entering contractual agreements that may generate future expenditures. The ministry of finance should be consulted systematically before committing the government, even implicitly. Such commitments should be disclosed in a transparent manner. When deciding whether or not to include a preparatory study in the budget, the prior question of whether the whole project can be realistically financed should be addressed.

As noted above, some countries prepare from time to time programme laws to provide a legal basis for preparing investment programmes of a significant size, within a sector or a subsector. Such laws, however, should not create rights for future spending and committing expenditures. Prior to the presentation of draft programme laws to the council of ministers, the ministry of finance should assess their possible future fiscal impact, and verify whether the proposed programme is compatible with the government's medium-term fiscal objectives.

A more formal exercise, used by several transition economies, consists of preparing a rolling public investment programme.

5. Rolling public investment programmes (PIPs)

a. What is a PIP?

PIPs are aimed at providing a framework for investment programming and project selection, but also at improving aid co-ordination and channelling external resources to priority areas. They are a useful basis for programming externally financed projects, which must be prepared and discussed with donors two or three years in advance. The PIP includes both the capital expenditures and the current expenditures that are financed by the donors through projects of this kind.[17]

In general, the main elements of a PIP can be described as follows:

- The PIP covers a period of three or four years in which the year-by-year costs (capital and current) of projects are shown, together with the balance of funds required to complete the projects, in years beyond the PIP period.

- To adapt to changes in the economic and financial environment, the PIP is prepared annually, on a rolling basis. At the end of each year, the first year of the PIP period drops out and a further year is added.

- The first year of the PIP includes only projects for which implementation has been firmly decided and is fully consistent with the annual budget in the sector concerned. The later years provide an indicative list of projects that will be active and their estimated costs.

- For projects financed by external aid, the following approach is often adopted: (i) the first year of the PIP includes only projects for which the financing has already been granted or where negotiations

are well-advanced; (ii) the second year includes projects for which the financing has clearly been identified; (iii) the third year includes projects for which the financing source has not yet been identified. As discussed below, a more restrictive approach for the second and third year would be preferable.

- The PIP includes both investment projects financed from domestic sources and projects financed from external sources, whatever their economic nature. Therefore, as noted above, the PIP can include both current expenditures and capital expenditures.

b. Potential weaknesses of PIPs

Investment programming is the most difficult part of multi-year expenditure programming. It is easier to estimate the forward costs of operational activities than those of investment projects, which are affected by many technical factors. Moreover, investment spending is subject to strong political pressures (the familiar "pork barrel" effect) and gives more opportunities for corruption than current expenditures, especially in countries with weak systems of governance (see Tanzi, 1997).

As a result, preparing capital investment programmes requires both disciplined procedures and a high level of technical expertise. The fact that new projects, programmes and policies can be included in the PIP does not itself discipline the PIP procedure. Confronted with excessive requests, the ministry of finance will tend to follow the line of least resistance described earlier, namely to include poor projects in the second and third years of the PIP, with the intention of dropping them later. Consequently, either the out-years of the PIP become wish lists, with little credibility, or the poor projects included in the out-years of the PIP are launched without proper analysis and scrutiny.

A more stringent approach to compiling figures for the second and the third year is preferable to the approach commonly adopted. It consists of including in the PIP only those projects for which a decision has been firmly made and the source of financing is certain (or at least highly probable). Of course, such a PIP, which would mainly include forecasts of already approved investment programmes, would not have some of the theoretical advantages of a fully-fledged rolling expenditure programme. But experience shows that, in practice, most of the PIPs are prepared each year from scratch, and are not genuine "rolling" programmes.

In some transition and developing countries, PIPs can sometimes be little more than a wish-list, used for attracting aid from donor agencies and the international financial institutions. Often such lists are hastily prepared and include an excessive number of non-prioritised projects. Fortunately, their role in the formulation of the budget is generally small. Nevertheless, the marginal usefulness of these "PIPs" as documentation for donor meetings is swamped by the generalised loss of credibility of the programming process.

Sometimes, both a "core" PIP and a "non-core" PIP are prepared. As discussed in Chapter 5, such a distinction in budgeting and expenditure programming is an attempt to circumvent the need for making hard choices. It is better not to prepare a PIP at all than to prepare a non-core PIP, or a PIP wish-list.

The process of preparing a PIP consists too often of only reviewing individual projects, without placing them in the context of the government's policy priorities, and its medium-term fiscal and budget strategy. In fact, some transition countries that prepare a PIP fill the document with hundreds of minor projects, while investment programmes of a significant amount are only roughly estimated and not debated within government (especially when these projects are deemed to be of "political" importance).

c. Conditions for preparing a sound PIP

The PIP should be prepared jointly with the budget, and framed by expenditure ceilings specified for each of the forward years. Preparing a PIP needs to start with a medium-term budget framework, that shows annual expenditure estimates divided up according to: (i) line ministry; (ii) "investment" (including current expenditures financed through externally financed projects) and other expenditures; (iii) domestic and external sources of finance. Ceilings for expenditures financed by external resources can be flexible. Nevertheless, this flexibility should be limited, since the impact of the PIP on both the costs of debt service and the financing needs for domestic counterparts should be taken into account.

As discussed in Chapter 5, presenting separate initial ceilings for capital expenditures has both advantages and disadvantages, depending on the sector concerned and the nature of the investment project. To avoid solidifying the preparation of sectoral budgets, joint analyses of current and capital budget are required at each stage in the preparation of the PIP. When preparing the PIP and the budget a certain degree of flexibility is needed in reallocating resources among current and capital spending. This requires full unification of the PIP and budget processes.

d. What can be implemented in transition countries?

In most aid-dependent countries, new policies are generally financed through donors' aid programmes. As a result, the PIP can be used as an instrument to review these new policies, and to programme in advance aid-financed expenditures. In this respect a fully-fledged PIP, as described above, fits less well the context of transition countries and middle income economies, which rarely prepare a PIP, than aid-dependent countries.

Transition countries that do not currently prepare a rolling investment programme should consider improving their budgetary management of investment projects (e.g. by making estimates of the forward costs of ongoing projects and programmes), and strengthening their methods of preparing and selecting projects within line ministries. They should also focus their multi-year investment programming on those areas where such an exercise is most crucially needed. For example, candidate countries for membership of the EU have to programme the uses of EU pre-accession funds.

Some transition economies still face an overhang of uncompleted capital investment projects. This requires special investment reviews and ruthless screening of ongoing projects, using the screening criteria discussed above. But an exercise of this kind is very different from preparing a rolling investment programme.

However, those countries that already prepare a PIP may want to continue doing so, provided they refine and streamline the PIP process and improve their budgetary management of investment according to the points suggested above. There is a case for PIPs in countries that only have annual budgeting. When a significant share of the budget consists of aid-financed projects, preparing a PIP can establish a useful link between the preparation of the budget and the negotiations with donors, provided the pitfalls mentioned earlier are avoided. Every "partial" multi-year expenditure programme should be part of a multi-year budget framework that is properly designed. This applies both to investment projects as well as to sectoral budget programmes.

6. Organisational arrangements for screening projects

Line ministries, which are responsible for preparing the budgets for their sector, should also be responsible for preparing, screening and selecting projects within any overall spending limit set by the

government. However, projects of significant size need also to be reviewed by the ministry of finance when preparing the budget.

There are sometimes insufficient links between the activities of the investment department and the financial department responsible for the preparation of the budget within the ministries. In some transition countries, project preparation is mainly driven by the design institutes attached to the relevant line ministries, which focus on the engineering and other technical aspects of projects, instead of being policy driven. A close co-ordination between project preparation and sector policy and budget formulation is thus required within sectors.

Several developing countries and a few transition countries have set up central procedures to screen and approve projects.[18] In such cases, a "central investment unit" prepares standards for project appraisal, provides technical assistance to investment units within spending agencies or municipalities and screens projects above a certain threshold value. Projects are approved by the central investment unit, or by an interministerial committee, or by the council of ministers.

These approval processes have the advantage of "filtering" technical studies and therefore easing budget preparation. However, they also have a number of potential weaknesses. The review of projects is sometimes purely formal. The procedures may be cumbersome, and hundreds of studies of smaller projects are sometimes submitted to the central investment unit. The council of ministers may dissipate its activities in reviewing dozens of projects, which will never be implemented because of inadequate financing. In some countries, the central investment unit is not attached to the ministry responsible for preparing the capital budget. As a result, policy and financial issues are merely taken into account when screening the projects. The central investment unit, if any, should be placed within the ministry of finance.

The central investment unit should focus on projects of major importance. It must be clear that screening projects is not the same as selecting projects. For smaller projects, the functions of the unit should consist of providing technical assistance, training and guidance. The mechanism of approving projects by the council of ministers is questionable. It risks putting upward pressure on the budget. The term "approval" should be understood as "pre-approval", since the substantive decision to launch a project should only be made through the budget process. Thus, only projects of a substantial size that need to be prepared in advance should be submitted to the council of ministers. This (pre-)approval procedure should be exceptional. The ministry of finance should be consulted before the projects are submitted to the council of ministers for approval.

NOTES

1. See comparisons of forward budgeting systems in Premchand (1990a).

2. Premchand (1983) and Allan (1996).

3. OECD (1995).

4. "Expenditure planning" should not be confused with developmental planning or central planning. "The distinction between a development plan and formal expenditure planning is that the former represents an organised outlook into the future taken at a particular time, while the latter is a continuous process of making a forecast and assessing its validity as further progress is made in its implementation." (Premchand, 1983).

5. Drawn up from OECD (1997b) and Allan (1996).

6. See Premchand (1983), page 217.

7. To reconcile difficulties related to uncertainty and the need for full assessment of the forward costs of programmes, a number of countries have experimented with a two-stage presentation of multi-year estimates: a "planning-programming period", which can include new programmes, followed by a "forecasting period" which shows only the forward costs of programmes planned in the first period. (for example, the US in the 1980s had a programming horizon of three years and a forward budget of five years).

8. In the 1950s, for example, France made extensive use of "programme laws". Today such a procedure is still used for military programmes, but the figures included in the law are not binding. Projects/programmes are launched only when an "authorisation to commit" is included in the annual budget.

9. On this issue, Premchand (1996) comments: "Donors generally insist on having a medium-term commitment of the authorities in regard to the projects and the programs proposed for aid financing. …Meanwhile expectations are aroused, advance plans made and lobbies arranged in anticipation of aid that may lead to disappointment when the expectations are not sustained".

10. OECD (1997b). See also Allan (1996).

11. See for example, United Kingdom, HM Treasury, Central Unit for Procurement (1995) Guidance Note 52.

12. Such an approach tends to be favoured by the donors: "A frequently debated issue in the [World] Bank is the tendency to enclave...To some extent these reasons are inherent in any project-centred approach to lending. But they reduce the pressure on government to reform, and they may weaken the domestic system by replacing them with donor-mandated procedures". World Bank (1997a).

13. See Ward (1994) and Gittinger (1982).

14. For an excellent survey of these issues, and a useful bibliography, see Spackman (2000).

15. "The ranking issue is a rather ambiguous notion. For a given investment budget... projects are either acceptable and should be included in the investment program or are not acceptable and should be excluded... The only ranking in such instances is between the 'ins' and the 'outs'... There is no single ranking of projects that are added or deleted from the program in accordance with variations in its size. Changes in the investment budget tend to affect its general composition and not simply marginal projects." (Squire and Van der Tak, 1975.)

16. For example, when the objectives are to generate employment and improve infrastructure, ranking individual projects would suggest carrying out a programme for road construction using labour intensive techniques. At first sight, such projects may appear to be suitable for many low-income economies. Nevertheless, it is likely to be more efficient in such countries to build roads using modern techniques and to set up a targeted programme for meeting the social objectives.

17. In aid dependent countries, current expenditures account often for 30 to 40% of the total costs of the PIP.

18. For example, Romania. Examples from Latin America can be found in Petrei (1998); for Asia, in United Nations (1993).

SUMMARY — PART II

A. KEY POINTS

1. Expenditure classification

Classifying expenditures is important for policy formulation and identifying the allocation of resources among sectors; for the establishment of clear lines of accountability; for achieving compliance with the legislative authorisations; for policy and performance analysis; and for day-to-day administration of the budget. An expenditure classification system provides a normative framework for both policy decision-making and accountability.

Different approaches to and aspects of budgeting often have a strong influence on the structure and organisation of the expenditure classification system. Thus, compliance budgeting focuses on the uses of resources and, therefore, on the classification of inputs and organisations. Policy formulation and allocative efficiency concerns are the basis of a classification of expenditure by function and programme. Detailed classifications of programmes by activity or output are required if operational performance is being assessed. Aggregate fiscal control requires an economic classification based on clear concepts (e.g. separating borrowing from receipts), as with the GFS classification prepared by the IMF. Meeting all these different, and to some extent conflicting, requirements calls for a pragmatic and flexible approach.

A functional classification organises government activities according to their broad objectives or purposes (e.g. education, social security, housing, etc.). Such a classification is important in analysing the allocation of resources among sectors. It is independent of the government's organisational structure. A functional classification is required to produce historical surveys of government spending and to compare data from different fiscal years. The Classification of the Functions of Government (COFOG) established by the United Nations, is a useful international standard in this field.

An economic classification of expenditures is an instrument for aggregate fiscal control and fiscal analysis, provided it is based on clear concepts and is compatible with the GFS classification. The line-item/object classification is used for budgetary controls, monitoring and administration (personnel expenditures, travel and transport of persons, etc.).

An administrative classification (line ministries, directorate, etc.) is a valuable tool for promoting accountability and budget administration. For administering the budget (also useful in the EU context), a classification by fund and source of financing is also needed.

A programme is a group of activities related to a set of shared objectives. Classifying expenditures by programme can serve two purposes: (i) identifying and clarifying objectives and policies; and (ii) monitoring operational performance through performance indicators based on inputs, outputs and

outcomes. Such indicators should be set up by activity or programme depending on the purpose of monitoring the performance of that programme. Compared to COFOG, a classification by programme takes into account a country's policy objectives and its administrative context.

When establishing a programme classification, it is important to ensure that: (i) accountability is not restricted by obscuring the responsibility of different administrative units; and (ii) the requirements for data collection and analysis are kept within reasonable bounds. A programmatic approach has the advantage of encouraging managers in each organisation to define clearly their objectives and to consider what results have been achieved. However, the main conditions for developing such an approach are to clarify the responsibilities of each participant in the budget process, to prepare the budget under hard constraints, and to co-ordinate properly the budget and policy formulation procedures. Past experiences of programme budgeting show that excessive expectations should not be placed on the role of formal instruments of this kind in making decisions, at the central level, about the allocation of resources.

The budget presented to the legislature must clearly show the responsibilities of the main participants in budget management, and should present expenditure forecasts classified according to the ministries and agencies that are responsible for implementing the budget. In addition, other presentations of expenditures are desirable, such as historical analyses of expenditures by function; a presentation of the main programmes by line ministry, accompanied by a brief description of these programmes; projections of the forward costs of major investment projects; and a list of projects financed from aid programmes and other external sources.

2. Policy formulation and the budget-policy relationship

Mechanisms for sound policy formulation and strengthening the policy-budget link are essential. They include:

- Co-ordination mechanisms for policy formulation within the government.
- Consultations with non-governmental organisations and representative groups (e.g. employers' organisations, trade unions).
- Providing adequate resources and information to parliament for scrutinising policy proposals and the budget.
- Regulations to discipline policy formulation and reinforce the budget-policy link.

3. Medium-term budget and policy formulation

It is always necessary to place the annual budget in a multi-year perspective. Policies stated in the annual budget have a forward fiscal impact that must be assessed. The time span of an annual budget is generally too short for the purpose of making rational decisions about expenditure priorities.

Every country should prepare a medium-term macroeconomic framework that includes projections of the main government accounts, the balance of payments, the monetary accounts and the non-government sector. This macroeconomic framework includes a medium-term fiscal framework (MTFF) that should cover the financial transactions of all government entities, including EBFs and local authorities. The definition of the government and the public finance deficit should be consistent with the ESA95 standard. The MTFF should project aggregate revenue and expenditure targets over a

three- to five-year horizon, and show projections of the main fiscal indicators (such as the cash deficit and the ratio of government debt to GDP) over this period. It provides a broad framework for preparing the annual budget.

Preparing a medium-term macroeconomic framework and an MTFF is a necessary condition for sound budgeting. In addition, it is a specific requirement for EU Member States. Since July 1997, according to the Stability and Growth Pact, Member States are required to formulate and submit stability programmes, if they have adopted the euro, and convergence programmes, if otherwise. As described in Part I, candidate countries for EU membership will undertake similar procedures, including the preparation of "pre-accession economic programmes" (PEPs).

These stability and convergence programmes must provide the following information:

- Medium-term budgetary objectives in terms of fiscal balance or surplus, and the path of adjustments in the deficit and debt ratios.
- Main economic assumptions associated with the realisation of these objectives.
- Budgetary and economic policy measures taken or proposed to achieve the objectives, including an assessment of their effect on the general government accounts.
- Sensitivity analysis of the effects of changes in the main economic assumptions.

To prepare the fiscal projections on solid grounds, it is necessary to assess continuing expenditure commitments and to identify measures to achieve the fiscal targets. For this purpose, the fiscal framework should preferably be supplemented by a medium-term budget framework (MTBF) covering the central government, at least, and including aggregate expenditure estimates detailed by broad sector or function, and forecasts of the forward costs of the most significant entitlements and ongoing investment programmes.

The macroeconomic framework should be prepared at the beginning of the budget preparation cycle, in order to give adequate guidelines to the line ministries, but it needs also to be updated frequently in order to take into account changes in the economic environment and the government's policy priorities. Appropriate organisational arrangements to carry out macroeconomic work should be set up. Whatever the distribution of responsibilities for preparing the projections, the ministry of finance must have internal capacity to review the macroeconomic projections and be responsible for the preparation of the MTFF. Internal forecasts should be validated by systematic comparison with economic forecasts from public and private sources.

4. Budget formulation

As discussed in Part I, in order to achieve both allocative efficiency and fiscal discipline, the budget should be comprehensive, and all policy decisions that have a significant fiscal impact or present a fiscal risk should be reviewed when formulating the budget. The ministry of finance should be fully responsible for the preparation of the capital budget.

Budget preparation is essentially an iterative process between the ministry of finance and spending ministries, but financial constraints and the opportunity for collective discussion of policy choices must be built into the budget procedures. Starting points for budget preparation are a clear definition of fiscal

targets, a strategic framework consisting of a comprehensive set of objectives and priorities, and the preparation of an MTFF based on realistic revenue projections. Overestimating revenues leads to poor budget formulation and therefore poor budget execution.

Spending limits by sector should be notified to line ministries early in the budget preparation process, and preferably at the start of the preparation of line ministries' budget requests. In preparing these ceilings, the ministry of finance needs:

- To define the overall expenditure ceiling (this is one of the major outputs of the macroeconomic analysis).

- To assess the costs of existing policies or, at least, of maintaining the present level of government activity in delivering public services. This can consist of preparing some form of baseline budget, which can be either an internal working document produced by the ministry of finance, or a more formal document used to focus budget negotiations on policy changes or changes in the activity level (or work load) of different ministries/agencies.

- To identify possible savings and adjustments in low priority programmes.

- To distribute by sector the total budgetary "envelope" that is available to finance new policies or increased activity, according to government priorities.

The ministry of finance should issue an annual budget circular in order to assist line ministries and other budget entities prepare their budget requests. This budget circular should provide:

- A clear set of rules for the budget process and the main forms to be used in the line ministries' submissions.

- The economic assumptions to be used by line ministries in preparing their estimates.

- Information on government priorities.

- Spending ceilings or targets.

Line ministries and agencies are responsible for preparing their budgets, within the policy framework decided by the government. Their budget submissions should present the following information:

- A brief statement spelling out the objectives and expected outcomes of the policies and programmes for which the line ministry or agency is responsible; and an analysis of how these objectives will be achieved including some key indicators for monitoring the impact of the policies concerned.

- Expenditure estimates that comply with the ceilings notified in the budget circular. Preferably, line ministries' budget requests will distinguish between: (i) the expenditure deemed necessary to maintain the current level of services delivered (or, at least, the current level of activity); and (ii) costing of any policy changes that are proposed. The expenditure estimates should be compared with projections for the current year and actual data for previous year(s).

- Identification of the savings made on ongoing programmes; and clear identification of the measures needed to implement effectively the proposals.

- Number of staff positions (occupied and non-occupied). The procedure for calculating personnel expenditures should be clearly indicated and conform with a methodology laid down by the ministry of finance. It should specify the use of non-permanent and casual staff, and of consultancy contracts.

- For investment projects/programmes of a significant size and, for all projects that are externally financed: (i) total costs, and annual costs over a period of three to five years, and the balance of expenditure in subsequent years required to complete the project; (ii) an estimate of the recurrent costs after completion of the project; and (iii) a schedule of commitments (contracts to be engaged) over the project lifetime.

- Details of entitlement and subsidies programmes, such as the expected number of beneficiaries, the method of calculating benefits, and administrative procedues for making payments.

Line ministries must co-ordinate the preparation of the budgets of their subordinate agencies and give them appropriate instructions that are compatible with the budget circular and other instructions, norms and guidance issued by the ministry of finance.

The initial sectoral ceilings and the MTFF should be discussed and agreed at the interministerial level (i.e. the council of ministers or an interministerial committee), before the ministry of finance issues the budget circular. During budget preparation, it is important that the minister of finance and/or the prime minister has clear authority to negotiate differences bilaterally with other ministers. In some cases, differences may have to be submitted to the full council of ministers, or an interministerial committee, for resolution.

The approach to budget preparation described in Part II is a mixture of "top-down" and "bottom-up" budgeting. Sufficient time is needed in order to allow line ministries to prepare their budgets and identify measures to comply with the ceilings. The timetable should be laid down in the budget circular.

5. Capital investment budgeting

Most transition countries have adequate capacity for preparing the technical design of capital investment projects, but frequently do not have sufficient resources to carry out a rigorous microeconomic or financial analysis of such projects. Before being considered for inclusion in the budget, projects should be submitted to thorough screening. Line ministries must verify that the projects comply with the policy objectives of the sector; and are the most cost-effective means of reaching the programme objectives. They must assess the recurrent costs of the projects and whether these costs can be managed within the ministry's expected budgetary allocation. When applicable, a cost-benefit analysis, or cost-effectiveness analysis of the project should be carried out.

The fiscal sustainability of the budget for capital investment projects must be assessed. Many transition countries have a large backlog of partially completed investment projects. The completion of such projects should be considered alongside the funding of new projects and in general should be given priority. Moreover, no proposals for funding new projects should be considered unless their future fiscal implications are realistically assessed. The budget should show in annex the total costs of investment projects/programmes and their planned implementation schedule. Including in the budget authorisations for forward commitments, with an indicative payment schedule, provides an effective instrument to control investment expenditures. Other methods of controlling costs (e.g. efficient procurement procedures, modern techniques of contract management and project management) should also be developed.

6. Multi-year budgeting and expenditure programming

To increase discipline over government expenditures many OECD countries prepare indicative rolling multi-year estimates, which can either operate at a relatively aggregate level or be detailed by programme. Some countries have set up highly disciplined procedures to link annual budgeting and multi-year budgeting.

As noted earlier, transition countries are recommended to prepare a medium-term budget framework including aggregate expenditure estimates by main function. Once implemented, the MTBF can be progressively expanded with details of individual programmes. However, caution is needed in carrying out multi-year expenditure programming exercises. Economic uncertainty must be managed. Making unconsidered promises, which lead to increased claims from line ministries over future spending, should be avoided. As a general rule, multi-year expenditure programmes should focus on existing policy commitments and policy changes decided when preparing the budget. The preparation of detailed multi-year estimates, whatever their coverage (whole budget, investment expenditures or some sectors only), must be strictly linked with the preparation of the annual budget, within the framework of an MTFF, and supplemented with an MTBF.

Candidate countries will have to programme in advance the uses of EU pre-accession funds. This multi-year expenditure programme should comply with the MTFF, and its preparation should preferably be framed by a properly designed MTBF.

B. DIRECTIONS FOR REFORM

Weaknesses in budgeting depend in large part on political factors and on the organisation of the government. Lack of co-ordination within the council of ministers, unclear lines of accountability, or overlaps in the distribution of responsibility give rise to questionable approaches to budgeting. Reforming budget processes is not a sufficient condition for addressing all problems, of course, but it is a necessary one. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce co-ordination and cohesion in decision-making.

Priority actions should consist of establishing the necessary foundations for sound budget preparation:

- Establishment of an expenditure classification system, based on international standards, that facilitates functional and economic analysis and fulfils the requirement for effective day-to-day administration of the budget.

- Preparation of a medium-term macroeconomic framework, including an MTFF, covering a period of three to five years, in order to assess the fiscal sustainability of the government's policies, and (in the EU context) provide information required for stability and convergence programmes.

- Notifying initial spending limits early in the budget preparation calendar is desirable. Close co-ordination among the participants in preparing the different components of the budget (revenues, current expenditures and capital expenditures, etc.) is urgently required whatever the administrative arrangements.

To consolidate this framework and enhance policy decision-making, transition countries should develop a programme of reform that will include some or all of the following actions, phased as appropriate over a period of years:

- Development of appropriate policy co-ordination mechanisms that fit the institutional, constitutional and political context. The participation of civil society (NGOs, employers' federations, trade unions, etc.) through consultation mechanisms should be sought.

- Preparation of sector policy reviews and strategic plans by sector, showing the broad programmes or functions of each line ministry.

- Preparation of an MTBF including projections of expenditure estimates at least by main function and broad economic category. The status of this MTBF should be progressively enhanced to make it an effective instrument for resource allocation (presentation by the line ministry, effective review by the council of ministers and preparation of expenditure ceilings). In parallel, detailed forecasts of the forward costs of ongoing policies could be prepared. Eventually, in a later stage, the preparation of comprehensive multi-year estimates detailing each programme could be considered, but this depends on the country context, notably its degree of economic stability and its capacity to ensure a disciplined expenditure programming process.

In some special areas (such as the management of EU pre-accession funds), the preparation of expenditure or investment programmes, fully consistent with the MTBF, is needed. Countries should also consider the preparation of a programme classification of budgeting expenditures, and the development of related indicators in order to monitor performance and conduct policy evaluation.

PART III

MANAGING BUDGET EXECUTION

CHAPTER 7

THE BUDGET EXECUTION CYCLE

A. Objectives of Budget Execution

1. Importance of budget execution

Budget execution is the phase where resources are used to implement policies incorporated in the budget. As already noted, it is possible to implement poorly a well-formulated budget; it is not possible to implement well a badly formulated budget. Good budget preparation comes first, logically as well as chronologically. However, budget execution processes are not simply mechanisms for ensuring compliance with the initial programming. Even with good forecasting systems, unexpected macroeconomic developments may occur during the year, and need to be reflected in the budget. Of course, changes should be accommodated in a way that is consistent with the initial policy objectives so as to avoid disrupting the activities of agencies and project management. Successful budget execution depends on numerous other factors as well, such as the ability to deal with changes in the macroeconomic environment, and the implementation capacities of the agencies concerned. Budget execution involves a greater number of players than budget preparation, and calls both for assuring that the "signals" given in the budget are correctly transmitted, and for taking into account feedback from actual experience in implementing the budget.

Hence, efficient budget execution calls for: (i) ensuring that the budget will be implemented in conformity with the authorisations granted in the law, both in relation to the financial and policy aspects; (ii) adapting the execution of the budget to significant changes in the macroeconomic environment; (iii) resolving problems arising during implementation; and, (iv) managing the purchase and use of resources efficiently and effectively.

2. Budget execution systems

Systems for budget execution system should ensure rigorous aggregate expenditure control, but also effective and efficient uses of resources in accordance with budget priorities. Its procedures should be appropriately balanced in order to avoid or resolve conflicts between these objectives. Aggregate expenditure control requires defining fiscal targets, and is therefore largely concerned with budget preparation. Nevertheless, budget execution procedures must ensure that fiscal targets are effectively enforced and that managers comply with the budget authorised by the legislature. However, this should not consist of replicating the "traditional" budget execution systems, which focus on detailed input controls, often performed by the ministry of finance. Such an approach is aimed at assuring fiscal discipline, but generally poses two different sorts of problems. On the one hand, excessively detailed controls are time-consuming, make the budget rigid, and do not give managers the flexibility in the allocation of inputs needed to implement their budgets efficiently. On the other hand, traditional compliance controls are not sufficient to ensure fiscal discipline. They tend to focus on cash payments for supplies, while the most crucial

problems are often found elsewhere (overstaffing, entitlements, arrears, etc.). Keeping budget execution under control requires effective management control systems, not excessively detailed compliance controls.

This chapter reviews the general features of the budget execution cycle, including the issues related to compliance controls, while subsequent chapters deal with the specific methods and systems that are required for effective budgetary control. These systems include:

- Payables and public procurement (Chapter 8).
- Cash management and the treasury function (Chapter 9).
- Internal (management) controls and internal audit (Chapter 10).
- Accounting and financial reporting systems (Chapters 11 and 12).
- External audit (Chapter 14).

3. Overspending and underspending

Overruns are sometimes caused by non-compliance of budget managers with the spending limits defined in the budget, when committing expenditures. Since cash allocated to spending units for appropriated expenditures is generally controlled, these overruns generate spending arrears. Overruns are often the result of off-budget spending mechanisms (payments from special accounts, "below-the-line" accounts, etc.). In some countries, the expenditure procedures can be so cumbersome that "exceptional arrangements" have been created to bypass them. Payments made through these exceptional procedures are not controlled against the appropriations and are therefore an important cause of overruns. Lack of compliance can be addressed through strengthening the audit system, and the reporting system, and ensuring the effectiveness of the basic budget execution controls reviewed below. A comprehensive coverage of the budget is required. Exceptional procedures should be avoided, and in a number of countries this requires simplifying the system of control.

Overruns can be caused by deficiencies in budget preparation. Elements such as continuing commitments for investment projects and entitlements, or the impact of inflation on wages, are in some countries poorly taken into account when preparing the budget. Also, particular interests and political pressures may affect budget preparation, budget enactment and budget execution. In some countries, the executive or the parliament adopts decrees and laws that have a financial impact on the budget even if they do not concern the budget directly. As discussed in Chapter 1, regulations are needed in this area. The ministry of finance should review any regulation or draft decision that can have a fiscal impact. Sound budget preparation processes and adequate institutional arrangements are a prerequisite for avoiding overruns. But in some countries with weak systems of governance, seeking technical solutions of this kind is insufficient without the necessary degree of political commitment and leadership.

In a number of countries, the official budget is underspent, particularly its non-wages expenditure items. This does not necessarily mean that there is good fiscal discipline in these countries. In some countries with poor governance, underspending of the official budget may coexist with large amounts of off-budget spending.

In most cases, underspending, as well as overruns, is related to insufficiencies in budget preparation and programme preparation. An overestimated budget and unrealistic projections of revenues may lead

to budget revisions during budget execution and to a practice known as "repetitive budgeting".[1] After the budget is approved, the ministry of finance relies on its own views in preparing the budget implementation plan. A treasury committee reviews the revenue situation and may decide that only a part of what the official budget actually calls for will be released. Under this approach, funds are released from a "core budget" known only to the ministry of finance and the treasury.[2]

Any analysis of budget execution and the instruments for controlling the use of budget funds need to cover issues related to budget preparation, and to take into account both the risks of disruptive repetitive budgeting and the requirements for cash control and compliance control. The importance of these aspects depends strictly on the circumstances in each country.

B. The Expenditure Cycle

1. Stages of the expenditure cycle

Once the budget is adopted by the legislature, the expenditure cycle consists of the following phases:

- *Apportionment of appropriations and release of funds to spending units.* Funds may be released through notification of cash limits, issue of warrants, funds transfers to imprest accounts, and other mechanisms. In some countries, the release of funds includes two steps: (i) *apportionment* by the central budget office, which consists of defining which part of the appropriation the line ministries and spending units can use; and (ii) *allotment* by the line ministries and main spending units, which consists of allocating apportioned appropriations to subordinate spending units.[3]

- *Commitment*. The commitment stage is the point where a future obligation to pay is incurred. A commitment consists of placing an order or awarding a contract for specified goods or services to be delivered. It entails an obligation to pay when the third party has complied with the provisions of the contract. However, as discussed below, the precise definition of a "commitment", in the budgetary sense, varies from one budget system to another, and depends on the economic category of the expenditure.

- *Acquisition and verification (or certification).* At this stage, goods are delivered and/or services are rendered and their conformity with the contract or order is verified. Assets and liabilities of the government are increased and recorded in the books, if the country has an accrual accounting system. Expenditures at the verification stage are also called *accrued expenditures* (e.g. in the US) or *actual expenditures* (e.g. in some FSU countries). Expenditure at the verification stage entails a liability, and arrears are the difference between expenditures at the verification stage and payments.

- *Payment*. At this stage, payments are made through various instruments such as: cheques, cash disbursed, electronic transfers, debt instruments, barter agreements, deduction from taxes and cash vouchers. The practice of making payments through barter agreements, deduction from taxes and cash vouchers is questionable. Payments through deduction from taxes are frequent in some FSU countries, but have negative consequences on both tax collection and competition among suppliers. Barter agreements impede competition among suppliers. Cash vouchers should generally be seen as an administrative stage in the expenditure cycle, rather than as a payment mechanism, especially when they are not paid immediately. Payments through cheques are, in most countries, recorded when cheques are issued. Comparisons with bank statements should be systematic. When the float of unpaid cheques is significant, payments must also be reported on the basis of cheques paid.

2. The commitment and verification stages

In budgetary jargon, depending on the nature of the expenditure and the country concerned, a commitment (or an obligation to spend) corresponds either to the commitment stage as defined above, or to the verification/acquisition stage, or to an administrative reservation of funds in anticipation of their use, or to a procedure for delegating authority. Some countries, e.g. the US, make a distinction between the (administrative) "commitment" which is a reservation of funds, and the "obligation", which corresponds to an order placed, contract awarded, service received, or similar transaction that will require payment (Schick, 1995). For multi-year contracts, a commitment, in the budgetary sense, often corresponds to the annual tranche of the contract, or to actual expenditures.

In this book, the term commitment, when not specified, corresponds to the definition given above (it entails a future obligation to pay, which will be effective when the third party complies with the provisions of the contract). When it is necessary to distinguish a multi-year commitment from its annual tranche, the expressions "forward commitment" and "annual commitment" are used. The (legal) commitment corresponds to the contract or the order, not to the "annual commitment". For budget administration, the commitment in "the budgetary sense" should correspond to the earliest stage within the expenditure cycle at which a claim against the appropriation can be recognised.

For debt service, personnel expenditures, transfers, and also some categories of expenditure on goods and services (such as consumption of electricity and telecommunication services), the commitment in the "budgetary sense" corresponds to the expenditure at the verification stage (e.g. the monthly wage bill, interest due, electricity charges). For these categories of expenditure, the obligation to pay comes from an event upstream to the commitment in the "budgetary sense" (staff recruitment, disbursement of a loan, office heating, etc.). Consequently, for these categories of expenditure, the commitment stage and the verification stage are combined in the budget execution phase.

The "commitment" (in the "budgetary sense") should be defined as: (i) the legal commitment, when it makes sense to define the commitment on this basis (for example, contracts and orders for supplies, investment, maintenance works, etc.); and (ii) expenditures at the verification stage, for other items (personnel, debt servicing, utilities bills and transfers). For orders concerning petty expenditures, the commitment and verification stages may be confused without major inconvenience in the reports used for budget implementation supervision. Nevertheless, for the purposes of agency and programme management, it is important to monitor all legal commitments, from an order for stationery to a multi-year contract for an investment project of a significant size. In the same way, an administrative procedure for reserving appropriations, or the annual tranche of multi-year contracts can match some organisational arrangements, but it is necessary also to define a stage in the expenditure cycle that corresponds to the legal commitments.

It is important to be precise about the definition of the term "commitment" which can take different meanings in different contexts, as follows:

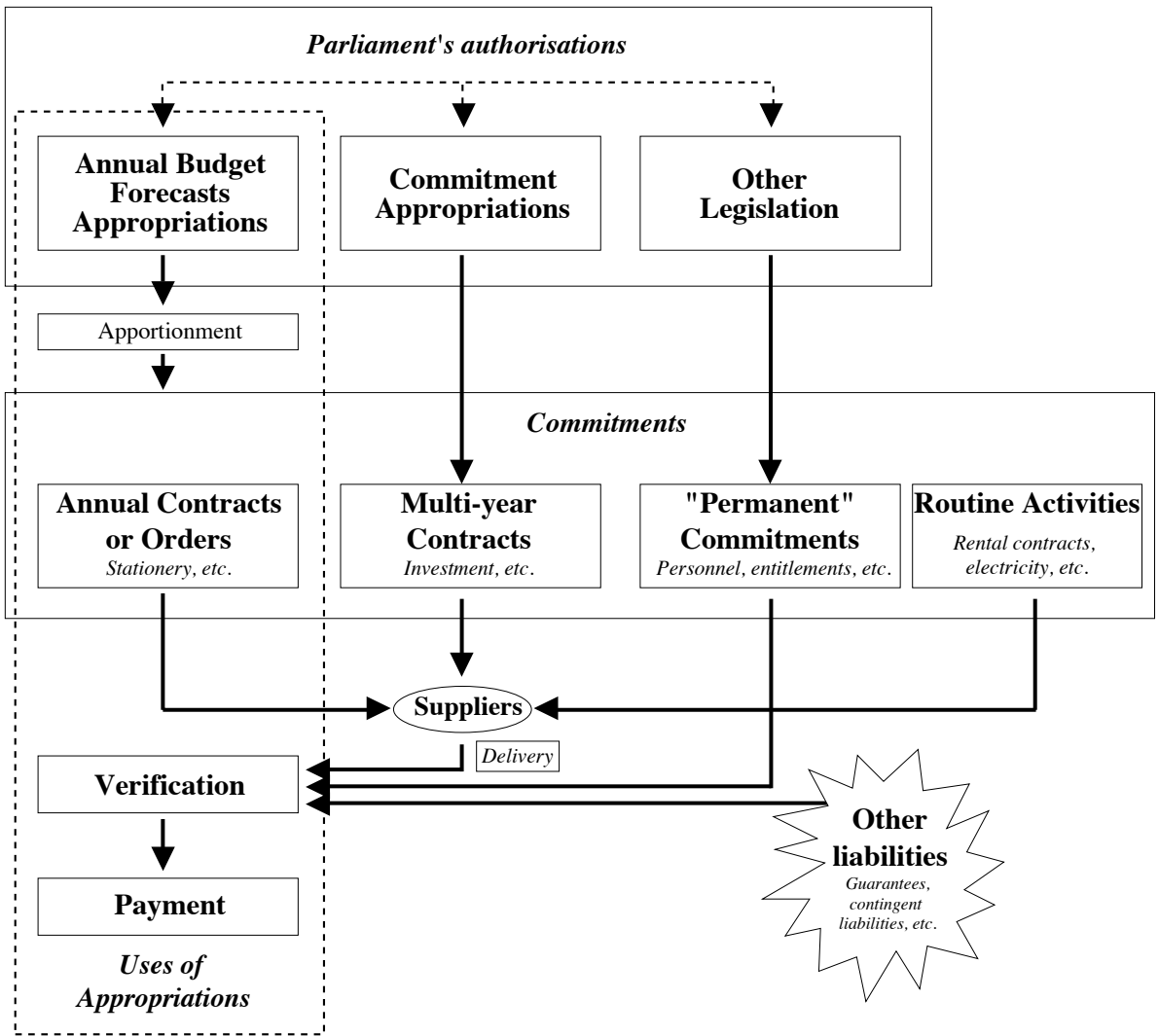
- For *cash planning and funds release*, it is important to know the obligations to pay that will occur over the period of the budget. It can be expected, for example, that an order for stationery will be completed over this period, but contracts for investment projects (and legal commitments) may cover several fiscal years. Therefore, for cash planning the important factor is the share of the commitment that will generate a liability over the planned period. Except in the case of multi-year investment projects, this will generally be the legal commitment for supplies.

- For *budget preparation*, it is important to know the forward costs of multi-year investment projects and the expenditures that are "compulsory" or that will occur without adjustment measures. The government has legal and/or moral obligations to meet the salary costs of government employees and the cost of entitlement programmes. It is necessary to calculate the cost of all such policy commitments whatever their form.

- For *fiscal analysis*, the cost of outstanding invoices, that is the difference between expenditures at the verification stage and payments, must be assessed. The difference between commitments and payments gives only an approximate estimate of arrears, since it includes orders not yet delivered.

- For *programme management*, information on both commitments and expenditures at the verification stage is needed. Spending agencies need to follow up accurately the orders and the contracts they have awarded. Accounting for expenditures at the verification stage gives the main elements for assessing costs, shows how far programme and project implementation has progressed, and is required for managing payables and contracts.

Figure 7.1. **IMPLEMENTATION OF BUDGETARY EXPENDITURE**



- For *expenditure control*, defining the (legal) commitment is very important, particularly for debt servicing, personnel expenditure and multi-year investment projects, which cannot be controlled only on the basis of annual appropriations.

The benefits of monitoring either commitments or expenditures both at the verification stage and the payment stage are sometimes debated. In practice, these stages of the expenditure cycle are equally important and electronic systems are available that allow the necessary data to be captured and stored easily.

Figure 7.1 illustrates the different stages of the expenditure cycle and the variety of mechanisms through which expenditures are committed. Thus, keeping budget commitments under control requires, besides controlling the uses of annual appropriations: (i) sound budget formulation and policy decision to ensure the conformity of permanent commitments with budget forecasts; (ii) control of multi-year commitments; and (iii) good administration, since many liabilities arise in practice from routine activities or informal procedures (e.g. telephone calls) rather than formal contracts or orders.

3. Assuring Financial Compliance

a. Release of funds

Instruments used by the ministry of finance to provide spending agencies with authority to spend vary from one country to the other (e.g. the issuing of warrants and notifying a budget implementation plan). What is important for the purpose of effective budget implementation is that the ministry of finance gives this authority in a timely and clear manner, in order to avoid any confusion in the uses of appropriations. As discussed in Chapter 9, sound cash management requires preparing in-year budget implementation and cash plans, but these plans must be in conformity with budget authorisations (except under special circumstances or if the budget is badly prepared).

In some transition countries, because of fiscal problems or an overestimated budget, funds are released to line ministries on a day-to-day basis. Where a centralised treasury system exists, this mechanism consists of an ad hoc selection of agencies to which cash will be transferred, or a selection of the invoices to be paid. In some countries, this selection is made by a committee composed of the treasury director, the minister of finance, and the prime minister. Funds are often released on emergency or political grounds, discarding the priorities defined in the budget. The effective "cash budget" formulated implicitly through this process is substituted for the authorised budget, and may be quite different from the budget approved by the parliament. Another weakness with systems of cash rationing is that spending agencies can continue to make commitments according to the budget, and thus accumulate arrears, whilst complying in formal terms with budget procedures.

Sequestering is the blocking of appropriations by the ministry of finance in order to rebalance the budget without adjusting cash plans. When sequestering appropriations, ongoing commitments should be taken into account. Although sequestering may sometimes be necessary, it diminishes predictability and should be used only in special circumstances.[4]

In some countries, warrants authorising spending agencies to make expenditure commitments require the prior approval (or "visa") of the supreme audit institution (SAI).[5] In most cases, these "somewhat ceremonial" or "pompous" (Premchand, 1993) procedures are purely formal and do not create unnecessary delays in budget execution. However, the relevance of this procedure is questionable, since the SAI should not be involved in the ex ante control procedure.

b. Compliance controls

The basic compliance controls during budget execution are the following:

- *At the commitment stage (financial control),* it is necessary to verify that (i) the proposal to spend money has been approved by an authorised person; (ii) money has been appropriated for the purpose stated in the budget; (iii) sufficient funds remain available in the appropriate category of expenditure; and (iv) the expenditure is classified in the correct way.

- *When goods and services are delivered (verification),* the documentary evidence that the goods have been received or that the service was carried out as required must be verified.

- *Before payment is made,* it is necessary to confirm that (i) the expenditure has been properly committed; (ii) a competent person has signified that the goods have been received or that the service has been carried out as expected; (iii) the invoice and other documents requesting payment are complete, correct and suitable for payment; and (iv) the creditor is correctly identified.

- *After final payment is made (audit)*, it is necessary to examine and scrutinise the expenditure concerned and report any irregularity.

C. Distribution of Responsibilities

1. General principles

Decisions relating to the implementation of a programme authorised in the budget must be taken by the relevant line ministry, as is the case in most countries. However, in some countries, controls exercised by the ministry of finance, treasury or other central agencies can interfere in the effective implementation of sector policies. In such circumstances, some "rebalancing" of the relationship between the centre and line ministries — or of the way central controls are exercised in practice — should be considered.

There may also be problems concerning the allocation of responsibilities between the central departments of the line ministries and their subordinate agencies. In some countries, continuous interference by the central departments in the management of projects and programmes impedes the effective implementation of these programmes. In other countries, powerful agencies implement programmes without reporting to their "parent" ministries. There is a need to clarify the distribution of responsibilities within line ministries to ensure that the central departments are fully responsible for co-ordinating sector policy and that subordinate agencies carry out their activities under the supervision of these departments but without unnecessary interference in day-to-day administration.

Budget execution covers both activities related to the implementation of policies and tasks related to the administration of the budget. Both central agencies and the spending agencies are involved in these tasks. The distribution of responsibilities in budget management should be organised according to the respective areas of responsibility and accountability of these agencies.[6]

The responsibilities of the ministry of finance are the following:

- Concerning the *control of budget execution*, administering the system of release of funds, monitoring expenditure flow, preparing in-year budget revisions, managing the central payment system (if any)

or supervising government bank accounts, administering the central payroll system (if any), preparing accounts and financial reports.

- Concerning *policy implementation*, reviewing progress independently or jointly with spending agencies, identifying policy revisions where appropriate, and proposing to the council of ministers reallocations of appropriations within the framework authorised by parliament.

The responsibilities of spending agencies are the following:

- Concerning *budget administration*, allocating funds among their subordinate units, making commitments, purchasing and procuring goods and services, verifying the goods and services acquired, preparing requests for payment (and making payments, if the payment system is not centralised), preparing progress reports, monitoring performance indicators, and keeping accounts and financial records.

- Concerning *policy implementation,* periodically reviewing the implementation of the relevant programmes (including the monitoring of performance indicators), identifying problems and implementing appropriate solutions, and reallocating resources among sector programmes (but within the overall policy framework of the budget).

When several departments in the ministry of finance and other agencies are involved in the supervision of budget execution, close co-ordination of their activities is required and their respective functions should be clearly delineated. In particular, in a number of countries, co-ordination between the budget department of the ministry of finance, which is responsible for budget preparation, and the treasury[7], which is primarily responsible for budget execution, is often insufficient. The budget department should be responsible not only for preparing the budget but also for budget revisions and the reallocation of resources among sectors. The treasury should provide it with all the information that is needed on budget execution.

2. Centralised or decentralised controls?

Generally within any organisation, there is a separation of duties for authorising expenditures, approving contracts and placing orders, certifying that goods have been received and that services have been provided as specified, and authorising payments. In addition, in many countries, an ex ante control by a third party is performed before an official in a spending agency can make a commitment or payment. Such arrangements are aimed at limiting cases of misconduct, and ensuring that public funds are used efficiently and effectively (see Chapter 10, for a description of internal (or management) control procedures).

Depending on the country, commitment and accounting controls may be either internal to the relevant line ministries or performed by a central agency (the ministry of finance, financial comptroller's office, etc.). Thus, in many countries payments are made through the treasury, but the extent of the involvement of the treasury in the execution of accounting controls varies widely from one country to the other. In some countries, the ministry of finance assigns a financial advisor or a budget officer to each line ministry in order to control budget execution.

Depending on the administrative culture of the country, centralised ex ante controls can lead to excessive interference of central agencies in the day-to-day management of line ministries' budgets, and, in some countries, even in the preparation of the sector budget.[8] Centralised ex ante controls may also cause delays in budget implementation and hinder efficient management, especially when the budget

execution process is not fully computerised. The system of having a financial adviser or budget officer appointed by the ministry of finance and posted in line ministries can create problems where the officials concerned are authorised to prepare sector budgets on behalf of the ministry of finance or exercise cumbersome ex ante controls on the activities of line ministries. Moreover, in countries with poor systems of governance, multiplying controls can have perverse effects and increase corruption. Unofficial "tolls" or levies may be imposed in exchange for bypassing these checks. As discussed in Chapter 9, a centralisation of cash balances is desirable, but this does not mean that the treasury should be involved in the day-to-day control of invoices and payment documentation.

Controlling commitments and payments on the basis of the annual appropriations is often insufficient to ensure compliance and fiscal discipline. Accounting controls can prevent blatant cases of misuse of appropriations. Regardless of how they are organised, however, accounting controls do not prevent the accumulation of arrears since obligations are made upstream. Nor do they prevent the commitment of expenditures that are not authorised in the budget. Thus, controlling personnel expenditures needs specific instruments, such as staff ceilings and/or ceilings on operating expenditures or "running costs". The control of annual commitments and payments cannot prevent overruns on the investment programmes that are carried out under multi-year contracts. Even for goods and services expenditures, centralised ex ante controls are insufficient. For example, controls on the consumption of utilities such as electricity and telecommunications, which represent a significant part of the government's current expenditure, need to reinforce internal management systems, not necessarily the budgetary procedures. Beyond formal compliance, economy and efficiency in the uses of resources must be ensured. One of the aims of centralised controls is to allow the ministry of finance to supervise budget implementation. In fact, with modern technologies, information on budget execution can be quickly available at the centre, even when transactions are fully administered within spending agencies.

Most transition countries need to reinforce their controls on expenditure, but addressing compliance, economy and efficiency issues requires a broader approach than focusing on centralised budget execution controls. Soundly based systems of internal control, internal audit and external audit are also required. In many transition countries, these essential bases for sound expenditure management are not yet built.

D. Budget Appropriation Management Rules

1. Annual nature of appropriations

Although there are exceptions, notably where some appropriations are obligation-based, a classic rule of the budget is the annual nature of appropriations. At the end of the year, unused appropriations are cancelled. The annual rule can create a rush for spending at the close of the fiscal year, variously described as the "end-year surge", "spree spending" or "squander mania".[9] This spending bulge at the end of the fiscal year does not necessarily mean bad management, since it can be the result of prident purchasing procedures. Nevertheless, the potentially adverse effects of a strict annual rule are many. For example, revolving funds or extra-budgetary funds may be set up or ad hoc private organisations may be created to manage the budget under more "flexible" rules. To ensure that appropriations are not cut back in the following year, the annual rule encourages line ministries to make unplanned and economically inefficient spending at the end of the year.

To avoid such perverse effects, some OECD countries have recently altered the annual nature of the appropriation for operating expenditures and authorised the carry-over of a certain percentage of these unspent appropriations to the next fiscal year. However, systematically authorising carry-over for

operating expenditures in transition countries could pose problems as regards expenditure control. The annual rule calls for systematic in-year planning of cash payments, which is indeed one the basics of a sound budgeting system. If appropriate accounting procedures are not in place, altering the annual rule can lead to executing two budgets at the same time, and confusion. An eventual alteration of the annual rule for operating expenditures should be considered only in the countries where the budget preparation process is fully satisfactory. In any case, carry-over for operating expenditures should be limited initially to a small percentage of appropriations and be submitted to the approval of the ministry of finance.

Capital investment expenditures are difficult to manage within an annual budget framework. In principle, procedures for carrying over unused expenditure at the end of the year are needed for capital expenditures, provided that the budget includes soundly based estimates of their cost. Carry-over of capital expenditures should concern only ongoing projects and be submitted to the approval of the ministry of finance. Appropriate procedures are also needed for paying bills and invoices that were regularly committed over the previous fiscal year, but have not yet been paid because of delays in deliveries, for example. There are also some special activities for which revolving funds are needed (e.g. activities of departmental enterprises) but, as stressed in Chapter 1, such funds must be submitted to strict accounting and reporting requirements.

Some EU Member States authorise pre-spending for some categories of expenditures, although under very strict conditions. Authorising pre-spending should not be considered in transition countries which do not have appropriate control mechanisms for managing such expenditure.

2. Flexibility issues

Rules for transfers between budget items (chapters, line-items, etc.) are generally stated in the financial regulations or in the organic budget law. Such rules should distinguish transfers that may be made freely by line ministries, transfers submitted for the approval of the ministry of finance and transfers that are strictly forbidden. Although it is not generally the case in transition countries, in some other countries, control of these transfers is one of the major activities of the budget office during budget execution. The procedures involved are time consuming and absorb large amounts of administrative resources.

In some countries, there are many thousands of appropriations and their purpose is too narrowly defined. Appropriations should be defined in order to ensure that the budget is implemented according to the government's policy objectives. However, an excessive number of appropriations tends to impede efficient implementation of the government's expenditure programmes. Most EU Member States have reduced the number of appropriations included in the budget (for example, Italy has reduced the number from 6,000 to 800; in the UK the number is less than 100).

Determining the exact composition of the inputs of a programme is difficult. To implement policies and programmes in the most efficient and cost-effective way, the line ministries and agencies should be given adequate flexibility to manage their resources within the policy framework of the budget. Thus, during the implementation of programme expenditures, certain problems (e.g. delays) can occur, particularly in the case of investment expenditures. In such circumstances, appropriate measures should be taken to reallocate budget resources from investment projects that are delayed to other projects in order to ensure that government policy objectives are achieved. This flexibility concerns the composition of the inputs needed to carry out a given activity and the allocation of resources among activities and projects that meet a given set of objectives (within the same programme). However, it should not alter the policies stated in the budget or hinder the achievement of stabilisation objectives.

Several OECD countries have recently implemented block appropriations for operating expenditures. Line ministries are free to determine the best composition of inputs to implement their programmes and achieve results. To achieve greater efficiency, line ministries should be given a certain degree of freedom to allocate resources within their sector. This will contribute both to increased efficiency in delivering services and to keeping expenditure under control. The possibility of using savings on certain expenditure items for other expenditures gives an incentive to agencies to make these savings. Undoubtedly, in countries with a strong internal and external audit system, a long tradition of fiscal discipline, and a flexible management system for the civil service, it is better to allow spending agencies to determine the composition of the inputs needed to meet the programme objectives.

It would be difficult, however, to adopt such a system in transition economies. Depending on the internal capacities of line ministries to control their programmes and the nature of problems met in budget implementation, it will usually be necessary to restrict the ability of ministries to reallocate budgetary resources within their sectors.

Typically, therefore, transfers between personnel expenditures and other economic categories of budgetary appropriations should be regulated in transition countries. However, the effects of such regulations need to be carefully reviewed to ensure that they are designed properly. In some countries, for example, switching appropriations from other economic categories to personnel expenditure is not permitted; in other countries, the reverse form of transfer is forbidden. In the first case, the regulations are aimed at capping personnel expenditures. In the latter case, they are aimed at protecting personnel expenditures. Capping has the advantage of giving a clear signal to spending agencies. However, protecting expenditures already committed has the advantage of limiting budget overruns and arrears generation.

In some transition countries, it may be desirable to have rules either to protect some non-salary items for which arrears are frequently generated (such as electricity consumption) or to cap certain categories of expenditures. However, these rules should focus on what is strictly necessary and should not apply forever. What can be a problem of compliance in one year will not necessarily be a problem the following year.

3. Special issues related to multi-year commitments

It was suggested in Chapter 1 that authorisation for forward commitments should be included in the budget. Such measures may need time to be implemented. Nevertheless, an instrument to monitor and control multi-year commitments requires early implementation. If the budget does not include authorisations for forward commitments, an internal document should be prepared giving ceilings for these commitments. Such ceilings can be estimated from the forward costs of ongoing projects, which should be systematically assessed when preparing the budget. Typically, these commitment limits are equal to the total costs of projects under implementation less the amount of the contracts related to these projects that have already been committed. The notion of a project in this sense should be understood as the non-divisible expenditure that is necessary to achieve effective operation of the undertaking. For example, the commitment limit should comprise the entire cost of a bridge, since less than whole bridge is not operational, but it could comprise only a 100km section of a project to build a highway of 1,000km.

Preparing multi-year estimates can help in preparing the authorisations for forward commitments. However, caution is required. The multi-year expenditure programming documents should be prepared under hard constraints and the conservative assumptions that are used in budget management. Moreover, authorisations for multi-year commitments should deal only with the non-divisible part of projects and programmes, rather than including all projects of a large programme.

In a number of transition countries, an ex ante control of multi-year commitments by the ministry of finance may be desirable. Line ministries would have to submit a request to the ministry of finance, before committing to a contract of significant size. This control should be based on formal commitment authorisations or at least on the internal document discussed above. Ad hoc controls often have the disadvantage of not distinguishing between financial controls and policy or procurement controls.

Multi-year commitments should be reported in the same way as the uses of annual appropriations.

E. Other Issues of Budget Implementation

1. Monitoring the execution of the budget

To keep budget execution under control, a comprehensive and timely system for monitoring budget transactions is required. It is necessary to systematically register and track the uses of appropriations. Budgetary (or appropriation) accounting should cover appropriations, apportionment, increases or decreases in appropriations, commitments/obligations (including special procedures to monitor forward commitments), expenditures at the verification/delivery stage, and payments. Such a system is only one element of the government's accounting system, but the most crucial one for both formulating policy and supervising budget implementation.

Financial reports on budget execution at each stage of the expenditure cycle detailed by organisation, function, programme, and economic category should be produced every month, while aggregate in-month "flash reports" are needed for efficient cash management. Issues related to accounting and reporting are discussed further in Chapters 11 and 12.

A comprehensive mid-term review of the implementation of the budget is needed to ensure that programmes are implemented effectively and to identify any policy problems. This review of budget execution should cover financial, physical and other performance indicators. Cost increases due to inflation, unexpected difficulties, insufficient initial study of projects, and budget overruns must be identified so that appropriate counter-measures can be prepared.

Capital investment programmes are often beset by implementation problems because of insufficient implementation capacities and other factors such as delays in mobilising external financing, over-optimistic implementation schedules, climatic hazards, or difficulties in importing supplies. Mechanisms for reviewing the most significant or problematic projects are needed. These could consist of a regular monthly or quarterly review of projects within line ministries and a mid-year review involving line ministries and central agencies.

2. In-year budget revisions

It is often difficult to make accurate forecasts of the implementation of certain programmes or of key macroeconomic developments such as changes in the world economy, inflation, interest rates or exchange rates. Moreover, some spending needs that were not foreseen during budget preparation may appear during budget execution. To limit the effects of such problems, rules for transfers must be flexible, and a contingency reserve should be included in the budget, as noted earlier. Appropriations for debt service, for example, cannot be a spending limit and should be revised according to developments in interest rates and exchange rates.

In the case of in-year changes that alter the composition of the budget or when an overall increase in expenditures is unavoidable, the budget may have to be revised. Mechanisms for revising the budget vary from country to country, and should be clearly stated in the organic budget law. Some broad principles are as follows:

- Since the budget has been passed by the legislature, revisions should generally be made by law.
- In general, changes in appropriations above a certain percentage of the initial appropriation, or changes that affect the total amount of expenditures, must be submitted to the legislature for approval.
- To allow the government to address urgent problems rapidly, procedures authorising exceptional expenditures before the parliament approves them can be considered. However, such authority should be regulated and time limited, and the executive required to present a revised budget to the parliament shortly thereafter.
- The number of in-year revisions should be strictly limited (preferably only one) and requests from line ministries should be reviewed together. Some countries present supplementary estimates to parliament on a case-to-case basis, each time the council of ministers approves a request from a line ministry, and numerous supplementary appropriations are thus voted every year. Such procedures should be avoided. Budget execution is difficult to control when the budget is continually being revised. Moreover, supplementary appropriations granted to one sector may all too soon seem better allocated to a higher-priority sector.

NOTES

1. See Caiden and Widalvsky (1990).

2. See Caiden and Widalsky (1990) and the discussion of the "core budget" in Chapter 5 of this book.

3. This distinction between apportionment and allotment is based on US terminology.

4. A discussion of the drawbacks of sequestering in France may be found in Hel-Thelier, Meny and Quinet (1996).

5. For example, in Turkey, and several British Commonwealth countries.

6. See the chart on page 259 in Premchand (1983), which lists "budgetary tasks" and "administrative tasks". The distribution of tasks suggested below is partly drawn from this chart.

7. In some countries the treasury is a department of the ministry of finance, in others it is an independent or quasi-independent agency, usually under the supervision of the minister of finance. For further discussion of these issues, see Chapter 9 below.

8. For example, in Turkey, budget offices from the Ministry of Finance control both budget preparation and budget execution.

9. Premchand (1993). This practice was standard in the ex-Soviet system and was called *shturmovschin*.

CHAPTER 8

PAYABLES, PERSONNEL AND PROCUREMENT MANAGEMENT

This chapter deals with some of the most crucial technical issues in the budget execution process: management of payables; issues related to arrears and non-budgeted expenditures; control of personnel expenditures; and procurement, including the management of contracts that are contracted out to the private sector.

A. Managing Payables and Arrears

1. Managing payables

Besides issues related to procurement, which are reviewed in Section C, an important element in budget execution is the management and monitoring of contracts and other obligations. Each contract needs to be monitored at the spending unit level. Goods and services delivered must be accounted for. Where there is provision for advance payments or progress payments, the planning of the deliveries needs to be followed up accurately. For contracts concerning civil works and projects of a significant size, cash payments that will be made over the fiscal year must be carefully planned.

In the day-to-day management of payables, it is necessary to take into account the date at which the payments are due. To avoid penalties for late payments, invoices should be paid on the due date, but to reduce borrowing needs they should not be paid in advance. Whatever the accounting system within the government, spending agencies must track their commitments and the deliveries of goods and services.

In some countries, payables are often distributed among various offices, such as the programme manager's office, the departmental office, the financial adviser's or controller's office, and the treasury. The following broad principles should be adopted:

- Expenditures must be verified as soon as the goods or the services have been acquired.
- Expenditures that are verified must be entered immediately into the accounts.
- Payments must be recorded as soon as they are made.

Computerisation helps in tracking the invoices, but only if the system if properly designed and managed. Otherwise, invoices can accumulate upstream of the computerised cycle and even downstream. For example, if checks are made by the treasury through its financial information system, invoices can be accumulated at the level of the spending agency managers, who do not submit invoices when they believe that the treasury has insufficient cash to make the necessary payments.

2. Arrears

A number of transition countries face arrears problems. Arrears pose financial problems for suppliers and have disruptive effects on public expenditure management. In order to deal with these difficulties, suppliers may respond in various ways: for example, adjusting their billing strategy by requesting to be paid before they deliver; overbilling invoices; and (as an extreme measure) offering bribes to officials in line ministries and/or the treasury who are responsible for the management of the waiting list of arrears.

Arrears have many causes, such as insufficient commitment controls or the perverse effects of a cash rationing system that does not take into account commitments already made. Thus improved monitoring of commitments, including multi-year commitments, is generally required. However, in many cases, the decision or the event that generates an obligation to pay, is upstream of the commitment in the budgetary sense. Arrears in the consumption of services provided by utilities are frequent. Generally, state-owned utilities (and even private companies) do not stop providing services to government agencies even when they are not paid. Limiting arrears generation in this sector requires both realistic estimates of annual consumption and internal management measures (such as installing meters and regulating phone calls).

Limiting arrears generation needs therefore a combination of measures such as realistic budget estimates, internal management measures, control of personnel staff, monitoring and controlling commitments and especially of multi-year commitments, and decisions related to entitlements. The required measures to contain commitments must be identified at the budget preparation stage.

The estimation of arrears is an important issue in some countries. Arrears are sometimes distinguished from "float", which corresponds to the usual processing period for outstanding invoices. A stricter definition is to say that any invoice due on one date and not paid on that date must be included in the stock of arrears. An appropriate registration of deliveries and expenditures at the verification stage as suggested above is necessary for establishing an effective and durable system for monitoring arrears.

When a country faces arrears problems, it should prioritise its payments on the basis of the date on which invoices are due and their order of precedence. Programmes to reduce the stock of arrears should not lead to questionable practices, such as the generation of new invoices which are given the privileged status of arrears and the payment of expenditures that do not comply with the procurement regulations. Strict control of the judicial regularity of arrears payments is required. The supreme audit institutions should scrutinise such operations.

3. Issues related to non-budgeted expenditures and "unfunded" liabilities

Liabilities are defined as debts and obligations to pay resulting from past events. In some countries, a distinction is made between funded and unfunded liabilities, the difference being whether or not resources to finance the related expenditures have been budgeted. It is sometimes argued that the unfunded liabilities should not be paid, since the expenditure was not authorised by the legislature. However, unfunded liabilities may correspond to legal obligations that the government cannot ignore. As a result, these unfunded liabilities are sometimes paid, but the executive waits for the following budget to regularise them. In the budget execution reports, expenditures of the current year are thus underestimated, while the budget of the following year includes appropriations for expenditures already made.

Measures to improve the management of unfunded liabilities depend on their causes, which fall into the following main categories:[1]

- *Liabilities arising from legislative changes*. Legislation after the start of the fiscal year may augment existing benefits. Regulations should be established to eliminate or at least limit the generation of such liabilities.

- *Compulsory indemnities*. The legislation may include provisions for compensating losses caused by special events, for example, to compensate disaster victims. The government may be required to pay judicial indemnities, or to indemnify contractors because of a breach of contract, etc. Including a small reserve in the budget, as suggested earlier, limits unfunded expenditures.

- *Exceptional expenditures* that are not included in the budget or cannot be estimated accurately when preparing the budget: for example, the cost of cleaning up natural or environmental catastrophes; or unforeseen expenditures related to a banking sector restructuring programme. Expenditures related to such liabilities must be shown in the budget execution report, and the year-end report, and posted in the accounts. An in-year budget revision should be made to include exceptional expenditures in the budget.

Besides the cases mentioned above, some unfunded liabilities are related to lack of compliance. An appropriate and effective system of sanctions is needed. However, these liabilities may have to be recognised, if the contracts are regularly committed in conformity with the government's procurement law. Issues related to hidden liabilities such as unfunded pension liabilities are reviewed in Chapter 11.

B. Personnel Budgeting and Expenditure Control

Issues of personnel management cover different areas. On the one hand, current fiscal constraints and the changing role of the government focus attention on procedures for controlling personnel expenditures. The size of the public service is a major concern in most countries. This is mainly a policy issue, but it requires appropriate tools for budgeting personnel expenditures. On the other hand, transition countries have to build an efficient civil service and reinforce their budgetary and managerial systems for controlling personnel costs.

1. Civil service issues in transition countries

a. Legal framework

Many civil service laws cover the conditions of employment in great detail but are weak in regulating the role and responsibilities of civil servants as well as the aspects related to professional standards and management co-ordination. A civil service law should not only regulate conditions of service. It should also regulate the role of civil servants, the professional quality of civil servants, personnel management principles, and the control of staffing levels and pay costs.

Public servants should be accountable for their actions, and their decisions should be subject to judicial review. The legal framework must ensure that the principles of legality, impartiality and integrity are effectively enforced. The principle of legality means that there are procedures and control mechanisms in place to safeguard that public servants take decisions and act within the limits defined by law and regulations. If legality is not safeguarded there is a high risk for arbitrariness in the administrative decision-making. In most transition countries' legislation, oversight institutions or appeal mechanisms need to be strengthened to a greater or lesser extent.

All transition countries have problems with corruption and irregular behaviour, though to a varying extent. The inherited administrative culture does not promote impartiality and integrity. In some transition countries with an insufficient legal and institutional framework and where salaries are also very low, it may seem more efficient for a citizen or company to pay a public official to safeguard a certain administrative outcome (e.g. a procurement contract) than to rely on the outcome of the ordinary administrative process. A code of ethics could be attached to the civil service law and be legally enforceable.

b. Selection and conditions of service

Selection of civil servants based on merit is poorly provided for in many transition countries. This is due to unsatisfactory legal structures and lack of attractiveness of many public service jobs. Compartmentalisation and politicisation are the legacy of the social command control era. Thus, in many transition countries selection to senior positions is based on political grounds, leading to a high turnover in these positions and a lack of professional quality and continuity at the top management level. This is likely to have an adverse effect on the management and control of public expenditure.

In most transition countries, basic pay and seniority increments for civil servants are generally defined by law and openly disclosed. However, bonus awards and other kinds of supplementary payment are commonly made to employees at the discretion of line ministries and without sufficient transparency. Such payments are financed by keeping vacant a proportion of staff positions in the ministries concerned. In some countries, so-called "management contracts", characterised by total discretion and secrecy, represent a substantial component of take-home pay, leading to demotivation of those without such contracts and resistance to necessary change amongst those officials who receive them. Career progression is based mainly on seniority in most transition countries, and promotion means being appointed to a new position. Salaries are generally low, and in some countries are so low that second jobs are frequent and public servants are vulnerable to corruption.

c. Directions for reform

To improve efficiency of the public service in transition countries, actions should be undertaken in several areas, notably the following:

- Civil service laws should be reviewed and amended where necessary, to strengthen the role of civil servants, their professional standing and management co-ordination.

- Remuneration schemes should be reformed to offer improved career and performance incentives and to promote transparency and predictability.

- The administrative process needs to be strengthened both in terms of legislation, oversight capacity and judicial review. A general Administrative Procedures Act should be considered in countries lacking one.

- Computerised pay-roll administration systems should be made compatible throughout the administration to provide pre-conditions for better control of staffing and personnel costs as well as for staff planning.

- A well-designed staff redundancy scheme could be part of the implementation of a civil service law in some transition countries in order to strengthen capacity but also in order to ensure a transition leading to better performance.

- Anti-corruption programmes should be given political priority and need to be launched and implemented in most countries as a complement to legal and institutional reform.

One useful measure, in some countries, for improving the quality and efficiency in government decision-making and human resource management in transition countries can be the formation of a senior group of civil servants and a Top Management Service (TMS), as is the case in many EU Member States (Plesch, 1997). A TMS is a structured system of personnel management for the higher non-political positions. Such a service is centrally managed through appropriate institutions and procedures in order to provide stability and professionalism of the core group of top managers. One of the reasons for creating a senior civil service group is also to act as a control against corruption.

2. Comparative analysis of pay determination systems[2]

It is customary to distinguish between centralised systems — those in which both pay bill volume and salary growth rates are set at central government level — and decentralised[3] systems, in which government agencies or ministries enjoy autonomy in managing their staff and adjusting pay. These are in fact extreme positions, and some countries combine elements of both types of system. In practice, both systems contain arrangements for achieving a number of objectives: wage flexibility, work incentives, cutting public spending, maintaining control over wage increases, etc. In a centralised system, elements of decentralisation are usually introduced in response to the need to increase the flexibility of pay and personnel management systems, and to reduce public spending. However, some systems maintain a partial level of centralisation, even though the agencies or ministries take part in the pay determination process. Through budgetary constraints, the government endeavours to control or co-ordinate pay increases and to avoid attempts by the parties to outbid one another in workplace negotiations.

The OECD has proposed four criteria as the basis for assessing the relative degree of centralisation or decentralisation of a pay system:

- The presence or absence of collective bargaining and the number of levels of negotiations.
- The content of salary negotiations.
- Financial constraints imposed by the government and the degree of autonomy of the agencies and ministries with regards to the budget.
- The procedure used by the government for determining the annual salary cost adjustment.

a. Centralised pay negotiations

The same centralised level can be structured very differently in different countries in order to take job market pressures for specific groups of professionals into account. In Germany, Spain and France, for example, collective bargaining on pay is centralised, and the same agreement applies to all public service employees, regardless of the functional subsector or the level of government in which they are employed. Employment status does, however, lead to differences. In Germany, civil service pay is set by law, while the pay of senior civil servants is excluded from collective bargaining in Spain. In the Netherlands, a centralised pay agreement applied to all public sector employees until 1993. Since then, negotiations have remained centralised, but are now organised separately for each of the eight functional subsectors of the public service (ministries, education, police, defence, justice, provinces, municipalities and *Polder Boards*). In Italy, similarly, pay negotiations are held in each of the eight functional subsectors defined

as part of the 1993 civil service reforms. The police and armed forces, university professors and other academic staff, judges and prosecutors, as well as senior civil servants are excluded from these negotiations.

b. Decentralised and partly decentralised pay negotiations

If one shifts the focus to countries that have introduced two levels of pay bargaining, the extent to which their pay systems are decentralised depends primarily on how the overall pay bill volume is determined. In Ireland and Denmark, for example, total compensation costs are set centrally. There is a very strong tradition of negotiation and social consensus in these two countries. In Ireland, public sector pay negotiations are broken down into two steps. First, a centralised agreement determines the across-the-board rate of increase. A second round of negotiations is then undertaken by the unions, organised by occupational group, to present specific claims of the groups concerned. The pay bill is adjusted ex post, in order to pass on the outcome of local and central negotiations. It is clear that such a system could make the application of policies aimed at limiting pay bill increases difficult. However, the fact that the unions are involved in drawing up economic programmes and signing tripartite agreements should, in principle, keep demands for salary increases within reasonable limits.

In Denmark, a system has officially been put in place to ensure that part of the pay determination process occurs at the workplace. The government sets aside a certain percentage of the pay bill for individual allowances, the size of which is determined by local negotiations.

In another group of OECD countries, pay determination is delegated to agencies or ministries which are responsible for managing their own operating costs. Within this group, the main difference between Australia, Finland and Sweden, on the one hand, and New Zealand and the UK on the other hand, lies in the type of collective bargaining used. In Australia, Finland and Sweden, two levels of negotiation are still used, in addition to the implementation of decentralised management of the operating costs budget. In the UK and New Zealand, reform of the pay determination system has been accompanied by changes in the collective bargaining system.

When centralised negotiations are still held, it is important to specify what aggregate level of pay will be determined at that level, and who will finance it. Clearly, an across-the-board pay increase that is not funded out of the budget may penalise those ministries or agencies that have achieved smaller productivity gains. It may even force such ministries to cut staff in order to make the necessary funds available.

c. Single or multiple pay scales

Civil service employees' pay is made up of several components. This allows many diverse factors, such as pressures on the local or occupational job market, individual performance, etc., to be taken into account. This approach to individual pay determination raises the question of equity. Those countries having implemented a uniform job classification system for the entire civil service (e.g. Australia, Denmark, Spain and France) can guarantee equity and uniformity of pay. These systems are, however, rigid, and cannot adapt easily to employment trends and job market pressures. Spain, with its specific supplements, and France, with its recently introduced grade-related premia (*nouvelle bonification indiciaire*, NBI), have attempted to respond to new demands. The costs of these measures contributes to the increase in the pay bill. Australia completely overhauled its job classification system in the late 1980s, in order to adapt its workforce to the needs of its various services. When agencies and ministries are given the opportunity to implement their own classification systems (e.g. in Finland and the UK), salary increases in one agency may lead to increases in other agencies as well, undermining the effectiveness of decentralised systems.

3. Management and control of personnel expenditures

a. Organisational issues[4]

Personnel management must be performed by relevant line ministries. It is for example unrealistic to set up a central personnel management office to design or approve the organisational structure and staffing of a given ministry, because it lacks the necessary knowledge of that ministry's policies and operations. However, certain central control and co-ordination mechanisms are needed.

Schematically, there are two main types of control and co-ordination tasks in managing government personnel expenditures:

- *Budgetary control*, which concerns financial aspects of pay structure for macroeconomic and fiscal management purposes, the setting of policy priorities at sectoral level, and achieving economy and efficiency in government operations for programme management purposes. Any decision on personnel management issues that affects the budget needs to be prepared in consultation with the ministry of finance and be made subject to similar restrictions and controls as other items of public expenditure.

- *Managerial control*, which generally concerns technical aspects of the pay structure in order to establish parity in salary payments; organisational and staffing issues; and, more broadly, issues regarding working relations between the government and its employees which are normally covered by a civil service law.

In most OECD countries, the managerial control measures, though different in scope and coverage, are co-ordinated and exercised by central personnel management offices, such as civil service commissions, civil service boards, and establishment boards. In some cases, limited responsibilities have been delegated to line ministries within a general framework. Generally, finance ministries play a dominant role in determining and managing financial aspects of the pay structure. In most transition economies, in contrast, both technical and financial aspects of pay structure are shared between labour ministries (performing the role of the central agency) and line ministries, though in many cases line ministries have extraordinary powers in this area. The authority of the ministry of finance in relation to the management of personnel expenditures therefore needs to be reinforced.

In some countries a civil service board manages personnel positions, but such arrangements tend to create many problems in budgeting. Premchand (1983) has noted that:

"An organisational dualism has developed where the creation of posts is done by personnel management offices, while funding is provided by the finance ministry. This division of duties, in some countries, has led to several practical problems. The separation implies that the creation of posts will take place without resource constraint and that, once posts are created, either more resources are provided or the posts reduced. As budget reviews take place at different times, confusion between the creation of posts and their funding is to be expected. The main issue in personnel budgeting and controlling the government wage bill is the role to be assigned to the ministry of finance. The integration of selected sections of personnel offices with finance ministries would bring a coherent policy for the fast reorganisation of the line ministries and revising pay structures."

The areas in which the ministry of finance must be involved, and which should be integrated into the budgeting process, concern the determination of:

- Manpower levels in line ministries.

- Long- and short-term financial implications of staff reductions and retrenchment policies; and

- Financial components of the pay structure for the civil service as a whole.

There exist, however, several areas, such as staffing, training, drafting and revising civil service laws which can only be handled effectively by a central agency separate from the ministry of finance.

In parallel with reinforcing the role of the ministry of finance for personnel expenditure control, transition countries must build adequate capacity for managerial co-ordination and control (for example, civil service policy-making, initiating regulations, co-ordinating and monitoring personnel management in the various institutions, and providing advice).

b. The need for a specific control

In transition countries, the fiscal control of personnel expenditures is one of the most crucial issues in budget management. In some OECD countries, personnel expenditure is grouped together with goods and services expenditures in appropriations for operating expenditures. The possibility of using savings on personnel costs for other expenditures gives an incentive for spending agencies to reduce their personnel expenditures. However, such an approach could cause undesirable outcomes in many transition countries. Taking into account social pressures on the management of agencies, patronage, or simply the low level of wages, block appropriations could generate an uncontrolled increase in personnel expenditures. Bureaucratic resistance may not be easily overcome, and every spending unit may try to demonstrate that its current composition of inputs is optimal. It is doubtful whether a system of block appropriations can be a tool for reducing manpower levels in countries that face arrears on personnel expenditures (as it is the case in several FSU countries). These countries are currently confronted with the choice of incurring arrears or dismissing employees. Both politicians and civil servants show a preference for accumulating arrears. Block appropriations implemented in this context would transfer arrears generation from wage expenditure items to other elements of expenditure.

c. Spending limits and staff ceilings

Specific limits for personnel spending are needed in transition countries, and rules for limiting transfers between personnel and non-personnel items must be established. These specific limits should consist of both spending limits and staff ceilings.

Personnel expenditures must be accurately estimated. Information on manpower levels is required during budget preparation and should be made public (for example, as an annex to the budget). Funds for bonuses and special allowances should be identified separately within the personnel costs subhead of the line ministry's budget, and be monitored. Information on personnel positions should clearly distinguish occupied and non-occupied positions. Cost estimates should be supported by a dependable system of controls on employee headcounts, carried out either by the ministry of finance or by line ministries themselves. Forecasts of increases in salaries and benefits prepared by line ministries must be consistent with the ministry of finance assumptions or regulations.

During budget execution, if some personnel positions are not occupied, consideration can be given to whether spending agencies should keep part of the savings to fund other current expenditures, but such schemes should be regulated, transparent and reported. As noted above, in many transition countries

wage and salary payments related to non-occupied positions are shared among staff of spending units. Such a practice is unsound. Internal controls should be set up to prevent unauthorised transfers of funds from wage and salary budgets to increase bonuses and allowances. The ministry of finance should also maintain a register of civil service staff positions and information on payable costs as a tool to help prepare the budget and monitor its implementation.

Personnel expenditure ceilings are in general insufficient to control personnel expenditures in transition countries. They are often regarded, in practice, as a floor aimed at protecting personnel expenditures rather than a genuine spending limit. In practice, the system has a certain degree of flexibility, but tends to increase personnel expenditures. In many countries, appropriations for personnel expenditures are underestimated, and ensuring compliance during budget implementation is therefore extremely difficult (for example, dismissing teachers during the school year could have a high indirect cost because of the disruptive effects on the education system). There is a need for more clearly identifying constraints on personnel expenditures at the budget preparation stage, and reinforcing mechanisms to ensure that the legal commitments related to personnel expenditures (recruitment and other decisions) comply with the spending limits.

Several EU Member States make use of staff ceilings. These ceilings are generally based on the number of full-time staff equivalents, and are subject to internal or external controls or both. Staff ceilings have certain disadvantages. In particular, they may encourage spending agencies to avoid the ceilings by hiring consultants and external advisers to replace conventional staff. In some countries (e.g. the UK) staff ceilings were abolished in the 1980s (and replaced by operating cost ceilings) as a result of this upward pressure on personnel expenditures. However, taking into account their current budgetary problems, transition countries may find that staff ceilings are a useful tool for reducing staff numbers and implementing reforms in systems of payroll management and staff remuneration. The inclusion of staff ceilings in the budget, for example, would allow the risks of overcommitment of personnel expenditures to be identified clearly at the budget formulation stage.

Appropriations for personnel expenditures and staff ceilings should be consistent. Initial assumptions on staff ceilings could be announced together with expenditure ceilings at the start of the budget preparation cycle and, if necessary, adjustments made at a later stage of the cycle.

C. Public Procurement[5]

1. General Issues

a. Objectives

The main objective of the government as a purchaser is to obtain goods and services of the required quality at a competitive price. Procurement procedures should provide fair opportunity to all bidders, and be designed to achieve good value for money and minimise risks of corruption and patronage. While government procurement is certainly not the only possible source of corruption, it is one of the major ones, and vigilance is always necessary to minimise corruption risks, optimise the use of financial resources, and foster the growth of competition. Procurement law and procedures need to comply, as required, with international treaties and standards set by the World Trade Organisation, the European Union, the World Bank and other bodies (see below).

b. Procurement cycle

The procurement cycle includes the following stages:

- *Identification of user needs and project preparation*. In the case of goods and services, the procedures to be followed include establishing what users require, specifying the goods and services to be procured, reviewing whether the needs can be met from available sources, etc. For construction projects, different options and variants should be reviewed to choose the most cost-effective solution and a project execution plan should be prepared. At this stage, the possibility of forming a public-private partnership should also be reviewed.

- *Determination of the procurement procedure*. The law may include a number of options including open competitive bidding, local competitive bidding, or restricted tendering. These choices will be affected by the international context in which a country operates, e.g. whether it is a candidate for EU membership and/or a prospective member of the WTO.

- *Tendering process (can be preceded by a pre-qualification procedure, depending on the tendering procedure)*. For competitive bids, a formal tender announcement is normally published, specifying the characteristics of the project or the goods and services to be supplied, the selection criteria, and the award arrangements. Price is an important criterion in awarding contracts, but should not be the sole criterion. In many cases, price is less important than technical and quality criteria. Choosing systematically the lowest-priced bids could lead to buying obsolete or poor-quality goods or services. To avoid an excessive bias toward low-priced bids, it is often desirable to review the bids in two steps, first on technical grounds, and then on the basis of cost.

c. Procurement and corruption

In the context of public procurement, corruption usually consists of collusion between buyers and sellers leading to financial losses for the state. Such practices are often criminal in intent; they are always unethical and improper in terms of good procurement practices. Corrupt behaviour can be encouraged by factors such as:

- Excessive recourse to concessions, or contracting-out (see Section D).

- Dealing with contractors who are financially insolvent and do not meet other required qualifications and standards.

- Excessive use of restricted forms of tendering and single source procurement.

- Changing orders and variations in tender specification.

- Inadequate provisions for internal control, review of procurement complaints and external audit of procurement procedures.

d. Principles of competition and transparency

The key principles in procurement are open competition and transparent procedures. The procurement process should be made open to public scrutiny. The results of the bidding must be made public. The list of suppliers submitting tenders, their bid prices, and the name of the successful bidder should be disclosed.

Contract awards and the overall procurement process must be subjected to the scrutiny of the national parliament and the supreme audit institution. Written (or computerised) records must be maintained and publicly accessible. These records should show which suppliers were approached, which ones were selected, the reasons for the procurement decision, details of prices, reports on the acceptance of work done or the receipt of goods ordered, and comments on the performance of the supplier.

The legal framework and/or the government's code of ethics should include standards about procurement. There should be no conflict of interest between official duties and the private interests of civil servants. Appropriate levels of financial delegation and proper separation of duties must be established. Rotation of duties is generally needed to avoid the risk of collusion arising from the development of too close relationships between the buyer and the supplier.

2. Priority tasks in the context of EU accession

a. The basic requirements

Within the context of EU accession reform of public procurement laws, administrative structures and procedures is a high priority task for candidate countries. Such reform is a precondition both for membership of the European Union and for access to the pre-accession aids to which candidate countries are eligible. Some of these countries are well down the road of reform, but in some other countries substantial efforts are still needed to build up a satisfactory procurement system. The basic requirement are four-fold: (i) procurement legislation that is compatible with the European Community directives and other international obligations; (ii) effective procedures that include a central public procurement organisation (PPO) with overall responsibility for the development and the implementation of procurement policy; (iii) efficient exchange of information between the PPO and the public procurement units within spending agencies; and (iv) effective procedures for resolving disputes, financial control and audit.

b. Procurement legislation

Governments are expected to comply with the World Trade Organisation's Government Procurement Agreement (GPA), which sets legal obligations for national procurement systems and practices. Within the context of EU accession, many countries in central and eastern Europe face currently a problem because their legislation is based on the United Nations (UNCITRAL) model, not on the more detailed and specific EC Directives. For expenditures financed by external sources, procurement procedures must also conform to the guidelines established by external lenders or donors, for example, the World Bank.

Those countries with laws built on the UNCITRAL Model Law need to amend their existing legislation in the case of contracts over the EC thresholds. The UNCITRAL Model Law opens up the possibility of a preference for domestic tenderers, which would violate EC Directives and basic Treaty provisions. It also envisages that a government may exclude potential suppliers from certain countries. Any such exclusion would be in conflict with EC basic norms, if aimed at a Member State or a GPA participant. With regards to technical methods of procurement there are also differences between EC Directives and the UNCITRAL Model Law.

Some central and eastern European countries have already amended their procurement legislation in line with EC Directives, and others have draft laws under preparation. However, not all of these new laws fully satisfy EU requirements. Some, for example, include elements such as the continuation of national preference, incomplete coverage (e.g. omitting the utilities sector, which is covered by EC Directives), over-reliance on tendering procedures that are not permitted by the Directives (e.g. two-stage tendering,

single source procurement), and weak complaints review procedures. With respect to procurement procedures, the EC Directives concern only larger contracts, but there is also a need to regulate procurement transactions that fall below the thresholds. Of course, such regulations should fit basic Treaty of Rome obligations.

c. A central public procurement organisation (PPO)

Many countries have established a central public procurement organisation in order to supervise the procurement activities of contracting entities in line ministries and other public bodies covered by the procurement law. Such an organisation should be responsible for developing rules and regulations, creating a government-wide information and publication system, ensuring that government purchasing entities employ trained personnel, developing a training system, and maintaining general supervision of procurement systems. The PPO may be an independent, or quasi-independent, organisation reporting to the government or parliament, or a subordinated agency, or a department of a ministry such as finance or economy.

In many transition countries the purchasing function itself is decentralised. In some other countries, though a declining number, a central purchasing unit is established. In principle, centralisation of purchasing has the advantage of allowing the government to obtain lower prices by grouping its purchases. However, the results are often disappointing because of problems such as slow and bureaucratic response to customers, excessive inventories, losses, pilferage, and slow response to market and technological changes.

d. Procurement implementation and training[6]

Most countries in central and Eastern Europe have hundreds (or in some cases, thousands) of contracting units. These range from large, well-staffed and efficiently managed organisations to smaller organisations and municipalities that are poorly staffed and inefficiently run. The public procurement organisation should provide support to these units.

The following key issues should be systematically addressed:

- Are there effective system of recruitment and staff development in place? Have procurement staff be trained? What kind of training? Basic training? Sophisticated training? Are the actual skills matched against the desired skills profile? Are employees experienced in international procurement?

- Are numbers of staff adequate? Is there or is there not an excessive turn-over of staff? If so, what are the main reasons? Low salaries, lack of job advancement possibilities?

- Are handbooks, standard tender documents, model contract forms made available to contracting units?

- Are sample forms of contract and other documents included in the tender documentation? Are there standard conditions of contract?

- Does the PPO have access to a central computerised register of procurement transactions? Is the dissemination of information to contracting entities and the private sector adequate?

In many transition countries the private sector remains relatively underdeveloped. Therefore, the government has a legitimate interest in promoting the training of procurement staff in both governmental agencies and the private sector. Private sector suppliers need to be informed of the legislative and

institutional framework of the public procurement system and on how to compete for government contracts. They should be trained in specific skills such as negotiation and contract management. Awareness-raising seminars for policy makers and mass media campaign for the general public are necessary to explain the importance of public procurement and rally support for an efficient and transparent procurement system.

As regards training delivery, the public procurement organisation might consider forming a network of national institutions (such as universities and government training centres). In each of these institutions, a core team of trainers might be trained and certified by the PPO. This team would then initially supervise the training and license other trainers to carry out bulk training activities.

e. Control and complaint review procedures

There should be well-defined and widely understood procedures for the control and audit of procurement transactions including anti-fraud and anti-corruption measures. In addition, there should be methods of appeal from decisions of award of contract or other complaints that arise during the procurement process. Such complaints can be handled through specific arbitration committees or through the courts.

D. Contracting-Out

1. What is "contracting-out"?

Contracting-out is a broad concept describing the transfer to the private sector of responsibility for implementing activities financed and previously delivered by the government. Over the last 20 years, the use of contracting-out mechanisms has greatly expanded in many countries, although it is a very old practice. For example, "tax farming" was prevalent in ancient China, Greece, Rome.[7] Some countries have conventions or laws regulating concessions that sometimes date back many centuries.

Generally, under contracting-out arrangements, the activities transferred to the private sector remain financed by the government. Separating the financing from the delivery allows the government to take on the role of purchaser and thus to choose from among different suppliers and to control costs and quality standards, without being responsible for managing the operation. Contracting-out aims at reducing costs and improving efficiency by promoting competition between alternative suppliers. In the UK, the so-called "market-testing" approach is used so that government can assess whether the activities in question can be delivered more cheaply and effectively by the private sector through a service contract or, in other cases, by privatising them.

Governments are often faced with the need to seek private financing of large-scale infrastructure projects such as underground railways, motorways and airports. The private sector can, in some cases, have particular know-how or experience that is not available in the public sector (water, waste or urban transport management, for example). The forms taken by these public-private partnerships vary widely over time and from one country to another. The most common arrangement within the European Union is the "concession contract" (see Box 8.1 below). In "works" concessions or build-operate-transfer (BOT) schemes, the private sector finances the initial investment; recoups it through the profits of operating the project over a determined period; and, at the end of the concession, transfers the assets back to the government. BOT schemes are seen as a means of attracting private and foreign capital.[8] They have been used for many years in developed countries (the most publicised one in the European context being the Anglo-French Channel Tunnel).[9]

Some BOT contracts guarantee the contractor against losses in operating the project (in the example of a toll road, if traffic flows are less than projected, the government could guarantee the servicing of the debt obligations incurred by the contractor). In other BOT contracts, the contractor is formally responsible for the success or failure of the project. However, if the contractor goes bankrupt, in a majority of cases the government will have to continue operating the project and to provide the necessary funding.

Box 8.1. THE EUROPEAN COMMISSION'S INTERPRETATION OF CONCESSION CONTRACTS

According to recent communications by the European Commission, concessions under Community law are not directly addressed by the public contracts directives but are nonetheless subject to the rules and principles of the Treaty, including equality of treatment, transparency, proportionality, mutual recognition, and protection of the rights of individuals. Generally speaking, in the Commission's view, concessions contracting should be brought into line with the EC Procurement Directives: 93/37/EEC on works concessions, 92/50/CEE on service concessions, and 93/38/CEE for entities operating in the water, energy, transport and telecommunications sector. If the contract is principally concerned with the building of a structure on behalf of the public agency granting the contract, the Commission holds that it should be considered to be a works concession. A concessions contract in which the construction work is incidental or which only involves operating an existing structure is regarded as a service concession.

The Commission's definition makes clear that the risks arising from the operation of the concession are transferred to the concessionaire with the right of exploitation; specific risks are divided between the public agency and the concessionaire on a case by case basis, according to their respective ability to manage the risk in question. The Commission intends to examine other forms of public-private partnership to determine the extent to which the rules on public contracts might provide an appropriate legal framework for ensuring compliance with the rules of the Treaty while allowing these forms of co-operation to develop.

For more detailed information, see the Commission's Interpretative Communication on Concessions Under Community Law, 12 April 2000.

2. Managing the contracting-out process

Government activities cannot be contracted out simply on the basis of standard contract management procedures. A special assessment is required.[10] To begin with, it is necessary to define clearly the business need and to identify specifically the activities to be contracted out. It is also important to evaluate likely changes in conditions (e.g. changes in expected service levels and investment requirements); review issues of co-ordination between the activities to be contracted out and other relevant governmental activities; and assess whether governmental activities in other agencies could be incorporated into the project to increase its efficiency. The contracting-out process needs to be organised on the basis of a purchaser-provider relationship between the government agency and the contractor. Therefore, the quality of the

contractor's management and the nature of the relationship are important. A variety of options should be considered in relation to the type of agreement (lump-sum contracts, price-per-unit contracts, shared profits, etc.); and the objective of the project (e.g. cost saving only or service improvement). Project costs should be assessed (when possible) after an analysis on the experience of similar projects or specific studies; performance standards should be clearly stipulated in the contract; and the contract should incorporate provisions regarding contractor non-performance and dispute resolution mechanisms.

Contracting-out an activity does not discharge the government agency from its responsibility for that service. The agency has an obligation to monitor the performance of the contractor to ensure that standards are met and the objectives and outputs of the contract are fulfilled. Assessment and management of risks are important aspects of contract management. This means that the agency must retain some technical competence in the relevant areas.

Another important issue that the government needs to address is how to deal with the staff employed on activities that are contracted out. There are several options that can be considered: a) redeploying the staff to other work within the public service (but then most of the potential cost savings that result from contracting-out will not be realised); b) including in the contract with the private sector company a condition that some or all of the staff must be employed by the company (this may be combined with a guarantee by the government to re-employ the staff within a fixed period of, say, one year); c) retiring some or all of the staff concerned under a governmental redundancy scheme (but again this will involve additional costs that need to be taken into account when calculating the benefit-cost ratio of contracting-out the activities concerned).

3. The need for caution

As noted, contracting-out can be an effective tool for promoting efficiency and improving the delivery of certain public services. When preparing and reviewing ministries' budget requests, it is always advisable to ask whether a more cost-effective private solution could exist, and be prepared to move to contract out the service if the answer is positive. However, contracting-out cannot be a substitute for a sound restructuring of the public sector, or for full privatisation if the service in question does not properly belong in the public sector. Nor is contracting-out a panacea; indeed, it carries fiscal, efficiency, and governance risks if it is not well designed and monitored. It is always necessary, therefore, to determine accurately the contractual and market conditions in which the possible contracting-out or privatisation solutions can be implemented. When management contracts are aimed at rehabilitating ailing enterprises or improving their efficiency, substantial equity investment by the new management is likely to be required. Lump-sump contracts do not provide incentives for contractors to improve their performance.

A competitive environment is generally necessary to benefit from contracting-out. After reviewing several surveys of experience in the US that show uneven results, Donahue (1991) concludes:

"First, the profit-seeking private firm is potentially a far superior institution for efficient production. Second, that productive potential can be tapped only under certain circumstances. Public versus private matters, but competitive versus non-competitive usually matters more… Half a market system — profit drive without meaningful specifications or competitive discipline — can be worse than none."

Particularly in transition economies, realising the potential benefits of contracting-out depends upon progress with reforms to build a competitive environment. Public enterprises to which contracts are granted should be corporatised. There should be an arm's length relationship between the private or public contractors and the government. And an adequate market-oriented legal framework must be in place.

Contracting-out is sometimes seen as a way of slipping budgetary constraints rather than a deliberate choice on efficiency grounds. In theory, the financial risk should be transferred to the contractor, but contracts often include explicit or implicit government guarantees. Because of the importance of the service to the public, when the performance of the contractor is inadequate or the company is insolvent, the government has no practical alternative but to intervene and give financial support to the activity previously contracted out. Some contractors indeed have used the contracting-out process to win contracts, without intending to submit themselves to real market discipline afterwards. Contracting-out may also diminish transparency, since it substitutes "commercial confidentiality" for accountability and thus escapes legislative controls.

When the government is obliged to support an ailing project implemented under a BOT contract, the fiscal cost may be particularly high, as shown by the Mexican experience described in Box 8.2. This calls for a careful analysis of the legal and economic aspects of BOT arrangements. The usual cost-benefit analysis of projects undertaken under BOT schemes should be undertaken, but further assessment of the risks involved and other options for operating the service are required. A BOT arrangement should never be an excuse to launch an unprofitable project. When the government cannot find a genuine private sector solution, the reason is often that the project is not viable in the first place. Compared with normal procurement transactions, the complexity of BOT arrangements can provide even greater opportunities for corruption.

Box 8.2. CONTRACTING-OUT GONE WRONG: TWO EXAMPLES

In the 1980s, local authorities in the *UK*, faced with financial stringency, resorted to a range of private funding vehicles to evade public expenditure control. These unconventional means of finance involving private parties become known as "avoidance instruments". For example, many local authorities resorted to sale-and-leaseback arrangements with existing assets, in some cases reaching the extremes of realising cash through sale and leaseback of items such as lamp-posts or parking meters.

Mexico launched in 1987 an ambitious programme for contracting-out the construction and operation of roads under BOT arrangements. Initially, the arrangements appeared to be successful, and more than 5,100 km of new toll roads were built. However, resources were allocated poorly and were used before they were needed; construction periods turned out to be 55% longer than had been agreed with the contractors; vehicle traffic 37% lower than projected; and investment 29% higher than agreed. The profitability of the roads was naturally far lower than had been anticipated. The Mexican economic crisis of 1995 aggravated the financial situation of the toll roads under concession to private companies, forcing the government to implement a plan of emergency support of US$2.2 billion. As a consequence, the participation of the public sector rose to 40% of the capital stock of companies holding the concessions, and the concession terms were extended to allow private investors a greater opportunity to recover their investment.

Sources: Heald (1997) and Barrera (1997).

NOTES

1. The list of these liabilities is drawn from Premchand (1995).

2. This section is drawn from the out-of-print publication OECD (1997), *Trends in Public Sector Pay in OECD Countries*.

3. Decentralisation in this context means that all or part of the remuneration is set at the workplace (ministry, agency, unit etc.).

4. Largely drawn from SIGMA (1997a).

5. This section presents only a sketch of key issues on public procurement. For a detailed analysis of procurement principles and the management of the procurement process the reader may refer to Westring and Jadoun (1996). Several SIGMA Papers in the area of public procurement can be found on the publications page at http://www.oecd.org/puma/sigmaweb.

6. Drawn in large part from Jadoun (1998). In 1999, SIGMA and the International Training Centre of the International Labour Organization jointly produced a series of eight modules entitled *Training of Trainers in Public Procurement*. For more information, see http://www.itcilo.it.

7. See Premchand (1983) where John Brewer is quoted "The sinews of power: war, money and the English state" (originally published Knopf, 1989).

8. In developed countries with open financial markets, this alleged advantage of BOT schemes is questionable. See Heald (1999).

9. In France, for example, "public service concessions" have been used for about 40 years in the water supply industry. See Heald (1995).

10. See, for example, United Kingdom, HM Treasury, Central Unit for Procurement (1997a) *Guidance Note 61*.

CHAPTER 9

THE TREASURY FUNCTION AND CASH MANAGEMENT

A. The Treasury Function

Governments need to ensure both efficient implementation of their budgets and good management of their financial resources. Spending agencies must be provided with the funds needed to implement the budget in a timely manner, and the cost of government borrowing must be minimised. Sound management of financial assets and liabilities is also required.

Financial management within the government includes various activities: formulation of fiscal policy; budget preparation; budget execution; management of financial operations; accounting rules and controls; maintaining a record of historical and comparative data; and auditing and evaluating the financial performance and results of government policies and programmes. Within this broad financial management framework, the treasury function aims to achieve the set of specific objectives mentioned above. It covers some or all of the following activities:[1]

- Cash management.
- Management of government bank accounts.
- Accounting and reporting.
- Financial planning and forecasting of cash flows.
- Management of government debt and guarantees.
- Administration of foreign grants and counterpart funds from international aid.
- Financial assets management.

To carry out these activities, organisational arrangements and the distribution of responsibilities vary considerably according to countries. In some countries, the treasury department focuses only on cash and debt management functions (which are reviewed in this chapter). In a few countries, debt management is performed by an autonomous agency. In other countries, the treasury performs also budget execution controls and/or accounting activities. Often the treasury department is a subordinated agency of the ministry of finance, but in some countries, it is independent of the ministry of finance. In such cases a very close co-ordination between the ministry of finance and the treasury department is required, since budget execution must be based on the priorities stated in the budget. In transition countries, the treasury should be preferably part of, or attached to, the ministry of finance, because co-ordination between government agencies is often weak.

Figure 9.1. **MAIN FUNCTIONS OF THE TREASURY**

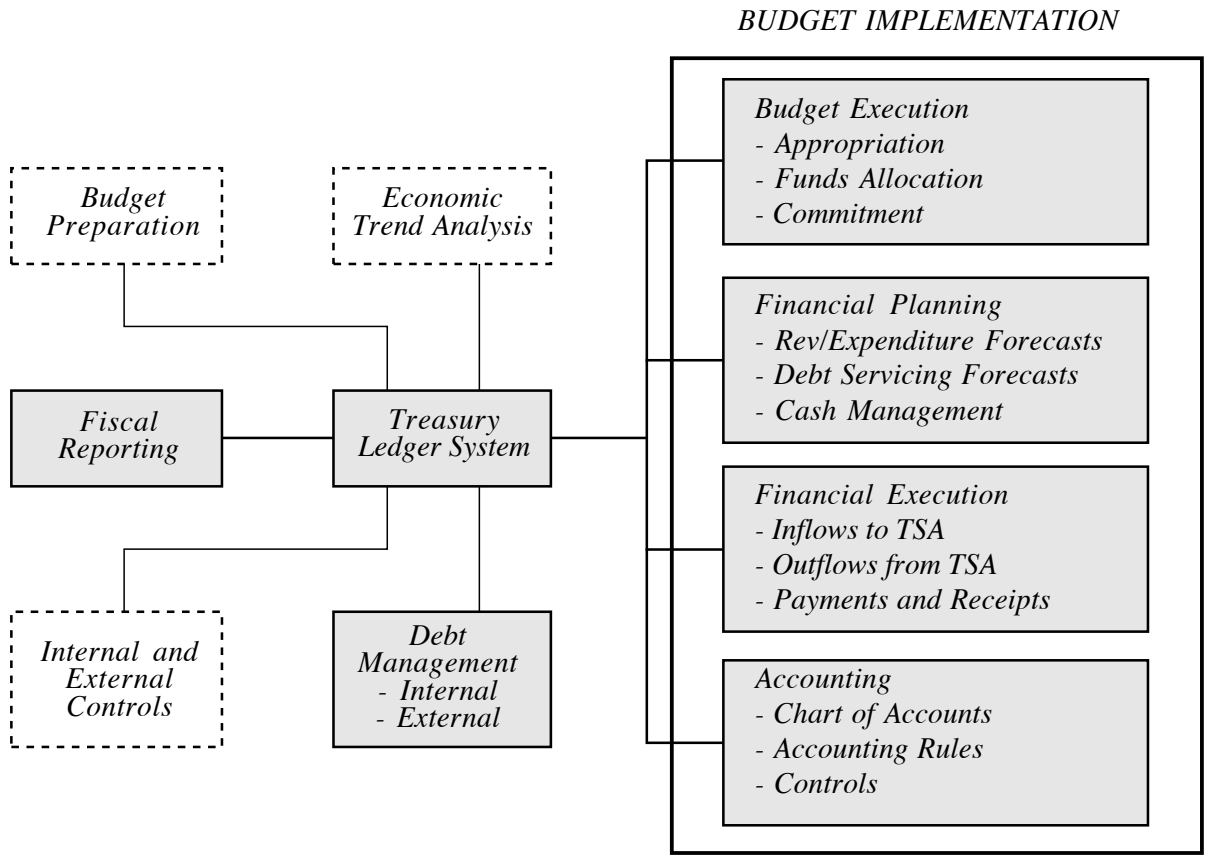
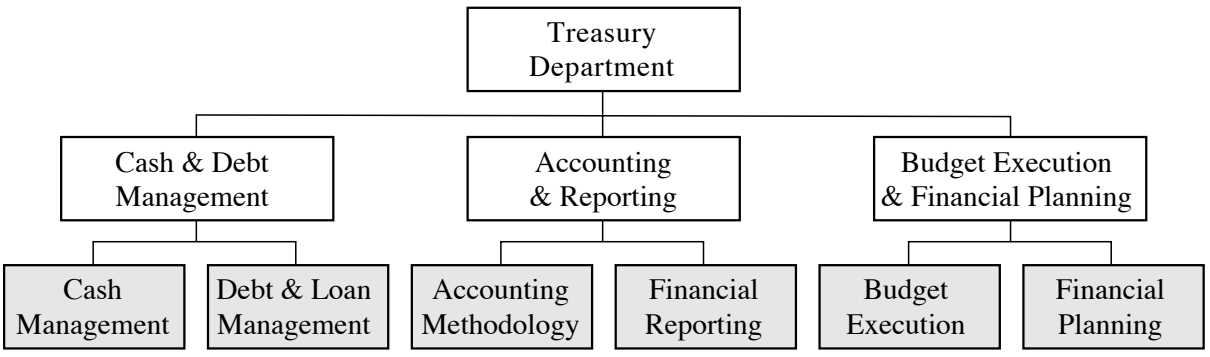


Figure 9.1 illustrates the main functions undertaken by the treasury (areas within dotted lines are often handled by separate systems). Figure 9.2 illustrates a possible organisational structure for the treasury, with separate areas handling the main functions of cash and debt management, accounting and reporting and budget execution and financial planning.

Figure 9.2. **ILLUSTRATIVE TREASURY ORGANISATIONAL STRUCTURE**



B. Cash Management

1. Objectives

Cash management has the following purposes: controlling spending in the aggregate, implementing the budget efficiently, minimising the cost of government borrowing, and maximising the opportunity cost of resources. Control of cash is a key element in macroeconomic and budget management. However, for budget management purposes, it must be complemented by an adequate system for managing commitments, and it is not a substitute for sound budget preparation.

For efficient budget implementation, it is necessary to ensure that claims will be paid according to the contract terms and that revenues are collected on time; to minimise transaction costs; and to borrow at the lowest available interest rate or to generate additional cash by investing in revenue-yielding paper. It is also necessary to make payments on a timely basis by tracking accurately the dates on which they are due.

Often in the past, governments did not pay sufficient attention to issues related to efficient cash management. Budget execution procedures and the management of cash flows focused on issues of legal regularity and compliance, while daily cash needs were met by the central bank. Spending units were not concerned with borrowing costs since their interest payments were already taken account of in the budget prepared by the ministry of finance. According to Garamfalvi (1996):

"Central planning has left an institutional and organisational legacy characterised by ill-defined boundaries between the budgetary and banking sectors. There was no appreciation of the fact that idle cash was costly because of foregone interest revenues, nor that borrowing (made necessary by shortages of cash resources at the aggregate level) increased future expenditures in terms of interest payments. The importance of cash and debt management in containing the public sector borrowing requirement and, consequently, in conducting fiscal and monetary policy was also not recognised."

However, the costs of borrowing, the fact that the credit granted to the government by the banking system is a key macroeconomic target and a performance criterion in IMF-supported financial programmes, and the increasing separation between the activities of the central bank and the government budget make efficient cash management an increasingly important issue. Concerns to improve fiscal performance have also had an impact on cash management and some countries have implemented reforms to make spending agencies more responsible for cash, while strengthening instruments to ensure overall fiscal discipline.

2. Centralisation of cash balances and the treasury single account

a. Centralising cash balances

To minimise borrowing costs or maximise interest-bearing deposits, operating cash balances should be kept to a minimum. In countries where funds are released through an imprest system, spending agencies sometimes accumulate idle balances in their bank accounts. These idle balances increase the borrowing needs of the government, which must borrow to finance the payments of some agencies, even if other agencies have excess cash. Also, where the accounts of spending agencies are held at a commercial bank, the idle balances can help loosen constraints on credit, by giving the banking sector additional resources for credit.

Cash balances are efficiently centralised through a "treasury single account" (TSA).[2] This is an account or set of linked accounts through which the government transacts all payments. In practice, within the broad concept of a treasury single account, there are a variety of methods of centralising transactions and cash flows. These can be grouped very broadly into the following categories:

- *Treasury single account and centralised accounting controls*. Requests for payment and documents justifying them (e.g. invoices) are sent to the treasury, which controls them and plans their payment. The treasury manages the float of outstanding invoices.

- *"Passive" treasury single account consisting of only one central account*. Payments are made directly by spending agencies, but through a TSA. The treasury, through the budget implementation plan, sets cash limits for the total amount of transactions, but does not control individual transactions.

- *"Passive" treasury single account including several subaccounts.* In such cases, the TSA is organised according to the following lines: (i) line ministries hold accounts at the central bank, which are subsidiary accounts of the treasury's account; (ii) spending agencies hold accounts either at the central bank or with commercial banks that must be authorised by the treasury; (iii) spending agencies' accounts are zero-balance accounts, with money being transferred to these accounts as specific approved payments are made, or the banks accept the payment orders sent by spending agencies up to a certain limit defined by the treasury; (iv) spending agencies' accounts are automatically swept at the end of each day (where the banking infrastructure allows daily clearing); (v) the central bank consolidates the government's position at the end of each day including balances in all the government accounts. This system allows but does not require diversified banking arrangements. Payments can be made through banks selected on a competitive basis.

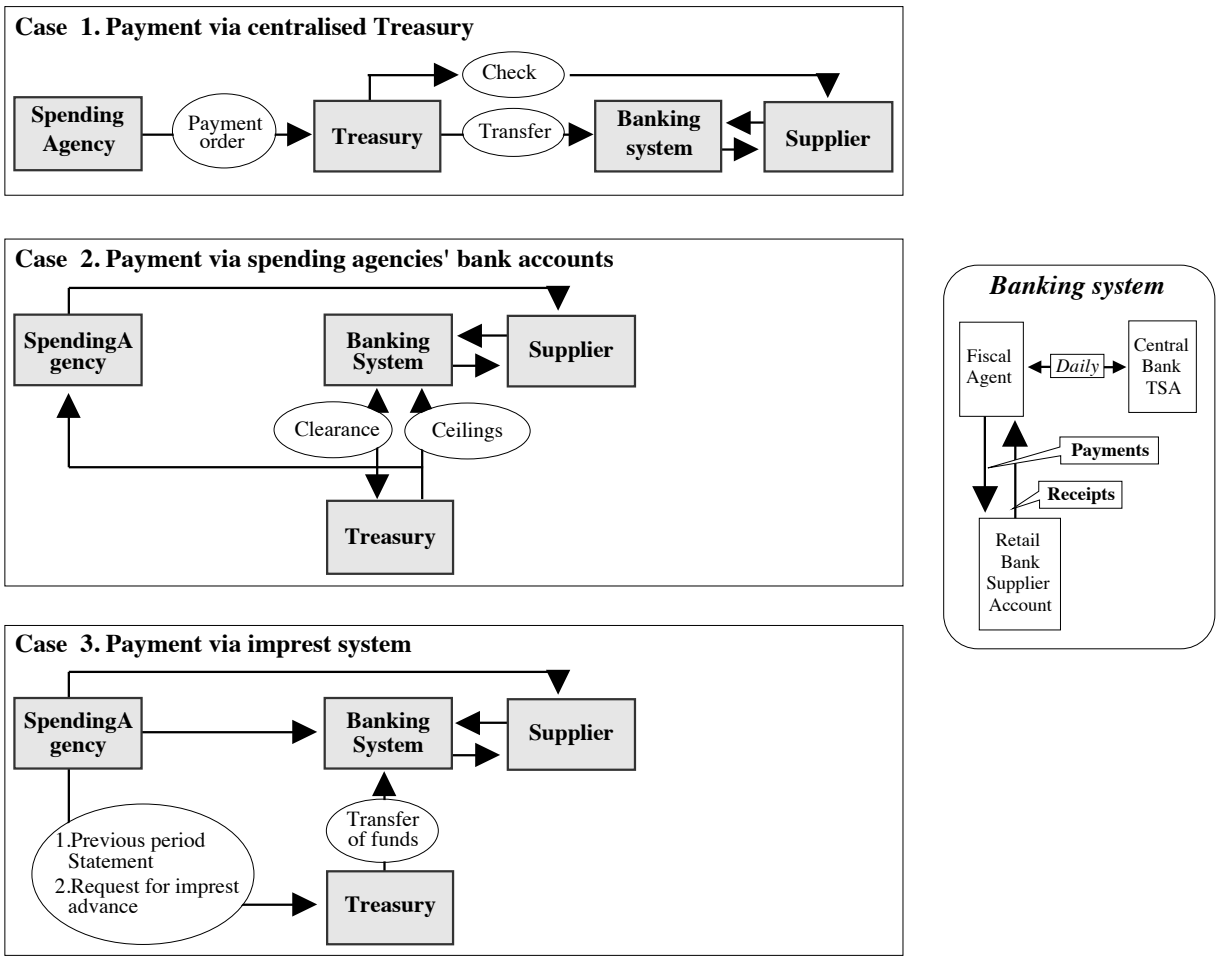
Case 1 in Figure 9.3 summarises the model where payments transactions are centralised within the treasury single account, which can play either an active or passive role in the sense described above. Case 2 refers to a "passive" treasury single account including several subaccounts.

When the central bank does not have an adequate network of regional branches, or does not have the capacity to handle the large volume of transactions that are associated with government payments and receipts, the retail banking operations are delegated to a fiscal agent (normally an authorised commercial bank). The fiscal agent makes payments on behalf of the treasury, the central bank recoups all payments made by the fiscal agent that relate to government operations, and the agent makes daily deposits of all government revenues to the TSA in the central bank. These arrangements can be set up both where the payments are channelled through the treasury and where government agencies are directly responsible for authorising payments. (See "banking system" box in Figure 9.3).

In some countries, poor banking and technological infrastructure is an obstacle to combining the centralisation of cash balances with the decentralisation of payments processing. Processing at the central level payment transactions of remote spending agencies is likely to hinder budget implementation. Geographically remote spending units can have separate bank accounts operated by means of imprest advances (meaning that a new advance is provided upon receipt of an account verifying the use of the previous advance). This scenario is illustrated in Case 3 in Figure 9.3.

Whatever the institutional arrangements, the centralisation of cash balances should cover all the government accounts used for payment transactions, including accounts managed by extra-budgetary funds. A Financial Ledger System (described in Chapter 13), in which all transactions are recorded, can fit either decentralised or centralised accounting controls and payment processing systems.

Figure 9.3. **THREE TREASURY PAYMENT SYSTEMS**



b. Designing the cash management system

From a cash management point of view, these modes of centralising cash balances give identical results. At first sight, the variant that places payment transactions processing and accounting controls under the full responsibility of the treasury department might seem more efficient from the viewpoint both of cash management and expenditure control. However, the centralisation of accounting controls and the central management of float can lead to inefficiencies, and even corruption, in countries with poor governance, particularly where the treasury has responsibility for selecting the suppliers to be paid. For instance, according to Premchand (1995):

"Those who favour reintroducing the treasury system suggest that treasuries would not only scrutinise payments, but would also be responsible for compiling accounts. But such a step could widen the chasm between expenditure responsibility and the power of payment. Moreover, experience shows that treasuries are no less resistant to political pressures than are the commercial banks. Circumvention and politicisation cannot be cured through the reintroduction of the treasury system. Rather, observance of discipline, which is an essential part of effective government financial management must be secured through tighter controls, periodic oversight, strengthened accountability, greater citizen participation and, above all, greater transparency."

The "passive" treasury single account system has the advantage of making the spending agency responsible for internal management, while keeping central control of cash. In transition countries that face difficulties of controlling the cash balances of powerful line ministries and EBFs, a passive TSA consisting of accounts centralised at the central bank will probably ensure better overall cash control than a TSA consisting of several accounts in different banks.

Reform of the cash management system must take into account its possible impact on budget management within spending agencies and must also be cost-effective. Implementing a system that centralises cash management does not pose major problems for the central departments of line ministries. But for regional departments, the organisation of the payment system must take into account the system of public administration and banking infrastructure in the country concerned.

In many countries, streamlining cash management could consist of:

- Daily centralisation of transactions made at the central level, through a TSA.

- For remote agencies, a procedure based on imprest advances.

Since most countries use the greater portion of their cash either for transactions at the central level (e.g. debt payments and expenditures managed by the central departments of line ministries) or for payments that are due on a fixed date (e.g. wage payments), such arrangements would allow most cash balances to be centralised.

Apart from the case of remote regions, modern technology allows electronic links to be created between spending agencies, the central bank (or commercial banks), and the treasury. However, in countries with an underdeveloped banking infrastructure, the existence of a large number of bank accounts can hinder the implementation of appropriate daily clearing and consolidation procedures.

Before considering any reform of cash management systems, its effect on the banking system should be assessed. Arrangements for cash management in several countries aim implicitly at supporting ailing banks. Restructuring the banking system in these countries is a policy issue that should be addressed. On the other hand, in a number of countries, entrusting the management of the government's accounts to commercial banks burden the banks with cash-flow problems, particularly if the treasury is not able to meet its obligations.

Centralising cash flows allows payments to be monitored in a timely manner, but does not release spending agencies from their reporting obligations. This is because the effective supervision of budget execution requires commitments to be monitored and expenditures to be verified.

c. Accounting and reporting

In many countries the treasury is responsible for developing and maintaining the chart of accounts; setting government accounting standards in consultation with professional/international bodies; and developing government accounting laws and regulations. The treasury is also responsible for reporting to the government on budget execution and government finances; preparing other statutory financial reports (e.g. mid-year and end-year reports, reports for the European Commission on the use of EU funds); and producing government financial statistics in conformity with IMF and EC rules.

3. Efficiency issues

a. Tax collection

It is necessary to minimise the interval between the time when cash is received and the time it is available for carrying out expenditure programmes. Revenues need to be processed promptly and made available for use. Commercial banks by virtue of the banking sector infrastructure are often able to collect revenues more efficiently than tax offices, which should therefore focus instead on tracking taxpayers, issuing tax assessments, monitoring payments and reporting results. When revenues are collected by commercial banks, arrangements must be defined to foster competition and ensure prompt transfer of collected revenues to government accounts. Systems of bank remuneration through float, which consists of authorising the banks to keep the revenues collected for a few days are inconvenient. Stringent rules to ensure prompt transfers should be established. Moreover, bank remuneration through fees is more transparent and promotes competitive bidding. An appropriate system of penalties for taxpayers is also an important element in avoiding delays in revenue collection.

b. Payment techniques

Payment methods affect the transaction costs of cash outflows. Depending on the banking infrastructure and the nature of expenditures, various payment methods may be considered (cheque, cash, electronic transfer, debit card, etc.).[3] Modern methods of payment — for example, payment through electronic transfer instead of by cheque or cash — allow the government to plan its cash flow more accurately, expedite payments, and simplify administrative and accounting procedures. However, whether one mode of payment is preferable to another depends on many factors, such as the degree of economic development of the country, the extent and maturity of the banking network, and the level of computerisation. For payments within the government sector (e.g. when a ministry or government agency provides services to another agency), a number of countries use non-payable checks, while others make accounting adjustments. Using non-payable cheques has the advantage of avoiding delays in the preparation of accounts. In some aid-dependent countries, non-payable cheques are used to pay taxes related to imports financed with external aid, in order to avoid loopholes in the tax system created by duty-free imports.

c. Creating incentives

If value for money is to become a working principle in government, a significant start could be made by establishing business-like arrangements between the government and the banking system. The principle that the government should earn interest on all its deposits and that it should, in turn, pay for all the banking services it receives should be seriously explored (De Zoysa, 1990). Box 9.1 shows an example of a reform aimed in this direction.

Countries where the spending agencies are responsible for making payments could consider implementing an incentive system for cash management at the spending agency level. However, in most transition countries, centralising cash balances should generally be the first measure to consider, since it is likely to give the most tangible benefits.

4. Management of government bank accounts

Whatever the organisation of tax collection or expenditure payment, the treasury should be responsible for supervising all central government bank accounts, including any extra-budgetary funds. When

Box 9.1. INCENTIVES FOR GOOD CASH MANAGEMENT IN SWEDEN

Efficient financial management is a key feature of the Swedish budgetory system. Annual budget appropriations are deposited into each agency's interest-bearing account, normally at the rate of one-twelfth each month. If an agency spends its appropriations at a slower rate, it is paid interest on the balance in the account. Similarly, if an agency spends its appropriations at a faster rate, then it must pay interest to reflect the government's cost of borrowing. Agencies, of course, vary greatly in their ability to time individual transactions precisely but this system has served to increase their cash-consciousness.

Another measure used in order to improve cash management allows agencies to carry forward their unused appropriations. This is designed to avoid end-of-year spending "surges"; increase discipline among managers, since any overspending in the year gets carried over as well; and give rise to efficiency gains in agencies beyond those assumed in the budget, since any gains would be retained by the agency.

Source: OECD (1998a).

commercial banks are involved in revenue collection or expenditure payments, the banking arrangements must be negotiated and contracted by the treasury. This will enable the government to negotiate better arrangements and to ensure that requirements for cash and budget management are appropriately taken into account. In addition to using bank accounts for budget management, the treasury may have deposit accounts with commercial banks, which should be selected on a competitive basis to secure higher-yielding terms. Accounts of counterpart funds generated by sales from commodity aid should be placed under the responsibility of the treasury.

C. Financial Planning and Forecasts

Financial planning and cash flow forecasts are needed both to ensure that cash outflows are compatible with cash inflows and to prepare borrowing plans. As indicated in Chapter 7, cash planning must be done in advance and communicated to spending agencies to allow them to implement their budgets efficiently. Moreover, reducing uncertainty about a borrower's debt management programme is generally rewarded with lower borrowing charges. Therefore, it is also important to prepare and announce borrowing plans in advance (Ferré Carradeco and Dattels, 1997). Financial planning includes the preparation of an annual cash plan and a budget implementation plan, monthly cash plans, and in-month forecasts.

1. Budget implementation plan and cash plans

a. In-year financial planning

In some countries, the budget department prepares a budget implementation plan, which shows forecasts of expenditures, and then the treasury department prepares a cash plan. The budget implementation plan is sometimes a requirement for commitments or requests for payment, while cash is controlled through the cash plan.[4] In other countries, there is only one financial plan prepared by the treasury.

Whatever the method used, the budget implementation plan and cash plan should be prepared for the entire fiscal year, and regularly updated and rolled over. The budget implementation plan shows expenditure forecasts by quarter (or six-month period) and should be rolled over every quarter (or six-month period).

The cash plan shows monthly forecasts of financial flows before taking into account new borrowing, including reimbursements of loans or bills due from the government, repayment of arrears, and drawings on loans already contracted. The cash plan must be consistent with the budget implementation plan. It should be updated every month. Borrowing plans are derived from the monthly forecasts of cash inflows and outflows.

Although the budget implementation plan, even in a cash-based budget system, is not necessarily on a pure cash basis, monthly cash plans should be on a pure cash basis. These plans should be updated every month. This updating should be made on technical grounds, taking into account developments in exchange rates and interest rates, changes in the payment schedule of investment projects of a significant size, and outstanding obligations, among other things.

The preparation of monthly cash outflow plans requires thorough monitoring of both payments and commitments. The plans are used to define monthly cash transfers within an imprest system or cash limits for payments within a treasury single account. Except in particular circumstances, these limits should conform to the budget implementation plan.

The preparation of the cash plan and its updating require close co-ordination between the treasury, the budget department, and the tax administration department. Preparing monthly cash outflow plans is more of a treasury task than a budgeting task. However, the treasury should co-ordinate with the budget department, in case any adjustments to the budget implementation plan appear necessary.

b. Budget implementation

To ensure effective and efficient implementation of the budget, the following principles should be adopted in preparing the budget implementation and cash plans and in implementing these plans:

- To prepare the implementation of programmes, agencies should know in advance the funds that will be allocated to them.

- Funds must be released in due time, without delay. In case of cash problems, the plan for releasing funds must be revised, but the revised plan should be communicated to the line ministries instead of making a non-transparent revision by delaying the release of funds.

- Particular attention should be given to agencies located in remote geographic areas. This needs adequate planning of the release of funds and good co-ordination between the central departments and regional offices of the ministry of finance and/or the line ministry concerned.

Budget implementation plans and cash plans must be carefully prepared and realistic. Hence, when preparing these plans, the following elements should be taken into account:

- The financial needs of ongoing commitments need to be included.

- Regulating cash flows without regulating commitments generates arrears. In many countries, when monthly cash limits are established, it is unclear whether spending units are allowed to make commitments up to the ceiling given in the budget appropriations or up to the monthly cash limits.

- The budget implementation plan and the cash plan should take into account the timing of payments and payment obligations arising from commitments over the fiscal year. A number of countries merely slice the budget into four quarterly parts, or release one-twelfth of the budgeted amount every month. This is not satisfactory. For example, the monthly schedule of disbursements for investment projects can be highly variable depending on various factors such as contractual payment schedules or the physical advancement of works.

- Adjustment of commitments needs time. Imposing monthly limits is generally more of a regulation of cash payments through float than a regulation of commitments, since even for non-personnel goods and services, one month may be too short a period to adjust commitments. To avoid arrears generation, monthly cash limits should be consistent with quarterly cash and annual commitment limits. A period of at least three months is needed to regulate non-permanent commitments, while issues related to permanent commitments should be addressed during budget preparation.

The preparation of the budget implementation plan should be driven by the budget, not by cash management concerns. In an emergency situation, strict monthly cash limits are needed, and should be preferred to day-to-day rationing. However, it must be keep in mind that regulating cash on a monthly basis is not sufficient to address problems related to overcommitment. Except in emergency situations, monthly forecasts of cash outflows should be derived from quarterly forecasts. Hence, the cash plan will be updated and rolled over in two phases: (i) every quarter for the entire fiscal year; (ii) every month, for the quarter under implementation, in conformity with the quarterly cash outflow limits. This process can ensure consistency between a cash plan and a quarterly budget implementation plan, when two distinct plans are prepared.

c. Revenue forecasts

Forecasts of the monthly distribution of revenues should be prepared. These forecasts should be updated regularly, preferably every month, since changes in the macroeconomic environment or in the tax administration system may affect revenue collection.

The preparation of monthly revenue forecasts requires economic analysis as well as management expertise, in order to take account of changes in the tax administration system. This exercise should be carried out by the tax and customs departments, in close co-operation with the treasury and the departments responsible for macroeconomic analysis. In some countries, monthly forecasts prepared by the tax administration departments are stronger on administrative detail than economic analysis. They show the distribution of budgeted revenues over the fiscal year but do not take into account fiscal and economic developments after the budget has been adopted by parliament. The government may therefore have to strengthen the forecasting capacities of tax administration departments.

A good monitoring system is a prerequisite for effective forecasting. Thus, revenue collections need to be monitored on the basis of the major tax categories and adjusted to reflect changes in the assumptions underlying the forecasts. In-year revenue forecasts should be based on revenue assessment and tax collection reports, the results of economic surveys, etc. Short-term forecasting tools, such as short-term macroeconomic models and tax forecasting models, are also helpful.

The revenue forecasts must also include forecasts of non-tax revenues prepared by the treasury in close co-ordination with the agencies responsible for the management and collection of these revenues.

2. In-month forecasts

The in-month distribution of cash flows must be estimated in order to determine the timing of treasury bill and government bond auctions and the date on which transfers of funds to agencies within an imprest system are made.

In-month forecasts of debt servicing and wage payments do not pose major problems. For other expenditures, there is a need to maintain an appropriate record of commitments and expenditures at the verification stage, including the date on which payments are due. In practice, only spending agencies can do this. Within a centralised payment system, and without appropriate tracking of commitments and verified expenditures, the treasury should focus on making forecasts of large payments (e.g. some investment projects), based on information from spending agencies, and prepare only rough estimates of other payments.

The preparation of in-month revenue forecasts is better undertaken by the tax administration department than the treasury, since factors related to tax administration or taxpayers' behaviour affect strongly the in-month distribution of revenues.

In-month forecasts should be reviewed and updated every week. For this purpose a number of countries have a treasury committee that meets weekly. Such arrangements can improve cash management, provided they do not slip into day-to-day budget management or the setting of priorities on political grounds.

D. Management of Government Debt

1. General issues

a. Legal and budgetary arrangements

To avoid uncontrolled indebtedness, legislation (e.g. the organic budget law or a separate public debt management law) should provide that only one government authority should be authorised to borrow. It should be the authority responsible for fiscal management (i.e. the ministry of finance).

Regulations can also provide for a limit to be placed on the amount of borrowing each year, which must conform to the annual budget.[5] The budget should outline the annual borrowing plan.

The legislation should provide guidance on the types of instruments and selling techniques that the government can use. However, the law should be sufficiently flexible to adapt to developments in the financial markets and information technology systems.

b. Transparency and predictability

The objectives of the government's debt management policy should be clearly stated and made public. The basic objectives are to finance the budget deficit, or specific projects (for project loans), and to minimise the costs of borrowing. Governments also pursue other objectives in debt management, such as the development of financial markets, support for monetary policy, and the encouragement of saving. The development of a large and liquid market for government debt facilitates monetary management and the development of financial markets.

As indicated above, reduced uncertainty about the borrower debt programme is generally reflected in lower borrowing charges. Many countries announce their borrowing plans in advance.[6] Taking into account uncertainty in revenue collection, the size of future auctions can be presented in public borrowing plans within a range of +/- 10-20% and, for example, the precise characteristics of a particular auction can be announced the week before it takes place. The results of an auction should be published shortly after it takes place.

The government should provide parliament with regular and detailed reports on its indebtedness and its debt policy, and publish statistics on the government debt, including details of government guarantees and contingent liabilities.

Debt management has two main aspects: (i) central bank borrowing operations as part of monetary policy; and (ii) government borrowing to finance the fiscal deficit. The use of government securities as instruments of monetary policy is seen a stimulus to the development of the financial markets. However, it requires adequate support arrangements, such as co-ordination between the monetary and fiscal authorities regarding the amounts to be issued; protection against overfunding of the government budget for the purpose of monetary management; and sharing the cost of this funding.

c. Debt policy and responsibilities

The initial step in formulating debt policy for financing the budget deficit is to set borrowing objectives in conformity with fiscal targets. The second step is to determine strategic choices.

Concerning borrowing in the financial markets (issues related to project loans are reviewed below), the formulation of debt policy includes strategic and tactical policy choices relating to the selection of instruments, currency, targeted markets, etc.[7] The choice of a suitable mix of these instruments should be based on the needs of investors, risk factors, and the objective of promoting the liquidity and overall development of the market. The choice of maturity is important in balancing the debt profile, adjusting the volatility of debt, and exploiting investor preferences. Targeting the wholesale domestic market reduces interest costs, but the development of the retail market may promote household savings.

In transition economies, extreme caution is required before considering certain instruments that increase volatility in debt service (such as index-linked and currency-linked instruments). Although portfolio theory suggests that borrowing in a variety of currencies diversifies risks and reduces the cost of borrowing, borrowing in foreign currency presents higher risks and costs in many transition countries. The use of derivatives requires a high degree of expertise and presents substantial risks. Apart from some exceptional cases, this technique should not be considered in such countries.

Responsibility for the formulation of debt policy, and for financing the budget deficit, should rest with the ministry of finance, but close co-ordination with the central bank is required, and the effects on monetary policy should be considered. In many countries, central banks are more knowledgeable about the functioning of the financial markets than ministries of finance. The distribution of responsibility for implementing the debt policy should be established according to technical capacities within the ministry of finance, the degree of development of the financial markets, and the objectives pursued. In several countries, the central bank is responsible for executing the debt policy and securities management. In developed countries, there is, however, currently a move toward placing debt management fully under the responsibility of the ministry of finance, with a view to avoiding any policy conflict between debt and monetary management.[8]

2. Medium- and long-term external debt management

In middle-income countries, increased openness of financial markets tends to diminish differences between external debt and domestic debt. Market rating covers both external debt and domestic bills or bonds which may be issued in foreign currency and held by foreign lenders. However, the management of project and programme loans needs specific procedures. In low-income countries, project loans and programme loans make up the major part of external debt.

Systems and procedures for managing medium-term external debt should cover the following features and functions:

- *Contracting loans*. Only one government authority (the ministry of finance) should be authorised to contract external loans and grant guarantees.

Programme loans (support for the balance of payments and/or the budget) should be included in the financial plan annexed to the budget. In some countries the signing of these loans is subject to the approval of parliament. This increases transparency, but may cause delays. Global authorisation of the financing plans might be preferable, but this depends on circumstances and the legal and constitutional framework of the country.

Project loans should finance only projects included in the multi-year estimates or the public investment programme (PIP), if such documents are prepared. The amount of project loans should be presented in these documents. A list of project loans should be annexed to the annual budget. This list should show the total amount of such loans and their terms. As mentioned earlier in Chapter 1, project loans or, at least, the total amount of the projects that the government intends to authorise over the fiscal year, must be approved by parliament.

- *Recording transactions*. Every loan transaction should be recorded, including loans contracted and guaranteed, disbursements, payments due, rescheduling, debt remission, cancellation of the non-disbursed part of a loan, and changes in the terms of a loan.

To facilitate comparison and accounting, it is better to register individual transactions than aggregated data. For example, it is easier to compare individual drawings expressed in foreign currency with actual expenditures expressed in domestic currency, than to compare monthly aggregated data. The average exchange rate for a month is rarely equal to the exchange rate weighted by drawings made within the month.

A crucial problem is the collection of information. In many countries, data on drawings are not readily available. The debt management office often records disbursements only on the basis of information communicated by lenders, but not every lender transmits this information in a timely manner. Consequently, as stressed by different supreme audit institutions, national auditors cannot perform audits satisfactorily since data on debt cannot be compared with budget execution reports. Information dissemination between line ministries, project managers, and the debt management office is often inadequate. Drawings on guaranteed loans are not systematically communicated to the debt management office. Procedures for disseminating information need generally to be strengthened, by establishing, for example, a monthly system of reporting by project managers and beneficiaries of guarantees to the debt management office. Data from lenders and users must be systematically compared. This needs appropriate bookkeeping for special accounts of projects financed by IFIs and adequate treatment of exchange rate variations in the accounting system.

- *Managing debt*. Future payment schedules and drawings, and the impact of rescheduling operations, should be kept and regularly updated, to provide a basis for macroeconomic forecasts and debt policy.

Payment forecasts are based on the terms of the agreements. However, determining the exact amount of payments due requires additional information. Many countries rely solely on the claims from lenders. Often the debt management office does not know exactly how lenders calculate payments (for example, when the amount of payments depends on the value of a currency pool). Debt accountants must be trained, and basic information on methods of calculating payments must be obtained from lenders.

In the same way, some debt management offices do not take full control of the payment schedules for rescheduling agreements. To forecast rescheduling, a simple spreadsheet model is sufficient. To manage rescheduling, the schedule of payments related to the rescheduling agreements must be calculated accurately. This problem is currently being addressed through the implementation of debt management systems that incorporate the management of rescheduling[9]. Often, public enterprise debts and even private debts are passed on to the government through a rescheduling operation. The government should account for this operation and be reimbursed by the entity that benefited from the rescheduling. Normally, rescheduling agreements should benefit only the government, and enterprises should pay back the government on the basis of the initial payment schedule.

- *Reporting*. The reporting system for debt transactions should fit the needs of macroeconomic analysis, negotiations with lenders or with countries, the preparation of financial programmes and budget monitoring. For this purpose, loans must be properly classified. The system of notification to the World Bank gives a basic framework for debt reporting, but should be supplemented to take into account other needs related to financial monitoring and forecasting, notably for the preparation of financial programmes or debt negotiations.

- *Accounting*. Countries with a cash accounting system generally also monitor debt service obligations, but this is not sufficient. A double-entry accrual accounting system is required. Payments are made not only in cash from government bank accounts, but also through debt operations (rescheduling, remissions, etc.). An increase in liabilities (e.g. drawings from external loans) may correspond to an increase in financial assets (e.g. through an on-lending operation concerning an external loan contracted by the central government for financing the investment of a public enterprise). The risks related to guarantees and on-lending should be assessed and accounted for. Accounting procedures should be based on recognised accounting standards, not on debt policy objectives. For example, an expected rescheduling operation may be taken into account in a financial programme, but should be accrued into the accounts only when it takes effect. Non-compliance with accounting standards, confusion between forecast data or policy objectives and actual data, and confusion between new operations (such as debt remission) and revisions in actual data, create difficulties in the interpretation of many debt management reports. Accounting methods used for specific operations, such as debt remissions, should be indicated in the debt reports.

In several countries, organisational arrangements within the government for the management of external debt are fragmented. The ministry of finance, the ministry of planning (or the ministry of economy), the ministry of foreign affairs, etc., may all be involved in debt management (Husain, 1990).

The ministry of finance, which is responsible for fiscal management, should also be responsible for debt policy and debt management. This will involve reviewing draft agreements, verifying whether the terms and conditions of loan agreements match the needs of debt policy and budgetary policy, assessing the future impact of debt servicing costs, conducting financial negotiations, and keeping books and the debt recording system.

In several countries, statistics on debt are kept by the central bank. Although the government is responsible and accountable for debt management, this organisational arrangement is acceptable. It should ensure more comprehensive coverage of transactions, since every payment is made through the central bank. However, where such a distribution of responsibilities is made, the statistics unit of the central bank should also report to the ministry of finance, which is responsible for managing and implementing the medium-term external debt policy. The existence of two statistics units, one at the central bank and one within the ministry of finance, is often a source of confusion.

A distinction should be made between functions related to debt management, budgeting and investment programming on the one hand, and aid management on the other hand. Budgeting and investment programming consist of prioritising expenditure programmes, and the debt management office should not interfere in this aspect of public expenditure management. On the one hand, in principle, project loans should finance only those projects included in the budget or multi-year expenditure programming documents. If detailed authorisations to commit, based on multi-year estimates, or investment programmes are not prepared, the ministry of finance should verify whether the project loan is compatible with government policy and medium-term fiscal targets. On the other hand, every loan should be submitted for the scrutiny of the debt management office.

3. Grants

As noted earlier, expenditures financed by foreign grants, including grants in kind, must be budgeted, recorded and accounted for. A central system of recording foreign grants and related transactions is needed, and should be linked to the government's overall accounting system. Special reporting mechanisms may be needed to monitor grants (e.g. comparing reports from spending agencies with data from donors). But in terms of broad principles, arrangements for accounting transactions made from grants are similar to arrangements for debt accounting and monitoring. A central registry of grants should be maintained by the treasury (or the central accounting department if separated from the treasury).

The special issues related to the management of EU pre-accession funds are reviewed in Chapter 10.

E. Management of Government Assets

Government financial assets consist of shares in enterprises, loans granted by the government, payments of guarantees not honoured by debtors, etc. The treasury has to record and account for these assets. It should manage the loans granted by the government, notably by authorising disbursements and tracking payments. It should gain access to financial information on enterprises in which the government has shares, monitor the dividend payments, and deal with the financial aspects of privatisation.

In a similar way, a register of real property assets should be maintained and regularly audited, either by the treasury, or another department of the ministry of finance. Every acquisition and disposal of state property should conform to standards and regulations issued by ministry of finance (or the treasury) and be budgeted.

F. Relationship with the Central Bank

The central bank is, in most countries, the main cashier of the government. Even where spending agencies hold their bank accounts at commercial banks, funds are released from a treasury account at the central

bank. More generally, central banks are the fiscal agents of governments and perform activities in such areas as government issuing, public debt management and intervention in the secondary market for government securities.[10]

In many countries, the central bank provides the government with overdraft facilities. However, to avoid assigning responsibilities to the central bank that could conflict with its monetary policy objectives (e.g. many central banks have a mandate to achieve price stability), more and more countries set stringent limits for government borrowing from the central bank or forbid it. In the EU, the Maastricht Treaty forbids such borrowing. From the cash management point of view, prohibiting borrowing from the central bank requires an active policy of issuing government securities in the capital market and also intervening in the secondary market. The prohibition may be unrealistic in the short run for countries with underdeveloped markets,[11] but borrowing from the central bank needs to be strictly regulated in conformity with monetary and fiscal policy objectives.

In principle, profits or losses of the central bank are, in most countries, transferred to the government, although actual practices vary. Often, losses of the central bank are not included in the government accounts (see the discussion on quasi-fiscal expenditures in Chapter 1). To encourage the government to optimise its cash management and to limit non-transparent quasi-fiscal expenditures, commercial terms should be applied to overdraft facilities granted by the central bank to the government. For the purpose of transparency, profits or losses of the central bank should be treated as revenues or expenditures in the budget. On the other hand, adopting these rules requires the central bank to reimburse the treasury deposits on commercial terms.

NOTES

1. See Ter-Minassian, Parente and Martinez-Mendez (1995).

2. This concept dates back to a British Act of Parliament of 1787 (George III) establishing the so-called Consolidated Fund that exists to this day.

3. Instruments for payment are described in Premchand (1995), page 25 (table 1) and page 27 (table 3).

4. In Turkey, for example, the budget department prepares the budget implementation plan and regulates the *tahakkuk*, which is an administrative stage before payment, while the treasury prepares cash plans. Similar approaches may be found in other countries that have a budget system derived from the French system.

5. In Canada, a borrowing bill that sets an annual ceiling on borrowing is prepared at the same time as the budget and submitted to Parliament (Miller, 1997). In Thailand, foreign borrowing under the law cannot exceed 10% of the annual budget (Premchand, 1993).

6. For example, in the United Kingdom, the Treasury announces each financial year in its annual debt management report the details of financing requirements, auction plans, and the maturity structure of the stock of gilts issued by the government. In Turkey, the borrowing plans are announced every quarter.

7. Ferré Carracedo and Dattels (1997).

8. See, for instance, United Kingdom, HM Treasury (1997c).

9. As with UNCTAD's Debt Management and Financial Analysis System (DMFAS), the Commonwealth Secretariat's Debt Recording and Management System (CS-DRMS), and the systems developed by a number of countries. The Debt Sustainability Model-Plus (DSM+) developed by the World Bank imports data from debt management systems to analyse external financing requirements and to quantify the effects of debt relief operations.

10. See Blommestein and Thunhoml (1997) and Ter-Minassian, Parente, and Martinez-Mendez (1995).

11. Ter-Minassian, Parente, and Martinez-Mendez (1995). See also Cottarelli (1993).

CHAPTER 10

INTERNAL CONTROL AND INTERNAL AUDIT

A. Introduction

With the creation of the European Union and the current process of enlargement it is possible to get an increasingly clear overall view of the internal (management) control systems that different countries use to handle the management of revenue and expenditure. The picture that emerges reveals great variety in methods and procedures but at the same time a number of recurring features. Moreover, although this book is focussed on expenditure management issues in the public sector, it should be stressed that the approach to financial control is remarkably similar in the public and private sectors. It is, of course, essential in any organisation to ensure that financial control is proportionate, timely and effective, and that it is kept under permanent scrutiny to ensure that control systems do not become ends in themselves.

This chapter describes the concept of internal (management) control and internal audit systems and how these are applied in different countries, with an emphasis on European practice (Sections B and C). It also reviews in Section D the issues relating to control of funds channelled through the EU budget.

The essential features of control systems in the public sector and private sector are as follows:

- Identification of *risk*.
- The development of *internal control* systems and procedures to counter the perceived risk.
- The establishment of an *internal audit* procedure for checking that the systems of internal control are countering the perceived risk, and of identifying risks not covered, or not adequately covered, by the existing systems and procedures.

The concept of risk covers the following elements:

- Misuse, including waste, of financial, human and technical resources, including external aid.
- Failure to execute budgetary and other policy decisions in a regular and efficient manner.
- Fraud and error.
- Unsatisfactory accounting records.
- Failure to produce timely and reliable financial and resource management information.

B. Internal Control

1. Introduction

Internal control systems are those established in order to counter the perceived risk described above. It is clear, however, that such systems will vary widely from country to country and will reflect administrative culture and tradition. A system that works well in one country may not transplant successfully to another. The main test of a system is how effective it is on the ground.

Internal control may be defined as the organisation, policies and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making.[1]

The way in which financial control is practised varies considerably from one European country to another. One broad approach, found in France, Portugal, Spain and many other continental European countries with a legal tradition based on the Napoleonic Code, puts emphasis on the controls that are exercised by a third party organisation, at the centre of government, often an agency of the ministry of finance or that

***Box 10.1*. KEY UK CONTROL ARRANGEMENTS AND RESPONSIBILITIES**

- Ministers are answerable to Parliament for the activities of their departments (i.e. ministries).
- Accounting officers (the senior full-time official responsible for the management of a department) are held personally responsible for:
  - Regularity and propriety of transactions.
  - Keeping proper accounts.
  - Prudent and economic administration.
  - The avoidance of waste and extravagance.
  - The efficient use of resources.
  - Ensuring compliance with the requirements of parliament for controls.
- Departments cannot legally enter into commitment/spending without Treasury (the UK Ministry of Finance) approval. In practice, the Treasury has delegated this responsibility to departments and does not "micro-manage" approvals except for very large projects or unusual transactions.
- The Treasury sets government wide standards for systems of accounting, financial management and control, and internal audit.

ministry itself. A second approach, found in European countries such as the Netherlands, and the UK (see Box 10.1), and the Scandinavian countries emphasises that responsibility for control issues has been decentralised to the head of line ministries and other budget entities, or sometimes to officials in the budget and finance departments of these organisations. However, the latter approach does not mean a relinquishment of centralised control since the ministry of finance remains responsible for the overall consistency and effectiveness of the government's internal (management) control system. In some countries, a mixture of elements of the two approaches may be found.

The examples cited in this section have been limited to financial transactions, e.g. where expenditure for a service or a training course or the purchase of equipment is involved. They could equally well have referred to the receipt of revenue. But the scope of internal control goes wider and ultimately should incorporate the following control procedures (see also Box 10.2):

- Clear instructions and appropriate training to all staff on the objectives, policies and code of conduct of a ministry or agency.
- An unambiguous definition of the responsibilities of staff, in particular of delegated responsibilities.
- Clear separation of function between staff members involved in handling financial transactions or resource management operations, particularly contracts.
- Development of an "open" culture to encourage staff at all levels to draw attention to non-compliance or irregularity.
- Insistence that staff at all levels are aware of and apply all relevant instructions.

Box 10.2. FINANCIAL CONTROL CHECKLIST

SIGMA uses the following four basic questions when assessing the development of the financial control system in a country. These questions should of course be followed up in more detail:

1. Is there a coherent and comprehensive statutory base in place that defines the principles and procedures of financial control and internal audit?
2. Are there effective internal control systems and procedures in place? Do these scrutinise relevant areas of an organisation's activities, namely: accounting systems, procurement, ex ante control of expenditure, revenue control, audit trail and reporting systems?
3. Is there a functionally independent internal audit/inspectorate mechanism in place, with relevant remit and scope?
4. Are there systems in place to prevent and take action against irregularities and to recover amounts lost as a result of irregularity or negligence?

See SIGMA's audit and financial control pages at http://www.oecd.org/puma/sigmaweb.

As noted above, the term financial control usually refers to the financial aspects of internal control. Such controls may be either ex ante or ex post. The European Commission attaches a slightly different meaning to the term "financial control". In this context, "financial control" covers both what the Commission terms "internal financial control" and "external financial control". The former term is synonymous with what is usually referred to as financial control, while the latter describes what is usually referred to as external audit. As used by the European Commission, the key difference between the terms financial control and audit is that financial control includes both ex ante and ex post controls, whereas audit exclusively covers ex post controls. To further clarify the issue, the Commission is now using the term "Public Internal Financial Control Systems" or simply PIFCS when addressing the issue of financial control (see Box 10.3).

Box 10.3. **PUBLIC INTERNAL FINANCIAL CONTROL SYSTEMS**

Based on its experience in the candidate countries, the European Commission (DG Financial Control) frequently uses the term "public internal financial control systems" (PIFCS) in assessing the progress made by these countries in meeting the requirements for EU membership. PIFCS covers:

Public, covering all control activities in the public sector.

Internal, covering controls exercised by central and decentralised government agencies as opposed to external controls exercised by a body outside the government (e.g. the supreme audit institution).

Financial, to stress the financial (administrative, managerial or budgetary) character of the activities to be checked.

Control, meaning all activities to oversee the entire field of financial management, enabling the government to be "in control" of its finances (therefore comprising all control tools such as ex ante control and ex post audit); and

Systems, covering organisations, staff training, methodology, reporting, responsibilities, sanctions and penalties.

Source: European Commission, DG-Financial Control, April 2000.

2. Responsibility for internal control

In Member States employing the first of the two approaches described above, the ministry of finance not only plays a key role in preparing the budget and allocating funds to line ministers, but also in intervening directly with an ex ante control by its own staff in the line ministries. In Member States using the second approach, each line ministry takes full responsibility for spending its own budget and for ensuring appropriate checks and safeguards. It should however be noted that this in some cases is a responsibility originally delegated from the ministry of finance and over which that ministry retains powers of supervision and regulation to ensure that a consistent approach is applied in all spending units.

Following criticism by the European Parliament of financial management practices within the European Commission which led to the resignation of the entire Commission in March 1999, a Committee of Independent Experts concluded that "the existence of a procedure whereby all transactions must receive the explicit prior approval of a separate financial control service has been a major factor in relieving Commission managers of a sense of personal responsibility for the operations they authorise while doing little or nothing to prevent serious irregularities."[2] The committee recommended that a professional and independent Internal Audit Service should be set up reporting directly to the President of the Commission, that the existing centralised pre-audit function should be dispensed with, and that internal control — as an integrated part of line management — should be decentralised to the Directorates-General in the Commission. The Commission announced in January 2000 that it would accept this recommendation, and a reorganisation of the Commission services began later that year.

In general, the term management control or internal control describes the systems, processes and methods of managing activities rather than a specific unit in a ministry or government agency. It is interesting to note, however, that the Committee of Independent Experts referred to above recommended that a specialised internal control function should be established in each Directorate-General of the Commission. This function should be exercised under the responsibility of a senior official reporting to the Director General or Head of Service and an accounting function exercised under the responsibility of a delegated accounting officer.

Box 10.4. **KEY ELEMENTS OF EFFECTIVE SYSTEMS OF FINANCIAL CONTROL**

- Strong central ministry responsible for all financial matters.
- Central standards for accounting, financial reporting and internal audit and a system to enforce these standards.
- Clear and transparent lines of accountability for organisational units and government officials.
- Effective and coherent systems and procedures for ex-ante control (wherever situated).
- Clear, comprehensive and transparent procedures for financial and performance reporting of all public sector entities.
- Strong external oversight by parliament and an effective public sector external audit.

3. Prerequisites for effective control

Internal controls are the responsibility of the leadership of an organisation. Therefore, to establish and maintain effective internal controls, the top leadership of the organisation must, first of all, be committed to the effective management of the entity and demonstrate personal integrity and professionalism. Only if sufficient leadership and commitment are in place will it be possible to establish and maintain an effective system of controls. Other key elements of a financial control system are described in Box 10.4.

Internal (management) control requises a strong control environment as well as a coherent framework of control systems and procedures (see Box 10.5). The control environment includes management's philosophy and operating style, the assignment of responsibility and the policing of internal (management) control systems and procedures. It therefore affects the way in which control systems and procedures operate in the organisations concerned.

Box 10.5. FINANCIAL CONTROL ENVIRONMENT

The main risks in the financial control environment are:

- Inadequate management integrity and weak ethical values.
- Inadequate management commitment to professional competence among staff and inappropriate assignment of authority and responsibility.
- Inadequate management oversight.
- Inadequate management policies to prevent monitor and respond to illegal acts.

The consequences of a weak financial control environment include:

- Expenditure for purposes other than originally intended.
- Inappropriate or misleading reporting.
- Financial losses.
- Loss of public confidence.
- Increased risk of fraud and corruption.

The next requirement is a careful and thorough assessment of the risks facing the organisation and an identification of useful controls to manage those risks. In a complex organisation, this can be a difficult task and one for which the leadership of the entity may wish to seek expert assistance. Internal and external auditors are frequently the source of such assistance. Whatever assistance is obtained, however, it is essential that the leadership of the entity remain involved throughout the process and especially in the decisions about the control arrangements to be put in place. The controls that are implemented must be ones that the management will actually use, even when they create some inconvenience in day-to-day operations, and must be used throughout the entity. Few things weaken the credibility of the system more than the introduction of controls that are then left on the shelf.

The controls must therefore be cost-effective. They must not be so detailed and onerous as to paralyse the organisation. And the cost of the control systems must not be out of proportion to the risk they

are intended to avoid. This point is stated briefly, but is extremely important: "red tape" is an ever-present risk, and there can be a temptation to introduce new controls even when there is no need for them.

Because of the importance of management controls in assuring the effective control of public funds and the proper execution of the budget, the budget department of the ministry of finance in many governments plays an active role in strengthening the management controls of the operating units.

4. Types of internal (management) control

Because internal (management) controls must be designed for the individual circumstances of a particular entity there is no universally applicable list of controls. However, it is possible to describe categories of controls and the circumstances in which they might be appropriate.

- *Financial accounting and reporting*. The importance of these tasks is discussed at length in Chapters 11 and 12.

- *Performance monitoring*. This subject is examined thoroughly in Chapter 15.

- *Effective communications*. Managers should recognise that subordinates perform better if they have a clear understanding of the mission and goals of the organisation and the purpose being served by the activities they are asked to perform. Channels of communication are part of the management control system. For example, managers should communicate their performance expectations to subordinates, who should then define the expectations for their components of the organisation that are needed to accomplish the overall goals of the organisation. It is important that communications flow upward as well as downward. When management sets clear goals and expectations, workers can often suggest ways of achieving greater efficiency in the attainment of those goals. Management should pay careful attention to such suggestions, as front-line workers are often aware of procedural inefficiencies that escape the notice of senior managers.

In addition to ensuring that the goals of the organisation are achieved, however, managers are also responsible for ensuring that the resources available to the organisation are protected against improper use. A variety of devices might be used for this purpose:

- *Physical controls*. These would include, primarily, the security procedures intended to control access (e.g. to accounting records or to inventories of items — and to the items themselves — that have high value and might be easily stolen).

- *Accounting controls*. These include the procedures by which transactions are required to be recorded in the accounting system. For example, there might be a requirement that all cash receipts be deposited daily in a bank. The person who collects the cash might be required to provide a written receipt to the payer and to file a copy with the accounting clerk. The person who deposits the cash in the bank would be required to file a copy of the bank receipt with the accounting clerk. Accounting controls also include the internal procedures within the accounting systems that are intended to detect and report any anomalies. In this example, the accounting clerk might be required to reconcile the two reports — of cash collection and cash deposit — to report any discrepancies. Another typical accounting control would apply to expenditures, which would be compared with the budget or other authorisation. Expenditures that depart from the expected pattern would be reported while expenditures that exceed the maximum authorised amount would be blocked.

- *Process controls*. These are the procedures designed to ensure that actions are taken only with proper authorisation. For example, the issuance of a purchase order or the approval of a sizeable contract might require documentation from the requesting official, review by a purchasing clerk, and approval by a supervisor. Large purchases might require approval from a higher official. Payments to contractors might require documentation in the form of the original purchase order, a voucher from the contractor describing the goods and services provided, and a certification from the receiving official that the goods and services were received. Payments above a certain amount might require review and approval by a higher authority. In some countries, personnel standards are an important part of the management control system. Applicants for a post undergo rigorous examination and must receive a qualifying certificate before assuming the position.

- *Procurement controls*. These were discussed in Chapter 8.

- *Separation of duties*. This is both a control measure and an indispensable element of many control systems. The central feature is that, in any transaction, at least two people should be involved to minimise the risk of improper actions. In the previous example concerning the handling of cash receipts, one person collects the cash, another makes the bank deposits, and a third reconciles the cash receipt documents and enters the data in the accounting records. Separation of duties in this way is an essential element of almost every financial control system, but its use can be overdone. If carried to extremes, however, it can severely degrade the efficiency of an organisation and impair its ability to accomplish its mission efficiently.

- *Internal audit*. For a full discussion, see Section C below.

5. Limitations of internal control

No system of controls can be an absolute guarantee against the risk of wrongdoing or honest error. Any system that attempted to reach that goal, especially in a complex organisation, would impose costs far out of proportion to the risks and would create rigidities for the organisation. Thus, the proper goal of the control system should be to provide "reasonable assurance" that improprieties will not occur or that if they occur, they will be revealed and will be reported to the appropriate authorities. With this in mind, managers should be aware of certain risks involved in building and maintaining management control systems.

- *Design flaws*. It has been stressed that internal (management) control systems must be designed for the specific organisation, operations, and environment in which they will function, after careful consideration of the risk involved in that particular situation. Managers are sometimes tempted to shortcut the design process, for example by adopting the control systems designed for another organisation. This can be dangerous. A flawed design may leave the impression of safety but may overlook important risks in one part of an operation while creating unnecessary rigidities in another.

- *Poor implementation*. The best-designed system will achieve its goal only if it is implemented properly. Managers and supervisors at all levels must be vigilant to ensure that everyone complies with applicable control procedures. Even more importantly, the required procedures must be ones that employees will appreciate and accept, and which they will not be tempted to ignore when the procedures become inconvenient or in times of pressure and stress. Meeting this criterion is one of the key considerations in the design of effective control systems. Managers should also plan ahead for alternative arrangements that might need to be put in place in the event of an emergency requiring the regular procedures to be bypassed.

- *Poor response to reported anomalies*. Control systems are designed to call attention to events that depart from normal expectations. For the systems to remain effective, therefore, it is essential that supervisors and managers respond properly to alerts. The triggering event should be investigated promptly to determine if an irregularity was involved. If so, corrective action should be initiated. Failure to respond effectively to reports of anomalies will quickly undermine the effectiveness of the control system. This should also be a factor in the design of control systems. However, care should be taken to avoid making the systems so sensitive that they yield frequent "false alarms". If this happens too frequently, valid alarms might be ignored.

- *Collusion*. Any system of controls can be defeated if a sufficient number of dishonest key individuals conspire to subvert them and are able to falsify the relevant documents. A sufficiently complex set of controls can make it difficult to assemble the needed number of conspirators, but at a potentially great cost in organisational inefficiency. Conspiracies of this sort usually come to light when they are observed (and reported) by someone who is not a party to the conspiracy, or when there is a falling out among conspirators. They may also be detected during a routine audit if substantial amounts of funds are involved or if the conspirators are not sufficiently careful in falsifying the documents.

- *Wrongdoing by top managers*. Internal (management) controls are designed to help control the organisation on behalf of its management, not to control the top managers themselves. There are many examples of dishonest top managers evading the control systems to commit various forms of fraud and abuse. In a large organisation, however, such activities are usually noticed by subordinates. Thus, the best protection against wrongdoing by top managers may be an environment of openness, in which workers are encouraged to report evidence of irregularities, confident that they will not be punished for being disloyal to their superiors. Such openness in an organisation becomes part of the control environment.

Internal (management) controls are an essential part of the structure and operations of any organisation. The larger and more complex the organisation and its activities, the more care must be given to the design of the control systems. To be fully effective, control systems need the active support of managers in installing and maintaining them.

C. Internal Audit

1. Introduction

The Institute of Internal Auditors defines internal audit as follows:

"Internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve effectiveness of risk management, control, and governance processes." [3]

Internal audit is a concept which flows logically from internal control.

European models for specialised financial control organisations correspond to the two approaches — centralised and localised — referred to in Section B above. In Portugal, for example, a centrally placed Inspectorate General for Finance (IGF) reports directly to the Minister of Finance and is responsible

for ex post financial control of all public expenditure and revenue of the government administration. In addition to the IGF, line ministries have their own control organisations (Inspectorates General). By contrast, the Internal Audit Service of the UK's Ministry of Finance is not responsible for financial control of public expenditure and revenue as such, but rather for ensuring that management/internal control systems in the line ministries, including the ministries' own specialised financial control organisations (Internal Audit units), are properly enforced. Many central and eastern European countries have until now had no specialised financial control organisations as such, but have a "control office", which inter alia investigates allegations of irregularities and fraud before turning the cases over to the courts. Most central and eastern European candidate countries are transforming such functions into genuine financial control organisations.

The European Commission introduced its own internal audit function in 1990 by creating a special service in the existing Directorate-General for Financial Control. The European Commission's internal audit service was given the mandate to carry out a financial audit in each Directorate-General every three to five years. These audits examine the budgetary and financial systems and carry out substantive tests on a sample of transactions. They then draw conclusions as to the strengths and weaknesses of the systems and make recommendations for any necessary improvements. A follow-up audit is carried out 12 to 18 months later. In addition to financial audits, the internal audit service has been developing a performance audit capacity, and has increasingly been called upon to investigate problem areas as a result of which it has identified substantial amounts for recovery.

Many candidate countries have no systematic internal audit procedures as such, but some have a "government control office" or "control corps" based on the practice of the pre-independence regime, which investigates complaints against staff received from the public and may also investigate allegations of irregularity and fraud before turning the cases over to the criminal or fiscal police. Such units do not appear to audit financial management on any systematic basis.

2. The mandate of the internal auditor

The internal auditor carries out his functions, as defined above, by looking into how a selection of the transactions have been processed and also, indeed primarily, by assessing how well the systems and procedures of internal control function. In practice, the internal audit service should cover two main types of activity — financial audit and performance audit:

• *Financial audit*: Audit of budgetary and financial systems with compliance tests ("walk-through") and substantive tests of actual transactions. Financial audits are generally carried out on the basis of an annual plan providing for each department within a ministry or agency to be covered at least once in the course of a multi-annual cycle. Financial audit may also involve a specific assessment of the effectiveness of accounting systems, including IT system safeguards and reporting facilities.

• *Performance audit*: Performance, or "value for money" audits, which should also be part of an annual plan, cover the extent to which established objectives and specific programmes of the ministry or agency have been achieved or implemented, taking into account the extent to which they have been achieved — or not achieved — at a cost commensurate with the risk, and in an accurate and timely fashion with minimal use of resources.

Internal audit may also cover a specific analysis of staff resources with a judgement on the extent to which they correspond to the objectives of the ministry or agency and the tasks it is required to carry out. See Box 10.6 for some examples of issues typically examined by an internal auditor.

Box 10.6. WHAT DOES THE INTERNAL AUDITOR LOOK FOR?

The first concern of the internal auditor is that systems and procedures are in place to ensure that resources are used in accordance with the relevant rules and regulations. This will often involve, particularly in the EU context, a requirement that an adequate sample of transactions or products is checked by the national authorities.

In the case of agricultural expenditure, for example, the auditor will wish to have solid evidence that grants to aid livestock or crop production have been used for that purpose, and have gone to farmers eligible to receive them.

Similarly, grants for training the unemployed must be shown to have been used for the intended purpose and for real and eligible applicants.

In the EU context, a common problem found by the auditor is that funds are claimed for estimated expenditure rather than for expenditure which has actually been incurred and paid.

In the area of public procurement the internal auditor will seek assurance that there has been adequate publicity for calls for tender, that there are satisfactory procedures for receiving and evaluating tenders and that the justification for the award of contract is in accordance with national and/or EU requirements. A Commission study in the late 1980s suggested that the European taxpayer would have paid some 20 billion ecu less each year if public procurement throughout the Community had been in accordance with EC Directives.

Overall, the internal auditor will look for evidence that programmes and actions have achieved their objectives.

3. The independence of the internal auditor

The internal auditor should be responsible to the minister or secretary-general of a ministry or agency, giving technical advice on the efficient management of resources without becoming involved in political questions. In EU Member States where internal audit is carried out by a centralised Inspectorate-General of Finance, the independence of this office is ensured by its reporting directly to the minister of finance. In other countries the internal auditor reports directly to the head (top official) of the ministry or agency. Practice varies in the candidate countries. The "control office" inherited from the pre-independence regimes tends to report directly to the minister or to the prime minister's office in some cases.

It is important to be clear about the nature of the internal auditor's independence. It should not be compared with the independence of the external auditor (e.g. the supreme audit institution) who reports directly to the parliament or budgetary authority and whose independence is normally reinforced by the tenure and security of his appointment and safeguards against unjustified dismissal. The internal auditor is responsible to the head of the ministry and is part of the staff of the ministry or agency. The Institute of Internal Auditors defines independence in the following terms:

"Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgements essential to the proper conduct of audits. It is achieved through organisational status and objectivity."[4]

It goes without saying that, as the Institute of Internal Auditors stresses, "internal auditors should be independent of the activities they audit." There can be no question of an official responsible for, say, allocating housing grants subsequently carrying out an internal audit of the systems and procedures used in the allocation of these grants.

Since the internal auditor is not independent of the ministry or agency in which he functions it is essential for the internal audit function to achieve an appropriate status and weight in the organisation. One of the means of reinforcing the status of internal audit is to have an audit committee with, preferably, the head of the ministry or agency in the chair. The committee should include representatives of the ministry's senior management in addition to financial management and audit specialists. The private sector as well as the public sector has come to recognise the value of the audit committee in ensuring that all levels of staff take internal audit seriously and give their full co-operation to the auditors. The development of such attitudes on the part of the staff will help create the right conditions for effective management (internal) control. An important function of an audit committee is to identify the areas to be covered by the ministry's future audit programme and the conclusions to be drawn from ongoing audits.

4. Relation of internal audit to internal (management) control and to external audit

The internal auditor should not be involved in the internal (management) control process which he is required to assess and judge. There is clearly no objection to — and a great deal to be said in favour of — the internal auditor being asked to give an opinion on, or carry out a "pre-audit" of, the systems and procedures being prepared for a new action or programme. Internal audit should not, however, become part of, or be associated on a permanent basis with, internal control. It is essential that internal audit keeps its distance, so that line management recognises its responsibility for internal control and its interest in demonstrating that it is maintaining efficient internal control through its own efforts.

The relationship between the internal and external auditor can be fraught if the external auditor is seen as the supervisor or assessor of internal audit. It should be possible to establish an intelligent relationship in which each side clearly appreciates the role and responsibilities of the other side. While the external auditor may find room for improvement in the work of the internal auditor or may even be called upon to audit his work, this need not prevent a sensible working relationship based on partnership. There can be fruitful exchanges of views, experience and information on methodology, and valuable time and resources can be saved if the two sides have confidence in each other's work and plan their own work accordingly. This can be done without any blurring of the distinctive features and objectives of the two types of audit.

It is essential for both auditee and auditor that a clearly defined audit trail is available. It enables the auditee to keep constantly under review the timely and adequate flow of funds and the procedures for efficient accounting, and the reconciliation of expenditure reports with the funds received or claimed. Box 10.7 and Figure 10.1 illustrate the main requirements for an audit trail and a basic chart for the flow of funds and information, together with the corresponding control functions in the context of EU Structural Fund payments to Member States. An indicative description of information requirements for the audit trail is provided in Commission Regulation No. 2064/97 dealing with the financial control by Member States of operations co-financed by the Structural Funds.

5. Financial control of external aid

The general rule in dealing with external aid, whether incorporated into the national budget or not, is to use the national financial control mechanisms (internal control, internal audit, external audit) to ensure proper and efficient use of the aid.

Box 10.7. AUDIT TRAIL

The auditor will almost always need an audit trail in one form or another.

In the context of national or subnational budgets, it will be necessary:

- To trace the budget provision that authorises payment.
- To check the transfer of funds authorised by the ministry of finance (or treasury) to the line ministry and/or to the regional or local office.
- To trace and evaluate the systems/procedures through which approval for payment to the contractor or beneficiary will be required to pass.
- To locate completed payment files with evidence that payment has — or has not — been made in accordance with rules and regulations.

In the EU context it will be necessary:

- To identify the EU budget provision authorising funding.
- To locate the flow of funds from the European Commission to the ministry of finance.
- To trace the flow of funds to the line ministry responsible for administering funding and identify procedures for registering arrival and onward movement of these funds.
- To trace the flow of funds through regional and local offices and check procedures for registering arrival of funds, and the availability of national co-financing where appropriate, and identifying programmes and projects for which they are intended.
- To ensure that EU and national funds are available for payment to the fund beneficiary on production of the appropriate proofs of expenditure and work or service completed.
- To trace in reverse the flow of eligible expenditure back through local and regional offices to the ministry responsible for administering funding.
- To reconcile the proof of eligible expenditure for one project, or a series of projects, with funds initially received and with the report back to the Commission.

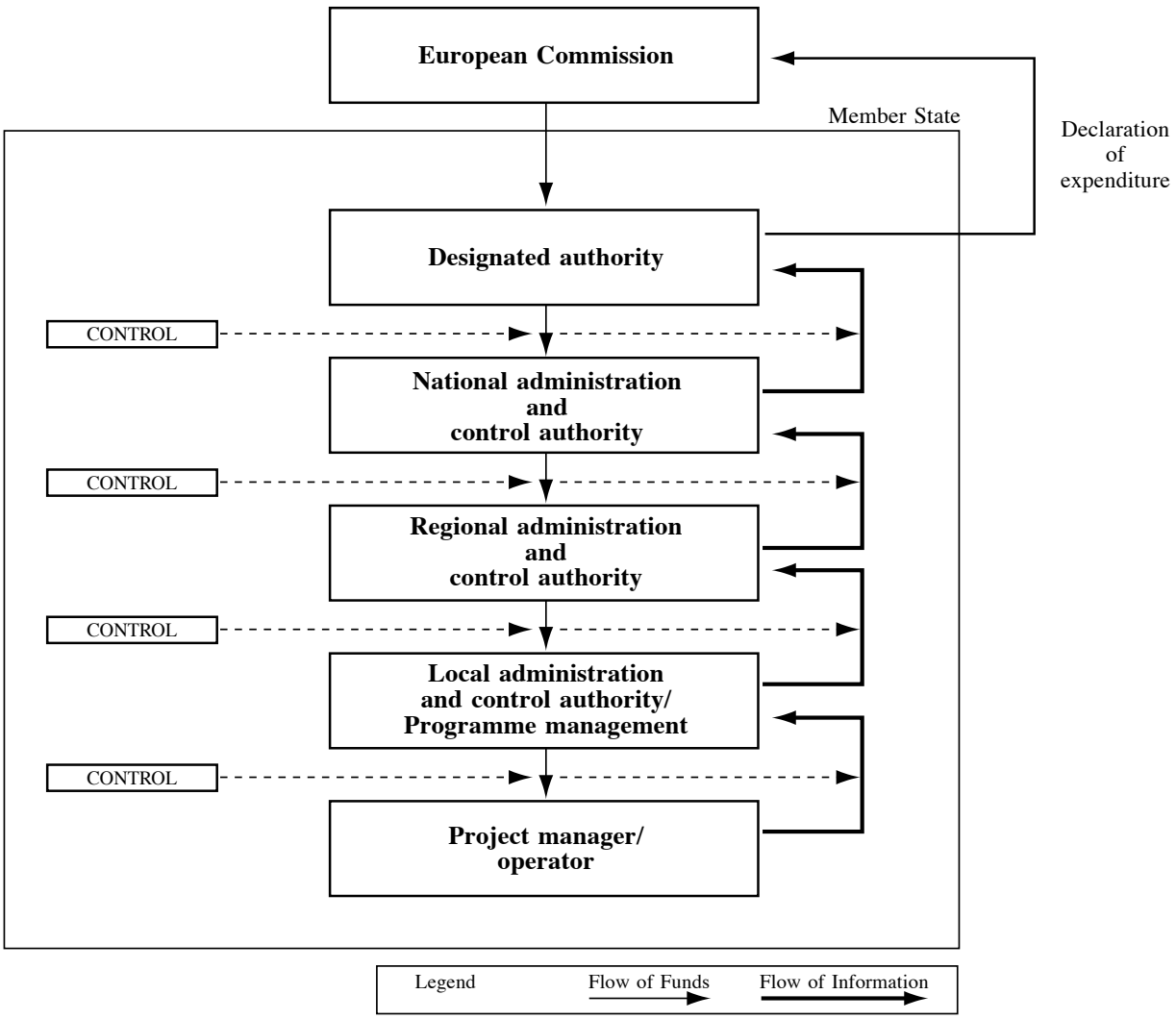
Examination of the audit trail can be helpful to both the Commission and the Member State in identifying possible delays in the flow of funds and the implementation of projects and possible difficulties in identifying items of expenditure, and in reconciling the actual use of funds with the amounts initially transferred. It can also highlight weaknesses or gaps in the control procedures.

It is for the beneficiary country to demonstrate that its financial control mechanisms are adequate to ensure sound financial management of the aid and that the aid can be channelled through existing systems. Where this is not the case solutions should be found, in consultation with the ministry of finance, through

specially created programme management units or through a network of implementing agencies linked to line ministries, with funds being channelled through a mechanism located in or attached to the ministry of finance (e.g. the National Fund in the case of EU pre-accession funds — Phare, ISPA and SAPARD — see Section D below).

As in any internal (management) control situation, it is essential to base the controls on a realistic assessment of the risk in the country concerned, but the tendency of international organisations, for perfectly valid reasons, is to apply their "house rules" across the board. This is no doubt inevitable, but as a compensatory measure, an attempt should be made by the international organisations to harmonise as far as possible these rules in order to facilitate the task of beneficiary countries in managing funds and to make maximum use of their existing systems. For their part, beneficiary countries can facilitate fund management by making one ministry — normally the ministry of finance — the co-ordinating body for external aid.

Figure 10.1. **EXAMPLE OF AN AUDIT TRAIL FOR EU FUNDS**



D. Financial Management of EU Funds in Candidate Countries

1. Introduction

The (questionable) practice in most of the central and eastern European countries that have received grant-based assistance (also called non-refundable technical assistance) from the EU and a number of bilateral and multilateral donors has been not to include such assistance in either budget planning or the budget execution process.

The reasons are several:

- As it was seldom within the power of the governments to decide on priorities for the use of such funds, and planning often took place outside the normal budget process, it made little sense to try and include the funds in the budget. In the case of aid received from bilateral donors, the amounts received are often not known by the recipient government.

- Aid funds often bypass normal controls by the state treasury.

- The procurement of services, supplies and works using the funds made available is generally the responsibility of the donor and not the recipient.

Some of the multilateral donors have already begun introducing greater responsibility to the recipient countries for the use of funds provided through loans or grants. The EU, for example, introduced the Decentralised Implementation System (DIS) several years ago, which gradually has shifted more and more of the responsibility for managing funds to the recipient country.[5] The National Fund system is a further decentralisation and the "Memorandum of Understanding on Establishment of the National Fund" signed by the Commission and candidate countries (at differing dates) defines the National Fund as "the central treasury entity within the ministry of finance through which the Community funds are channelled towards the recipient". The recipient country is responsible for the overall financial management of EU funds received during the period leading up to full membership of the EU (i.e. the "pre-accession funds") including procurement through the Commission's DIS system.

As the National Fund system transfers more of the management and control functions to the national administrations the overall responsibility and accountability for managing the system will be placed with the national senior officials in charge. In the case of mismanagement or misuse of funds the European Commission can require that the funds be reimbursed.

As a result of the introduction of the National Fund system, candidate countries need to adapt and strengthen their procedures for managing and controlling public funds. In particular, internal control and internal audit functions have to be introduced or improved. Accounting and public procurement systems also need upgrading in order to comply with European Union standards. Strengthening public expenditure management systems is a pre-accession requirement and a pre-requisite for effective management of EU funds. (Annex II sets out the main issues that need to be considered in establishing a National Fund system and the surrounding budget and control mechanisms).

A glossary of terms relating to the establishment of the National Fund, and related procedures, is shown in Box 10.8.

Box 10.8. NATIONAL FUND — DEFINITIONS

Decentralised Implementation System (DIS)
: Implementation system of the Phare Programme where part of the management responsibilities have been transferred to the recipient country whilst the Commission retains the final responsibility under the EC Treaties.

Central Finance and Contracts Unit (CFCU)
: An implementing body within the national administration in charge of tendering, contracting and making payments for Phare-funded projects. A Senior Programme Officer is responsible for technical implementation of the programme of these projects.

Implementing Agency (IA)
: An implementing body within the national administration in charge of tendering, contracting, making payments and technical implementation of projects.

Joint Monitoring Committee (JMC)
: A committee, consisting of the NAO, NAC, the PAOs and European Commission representatives, in charge of the review of Phare programmes and pre-accession measures.

National Aid Co-ordinator (NAC)
: An official of the national administration (in most cases a minister) with overall responsibility for planning and managing EU-funded programmes in recipient countries. The NAC also ensures a close link between the general accession process and the use of Community financial assistance, and is responsible for the monitoring and assessment of Phare programmes.

National Authorising Officer (NAO)
: An official of the national administration heading the National Fund. The NAO is responsible for the financial management of pre-accession funds.

National Fund (NF)
: The central cash-management entity, usually within the ministry of finance, through which EU funds are channelled to beneficiaries.

Perseus
: The financial reporting system of the European Commission, linked to DIS.

Programme Authorising Officer (PAO)
: An official of the national administration heading an Implementing Agency or the CFCU. The PAO is responsible for the operations of the IA/CFCU and for the sound financial management of the projects to be implemented.

Senior Programme Officer (SPO)
: An official of the national administration (line ministry/agency) in charge of the technical implementation of projects in cases where the CFCU is responsible for the administrative and financial implementation of the projects.

2. Including EU funds in the national budget

In many of the candidate countries, the external grant based resources are not part of the annual national budgeting process. This tends to reduce the scope for priority setting and can lead to overlapping and non-optimal resource allocation. As a result, the total resources available for a given area or ministry are not known accurately and the process is not transparent and difficult to control and monitor.

In order for a country to include external resources in the national budget process it is necessary to have an estimate of the amount of funds likely to be made available. Until recently this has rarely been the case. With the guidelines for Community assistance issued in 1999,[6] however, it is now possible to include priorities and target schedules within the multi-annual Accession Partnerships. It should thus become possible for each country to include both the assistance and the co-financing for particular activities in the budget either under a specific budget line or as an overall line for external grant-based resources. The former approach seems to be more desirable from a priority setting and transparency point of view. It is, however, of paramount importance that the amount of funds and priorities are agreed between the Government and the donor before the budget process is completed for the following year.

In many countries, this may mean that the budget law should include a provision for external grant-based resources (if this is not already the case) and that ministries of finance in their yearly budget instructions should include directions on how the assistance is to be included and presented in the budget documentation.

3. Choosing a model for the financial management of EU funds

With regard to budget execution, countries vary in terms of the system they have established and the degree of financial independence given to each ministry. Many candidate countries have established a treasury system through which all national budget funds are managed. Others have delegated this responsibility to line ministries and other state institutions. When it comes to the management of external resources, it is generally recommended to follow the existing system of the administration. There is no single "standard" solution for establishing a National Fund system; each country will have to develop its own system, which matches the administrative structure and culture of that country.

In some countries, the possibility of establishing a separate institution for the management of Community assistance has been discussed. So far as possible, countries should use existing structures of the administration and upgrade these structures, if necessary, to comply with the requirements of the National Fund system.

The main issue is to determine the division of responsibilities between the National Fund and the Implementing Agencies in particular with regard to payments. In general, the Memorandum of Understanding between a candidate country and the European Commission foresees a division of responsibility between the National Fund and the Implementing Agencies. Under this arrangement, the National Fund takes responsibility for the overall financial management of the Community assistance and the Implementing Agencies are responsible for financial and technical implementation of specific funds/grants. Payments may be executed in either of the two ways (a) or (b) described below.

a. Using the treasury

In countries with a developed treasury system responsible for managing the national budget, it is logical for the National Fund system to be placed inside the treasury. Under this approach, the treasury's main

responsibility in relation to the National Fund would be the financial management and execution of payments for the contracts concluded by the Implementing Agencies (see below). The treasury/National Fund would also make requests for funds to the European Commission, run the accounting system and prepare financial reports. As most treasuries are not banks themselves, the treasury would need to open bank accounts with commercial banks or the central bank of the country concerned.

b. Using a separate National Fund organisation

For countries that do not have a state treasury but where the individual ministries are responsible for financial management and hold their own bank accounts, a separate National Fund organisation/agency should be established under the ministry of finance. The National Fund will then act as a treasury for managing Community assistance.

In designing the system, a decision is required about who is authorised to make payments on the relevant accounts (which according to the Memorandum have to be opened by the National Fund). The payments can either be made by the National Fund or the Implementing Agencies. Responsibility for ensuring that financial management procedures are carried out correctly should be with the National Fund.

Some countries with a treasury system, however, may choose to establish a separate organisation for implementing the National Fund system, i.e. a parallel treasury. Under this approach, the accounts may still be run through the treasury or it may also be decided to establish separate accounts for EU funds outside the treasury. The main disadvantage with this approach is that there may be a duplication of functions with the treasury.

From a financial control point of view, it should be determined whether the institution is under the authority of an existing internal audit unit (e.g. within the ministry of finance) or whether a new internal audit function needs to be established.

4. Implementing agencies

The administration, and the financial and technical management, of programmes and projects funded by EU pre-accession aid (ISPA and SAPARD) and the Phare programme is carried out by Implementing Agencies. The Implementing Agencies are responsible for the design of projects and the entire procurement process according to the Phare Decentralised Implementation System together with the supervision of projects. Payments on the relevant contracts are either made by the Implementing Agencies themselves or the National Fund depending on which model has been selected — see above. If payments are made by the National Fund, the Implementing Agencies verify that they have received the required supplies or services and request that payment be made.

The National Fund should in all of the above examples conclude an agreement with each of the Implementing Agencies. This agreement sets out the responsibilities of the Implementing Agencies. Additional secondary legislation may be needed depending on a country's administrative system.

The Implementing Agencies can be either departments of ministries or dedicated procurement units. In some cases, Implementing Agencies have been created out of units that were involved with the implementation of Phare projects in previous years. Some experience with procurement under the decentralised implementation system is valuable. As described in Box 10.8, the Implementing Agencies operate under the supervision of a Programme Authorising Officer (the PAO).

5. Internal audit and control

The required internal audit functions should be carried out by the internal audit departments of the relevant line ministries. The internal audit department of the ministry of finance (or another body with overall responsibility for internal audit) may consider it necessary to participate in the internal audit of all Community assistance for a transitional period and, on a continuing basis, ensure that the standards and procedures for internal audit are implemented by the internal audit departments in the ministries concerned. This will be in addition to its overall and permanent responsibility for providing guidance and co-ordination to line ministries in relation to internal audit.

6. Monitoring

As required by Article 15 of the Memorandum of Understanding on the Establishment of the National Fund, a Joint Monitoring Committee should be established to review the progress of the Community assistance programmes. The National Aid Co-ordinator, National Authorising Officer, representative(s) of the European Commission and the PAOs of the Implementing Agencies, are the required representatives of this committee.

The Joint Monitoring Committee is assisted by Monitoring Subcommittees, which should be established on either a sectoral or a programme objective basis. The Monitoring Subcommittees will have the NAO, PAO and representatives of their Implementing Agency and of the European Commission as members. The Monitoring Subcommittees are established in order to review progress on the projects for which they are responsible on a regular basis.

7. Training of staff

A number of the officials involved in the National Fund system may already be familiar with the Phare Decentralised Implementation System e.g. through previous work in project implementing units. However, officials in the control and audit functions may have no prior knowledge of the Community procurement rules.

Training — both formal and on-the-job — of all officials involved in the National Fund system (treasury, National Fund, Implementing Agencies, internal audit departments and the supreme audit institution) should be arranged on the Community procurement rules. Exchanges of experience between Implementing Agencies can be helpful in improving the overall performance of the system, as can the experience of countries that are further ahead in this field.

8. Ensuring the operational effectiveness of the system

Considerable effort and planning will be necessary to establish the National Fund and the supporting control system. It may be necessary, as mentioned above, to implement specific secondary legislation that clearly sets out the role and responsibilities of the officials and institutions involved. It is also recommended to develop a set of instructions and guidelines, in operational manuals, which lays down the activities and responsibilities of these institutions.

The instructions and guidelines should cover:

- The internal procedures of the National Fund and/or treasury for managing EU funds.

- The procedures for managing transactions between the National Fund and the Implementing Agencies.

- Templates for standard documentation.
- The procedures for operating the bank accounts.
- The ex ante control and internal audit procedures.
- The monitoring procedures.

Preparing for the setting up of a National Fund system is a very time consuming exercise and should not be underestimated. All the institutions involved have to be part of the process of establishing the system, training the staff, and building the necessary working culture. In particular, ensuring that the necessary controls and control points are in place and that staff have been sufficiently trained seems to be a more complex task than most expect. Accounting, reporting and monitoring systems are often overlooked aspects, which require the right organisational structure, staffing and training before being implemented. For further discussion, see Annex II in this book.

NOTES

1. See also INTOSAI standards (1992), and SIGMA (1996c).

2. Second Report by the Committee of Independent Experts on Reform of the (European) Commission (10th September 1999) (Paragraph 4.18.1).

3. Definition approved by the Board of Directors of the Institute of Internal Auditors in June 1999.

4. *Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors.

5. The DIS Manual — September 1997 prepared by the European Commission is applicable to the implementation of decentralised Phare Programmes. The Manual defines the standard procedures which must be respected by all bodies implementing a Phare Programme unless other provisions have been formally agreed in writing with the Commission. The Manual is based on Phare and Financing Regulations — Framework Agreements concluded with each country — as well as on previous Phare Manuals.

6. Commission Decision (SEC (1999) 1596 final: *Guidelines for Phare Programme Implementation in Candidate Countries for the Period 2000-2006 in Application of Article 8 of Regulation 3906/89*).

SUMMARY — PART III

A. KEY POINTS

1. Budget execution systems

The essential elements of an efficient budget execution system are:

- Internal control systems that ensure probity, economy and efficiency in managing public funds, assets and liabilities.

- Systems for cash management.

- External and internal audit systems that are designed to verify that public expenditure management procedures achieve the necessary standards of legal compliance, efficiency and effectiveness.

- Accounting and monitoring systems (see Part IV).

2. The expenditure cycle

The expenditure cycle consists of the following phases:

- *Allocation of appropriations/release of funds to spending units.* To ensure effective and efficient budget implementation, the authority to spend must be given to agencies on time, through instruments such as budget implementation plans or warrants.

- *Commitment*. The commitment phase is the stage where a future payment obligation is incurred. It entails an obligation to pay when the third party has complied with the provisions of the contract. At the commitment stage, it is necessary to verify that (i) the proposal to spend money has been approved by an authorised person; (ii) money has been appropriated for the purpose stated in the budget and sufficient funds remain available in the relevant category of expenditure; and (iii) the expenditure is proposed under the correct category. Systems for managing multi-year commitments must be in place.

- *Acquisition/verification (or certification).* At this stage, goods are delivered and/or services are rendered and their conformity with the contract or order is verified. Assets and liabilities of the government are increased and recorded in the accounts, if the country has an accrual accounting system. Expenditure at the verification stage entails a liability. When goods and services are delivered, the documentary evidence that the goods have been received and that the service was actually performed must be verified.

- *Payment*. At this stage, payments are made. Before this is done, it is necessary to confirm through appropriate accounting controls that (i) the expenditure has been regularly committed; (ii) a competent person has signified that the goods have been received or that the service has been performed as

expected; (iii) the invoice and other documents requesting payment are correct and suitable for payment; and (iv) the creditor is correctly identified. After final payment is made, it is necessary to examine and scrutinise the expenditures incurred and report any irregularities.

Keeping commitments under control requires: (i) effective control of the uses of the appropriations at the commitment stage; (ii) sound budget formulation to ensure the conformity of commitments with budget forecasts; (iii) control of multi-year commitments; and (iv) good internal (management) control systems.

A complete budgetary/appropriation accounting system is necessary to keep track of transactions at each stage of the expenditure cycle.

To ensure efficient budget implementation, internal controls (made within line ministries) should be generally preferred to ex ante controls performed by a central agency, but this requires setting up robust management control (and internal audit) systems within line ministries.

For efficient implementation of programmes, managers should have a certain degree of flexibility in determining which inputs are needed to produce the services. Nevertheless, to keep expenditure under control, rules for limiting transfers between personnel and non-personnel items must be established. Transfers between programmes should not alter the priorities stated in the budget.

Appropriations are spending limits, which in principle lapse at the end of year. However, if the budget system is disciplined, carry-over appropriations may be considered for capital expenditures, and a small proportion of running expenditures. In every case, carry-over must be strictly regulated and submitted for the approval of the ministry of finance.

A comprehensive mid-term review of the implementation of the budget is needed to ensure that programmes are being implemented effectively, and to consider changes in the economic environment and other unforeseen developments that have budgetary implications. In-year supplementary appropriations may be needed through an amending budget adopted by parliament, but the scope and content for such supplementaries should be strictly regulated by the ministry of finance and the number of amending budgets limited to no more than one or two per year.

3. Budgeting and control of personnel costs

To improve the management of the public service in transition countries, improve the work incentives of employees, and strengthen the control of personnel costs, actions should be undertaken in several areas, notably the following:

- Most existing laws and all existing draft laws should be reviewed to ensure that their impact (fiscal and otherwise) has been assessed, and that the capacity is available within the government to ensure effective implementation. The administrative process needs to be strengthened in several countries both in terms of legislation, oversight capacity and judicial review. A general Administrative Procedures Act should be considered in countries lacking one.

- Remuneration schemes should be reformed to offer career and performance incentives and to provide transparency and predictability.

- Computerised pay-roll administration systems should be made compatible throughout the administration to provide pre-conditions for better control of staffing and personnel costs as well as for staff planning.

- Anti-corruption programmes or activities should be given political priority and need to be launched and implemented in most countries as a complement to legal and institutional reform.

- Training is needed to promote consistent implementation of the civil service law and to provide for a reformed administrative culture. Training should also be better linked to career progression.

Besides these actions, transition countries should consider favourably establishing standards and procedures to control the classification level of posts in civil service organisations. Another useful measure to improve quality and efficiency in government decision-making is the formation of a senior group of civil servants, centrally managed through appropriate institutions and procedures in order to provide stability and professionalism of the core group of top managers.

Fiscal control of personnel expenditures is one of the most crucial issues in budget management. The ministry of finance must be involved in the following areas, which should be integrated into the budget process: (i) decisions on changes in manpower levels in line ministries; (ii) short- and longer-term financial implications of staff reduction and retrenchment policies, including pension liabilities; and (iii) financial components of the pay structure for the civil service as a whole.

In many EU Member States, public service pay is determined through central mechanisms that determine both the total pay bill and the annual increases in personnel costs, rather than through decentralised systems in which government agencies or ministries have autonomy in managing staff and adjusting pay. Whatever approach is followed in the transition countries, the centre of government, especially the ministry of finance, needs to strengthen its horizontal systems for monitoring and controlling personnel costs.

Specific limits for personnel spending should be established. These limits should consist of both spending limits and staff ceilings. Information on manpower levels should be produced regularly by spending agencies, should distinguish between occupied and non-occupied positions, and should include data on the use of casual staff and consultants. Staff ceilings consistent with budget appropriations should be published in the budgetary documents.

In a number of transition countries, the wage payments related to non-occupied positions are shared among staff of spending units. "Special funds" are sometimes established, for the exclusive use of line ministries, to top up salaries, hire consultants and for other purposes. Such practices should be phased out. Internal controls should also be set up to prevent unauthorised transfers of funds from salary budgets to increase bonuses and allowances.

In parallel to improving budgetary management of personnel expenditures, transition countries must build adequate capacity for the managerial co-ordination and control of personnel management issues (civil service policy-making, initiating regulations, co-ordinating and monitoring personnel management in the line ministries and government agencies, and providing advice).

4. Public procurement

A properly functioning public procurement system that promotes fair and transparent competition for contracts awarded by public and private bodies is essential both to encourage market development and to promote good governance. Sound procurement policies and practices can reduce the costs of public expenditure, produce timely results, stimulate the development of the private sector, and reduce waste, delays, corruption, and government inefficiency.

Measures to improve procurement include: (i) the establishment of sound public procurement legislation, which should be in the countries concerned comply with the EC Directives and other international (e.g. WTO) requirements; (ii) the establishment of a central public procurement organisation (PPO) with the overall responsibility for the design and implementation of public procurement policy; (iii) development of the capacity of spending agencies in procurement; (iv) the design and implementation of national training programmes managed by the PPO; (v) the establishment of effective control and complaints review procedures.

5. Contracting-out

Contracting-out consists of transferring to the private sector some activities previously performed by government. When contracting out, it is necessary to: (i) scrutinise contracts and award them on a competitive basis; (ii) protect transparency and service quality; (iii) specify performance standards; and (iv) closely monitor the contractor's performance. Contracting-out may pose problems where the economic environment does not promote competition among contractors and the contractors are not closely supervised.

6. Cash management

Cash management has the following purposes: aggregate control of spending, efficient implementation of the budget, minimisation of the cost of government borrowing and maximisation of the opportunity cost of resources (i.e. deposit yielding interest receipts).

Cash planning is essential. It includes: (i) preparing an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, preparing monthly cash and borrowing plans; (iii) weekly review of the implementation of the monthly cash plan. To prepare monthly cash plans it is necessary to monitor commitments, in order to avoid arrears generation or delays in payment. Except under special circumstances, cash planning must be in line with budget forecasts.

A centralisation of cash balances is required. This centralisation should be made through a treasury single account (TSA). A TSA is an account or a set of linked accounts through which all government payment transactions are made. It should have the following elements: (i) daily centralisation of the cash balance; (ii) accounts opened under the authorisation of the treasury; and (iii) transactions that are recorded in these accounts according to a uniform classification system. For geographically remote spending units, however, it can be more cost-effective to put in place a system of separate bank accounts operated by means of imprest advances (meaning that a new advance is provided upon receipt of an accounting statement of the use of the previous advance). The use of a centralised TSA and treasury system must not lead to loss of responsibility of spending agencies in programme management. Spending agencies must keep their own accounting books and perform the required management controls, even when cash inflows and outflows are centralised.

Whatever the organisation of tax collection or expenditure payments, the treasury must be responsible for supervising all central government bank accounts, including accounts of extra-budgetary funds, if any. When commercial banks are involved in revenue collection or expenditure payments, the banking arrangements must be negotiated and contracted by the treasury.

7. Borrowing

The government's borrowing policy needs to be prepared in advance, and its borrowing plans should be made public. The medium-term external debt should be contracted in accordance with the budget or

multi-year expenditure programmes. Drawings and loans need to be accurately monitored. Borrowing and guarantees must be submitted to the parliament for authorisation and should be properly controlled. At a minimum, the budget should include overall ceilings for borrowing and guarantees.

8. Systems for internal control and internal audit

Internal control is set up by the government in order to ensure proper and effective functioning of ministries, agencies and other public bodies, consistent with their stated aims and objectives, and providing protection from waste, fraud and mismanagement. It includes a variety of mechanisms to ensure that budgetary and other policy decisions are executed properly, notably the following:

- Financial reporting.
- Performance monitoring.
- Effective systems of communication between managers and staff.
- Accounting controls.
- Process controls.
- Procurement controls.

Generally, the duties of officials working in government ministries and agencies should be clearly separated with a view to limiting risks of misconduct. Every government spending agency should include an internal audit unit, which is responsible for evaluating the effectiveness of the systems and procedures mentioned above.

A functionally independent internal audit/inspectorate mechanism with relevant remit and scope has to be put in place. It should meet the following criteria: (i) be functionally independent; (ii) have an adequate audit mandate; and (iii) use internationally recognised auditing standards. Systems must be in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence.

An effective system of internal control requires top management commitment to make it work effectively.

9. Establishing the National Fund system

The European Commission has shifted increasingly more responsibility for managing EU funds to the recipient country. The setting up of the National Fund system is a further step in this direction. The recipient country is responsible for the overall management of pre-accession funds, including conducting procurement operations through the Decentralised Implementation System (DIS). In the case of mismanagement or misuse of funds, the Commission can require the funds to be reimbursed.

As a result of the introduction of the National Fund system, countries need to adapt and strengthen their procedures for managing and controlling pre-accession funds. This includes:

- Establishing robust cash-management procedures, normally by incorporating the National Fund within the treasury system.

- Setting up and accrediting relevant Implementing Agencies responsible for the administrative and financial management of the funds.

- Strengthening internal audit and management (internal) control procedures.

- Establishing the required monitoring committees and monitoring procedures.

- Training staff involved in the National Fund system (e.g. staff in the treasury, National Fund, Implementing Agencies, internal audit departments/units and the supreme audit institution).

- Preparing the necessary secondary legislation and operating manuals.

The process of introducing the National Fund system is complex and time-consuming. All the ministries and organisations involved need to be included in the process of establishing the system, training staff and building the necessary organisational structures and working culture. It should normally be the ministry of finance to take lead responsibility for managing this process.

B. DIRECTIONS FOR REFORM

Budget execution needs generally to be improved according to two main lines: enhancing expenditure control and creating the conditions for increased efficiency in public spending. An adequate balance between these two different requirements must be found.

In transition countries, as a first step, reforms should focus on reinforcing the expenditure control systems. The preliminary condition for effective expenditure control is to prepare a realistic budget and identify measures to contain permanent commitments (such as entitlements, wages, etc.) when preparing the budget (see Part II). Concerning budget execution, particular attention needs to be paid to the following points:

- Release of funds in a timely manner.

- Cash planning in conformity with budget authorisation and taking into account ongoing commitments (a prior condition being a sound budget preparation). Improvement of revenue forecasts.

- Centralisation of cash balances (together with a centralisation of the monitoring of transactions) through a TSA.

- Effective controls of expenditure at each stage of the budget cycle (whatever the precise organisational form of these controls — ex ante, internal and external).

- Adequate budgetary monitoring, at each stage of the expenditure cycle (commitment, verification, and payment).

- Transparent procedures for procurement, which in the countries concerned must be in line with the EC Directives and WTO obligations.

- Enhanced responsibilities of the ministry of finance for managing and controlling personnel expenditures.

- Establishment of staff ceilings together with specific spending limits for personnel.
- Reinforcement of debt management procedures.
- Reinforcement of internal control systems.
- Establishment of internal audit units within spending agencies.

In the countries concerned, special attention needs to be given to the complex and time-consuming process of establishing the National Fund system for managing EU pre-accession funds.

Further steps can consist of improving efficiency in public spending through implementing flexible rules for making transfers of expenditure (e.g. from one chapter of the budget to another); carry over for capital expenditures and eventually operating expenditures, but under strict rules and supervision by the ministry of finance; and developing incentive measures to manage and forecast cash flows more efficiently.

PART IV

ACCOUNTING, REPORTING, AND AUDITING

CHAPTER 11

ACCOUNTING

Accounting and reporting systems are crucial for budget management, financial accountability, and policy-making. Thus, to ensure compliance and proper use of public money, it is necessary to track the uses of budget appropriations at each stage of the expenditure cycle. Concerns about the future impact of current policy decisions give governments an incentive to improve their accounting for liabilities, while operational performance concerns encourage the development of systems to assess the full costs of programmes and account for public assets and their uses.

A. Accounting Frameworks

1. 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.

a. Cash accounting

"The cash basis of accounting measures the flow of cash resources. It recognises 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.

Cash-based reports are required to demonstrate compliance with the appropriations, which in most countries are prepared on a cash basis. However, for the purpose of transparency, they must also be supplemented with data on commitments and liabilities arising from budget execution. Thus, in countries with a cash-based system, government accounting has traditionally had a two-fold approach: (i)"budgetary (or appropriation) accounting" which keeps track of appropriations and uses of appropriations at different stages of the expenditure cycle, especially at the commitment stage; and (ii) cash-based accounting which recognises a transaction only when cash is received or disbursed.[2] A cash-based accounting system is also supplemented by: (i) suspense or "below-the-line accounts" for some liabilities, such as the deposit of performance bonds by contractors, arrears, outstanding invoice payments, advances, and financial assets, such as imprests and liquid investments; and (ii) debt accounting on an accrual basis.

A common modification to the cash basis of accounting consists of holding the books open for a "complementary" period (e.g. 30 or 60 days) after the close of the fiscal year.[3] Because some cash

transactions made at the beginning of the fiscal year originate in the previous fiscal year, this modification is aimed at ensuring greater comparability between reported transactions and budget estimates. The complementary period concerns expenditures, and, less frequently, revenues. Payments during the complementary period that are related to transactions incurred during the previous fiscal year are reported as: (i) expenditure of the previous fiscal year; and (ii) movements of cash balances during the year in which they occur and debits of the "previous year's budgetary expenditures" account. Compared to the "pure" cash basis of accounting, this modification has the advantage of disclosing data on payables and receivables arising from budget execution, although only partly. However, holding two set of books during the complementary period, one for the current fiscal year, the other for the previous year, can lead to confusion and, sometimes, to creative accounting. Budget data must be adjusted chronologically to permit the comparison of fiscal and monetary statistics.

b. Accrual accounting

"The full accrual basis recognises 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 recognised when the assets are used to provide services" (IFAC, 1991). Full accrual accounting[4] is similar to the accounting systems for private enterprises (commercial accounting).

Financial statements produced under a full accrual accounting system cover revenues, expenses (including depreciation), assets (financial and physical, current and capital), liabilities, and other economic flows. The major features of accrual accounting systems are reviewed in detail later in this chapter.

Full accrual accounting is used to assess the full costs of programmes, which include consumption of fixed assets (depreciation).

Because requirements to implement full accrual accounting are heavy, there are in practice many modifications of the accrual basis of accounting, for example:

- Recognition of most assets and liabilities in accordance with the accrual basis, but recognition of revenues on, or close to, a cash basis since it can be a problem to calculate accurately what should be collected.

- Recognition of all liabilities with the exception of certain items, such as pension liabilities, where these programmes are revenue funded.

- Recognition of all assets apart from certain types of assets such as infrastructure, defence and cultural assets that are written off (expensed) at the time of acquisition or construction (e.g. Spain).

- Writing off all fixed assets at the time of acquisition or construction (e.g. most provinces in Canada). This method is sometimes referred to as "modified accrual accounting",[5] or "expenditure method", the term "expenditure" having the meaning given by the SNA93. (The SNA93 distinguishes the *uses of resources,* that is *expenses* recognised under full accrual accounting, over the accounting period from the *expenditures* incurred, which are the value of goods and services acquired over the same period). This modification of the accrual accounting basis cannot be used to assess the full costs of programmes, but it is easier to implement than full accrual accounting. Compared to cash accounting it has the advantage of accounting for payables at the time they are incurred, not at the time they are

paid and, more generally, of providing a framework for assessing liabilities. It is well suited to the basic requirements of government accounting and reporting.

2. Comparisons between the accounting bases

Box 11.1 and Figure 11.1 illustrate the broad differences between the cash, full accrual and modified accrual bases of accounting.

Box 11.1. AN EXAMPLE OF A COMPARISON OF ACCOUNTING BASES

Date	Transactions	Amount	
	Commitment 1996	**3,100**	
October 1996	Order of stationery	1,100	
October 1996	Order of office equipment	2,000	
	Undelivered or cancelled orders	**100**	
November 1996	**Delivery-Verification 1996**	**3,000**	
	Order of stationery	1,000	
	Order of office equipment	2,000	
	Payments 1996	**500**	
December 1996	1st partial payment of deliveries of Nov. 1996	500	
	Payments 1997	**2,500**	
January 1997	2nd partial payment of deliveries of Nov. 1996	1,500	
June 1997	Last partial payment of deliveries of Nov. 1996	1,000	
	Uses of goods and services 1996-2001	**3,000**	
Nov-Dec 1996	Use of stationery	300	(700 stocked)
Jan-Dec 1997	Use of stationery previously stocked	700	
1997 to 2001	Use of equipment (depreciation)	400	per year

Basis of accounting	Account	Debit	Credit
Year 1996			
Cash	**Expenditures on a cash basis**	**500**	
	Cash-Bank *(payments)*		500
Modification of accrual accounting: expenditure method	**Expenditures**	**3,000**	
	Current expenditures: *delivery of stationery*	*1,000*	
	Capital expenditures: *equipment acquired*	*2,000*	
	Variation of liabilities *(deliveries minus payments)*		2,500
	Cash-Bank *(payments)*		500
	Variation of physical assets		
	(Equipment acquired or written off)	2,000	2,000
Full accrual	**Expenses** *(Use of stationery)*	**300**	
	Variation of physical assets	2,700	
	Inventory: stationery stocked	*700*	
	Office equipment acquired	*2,000*	
	Variation of liabilities *(deliveries minus payments)*		2,500
	Cash-Bank *(payments)*	500	

(cont'd)

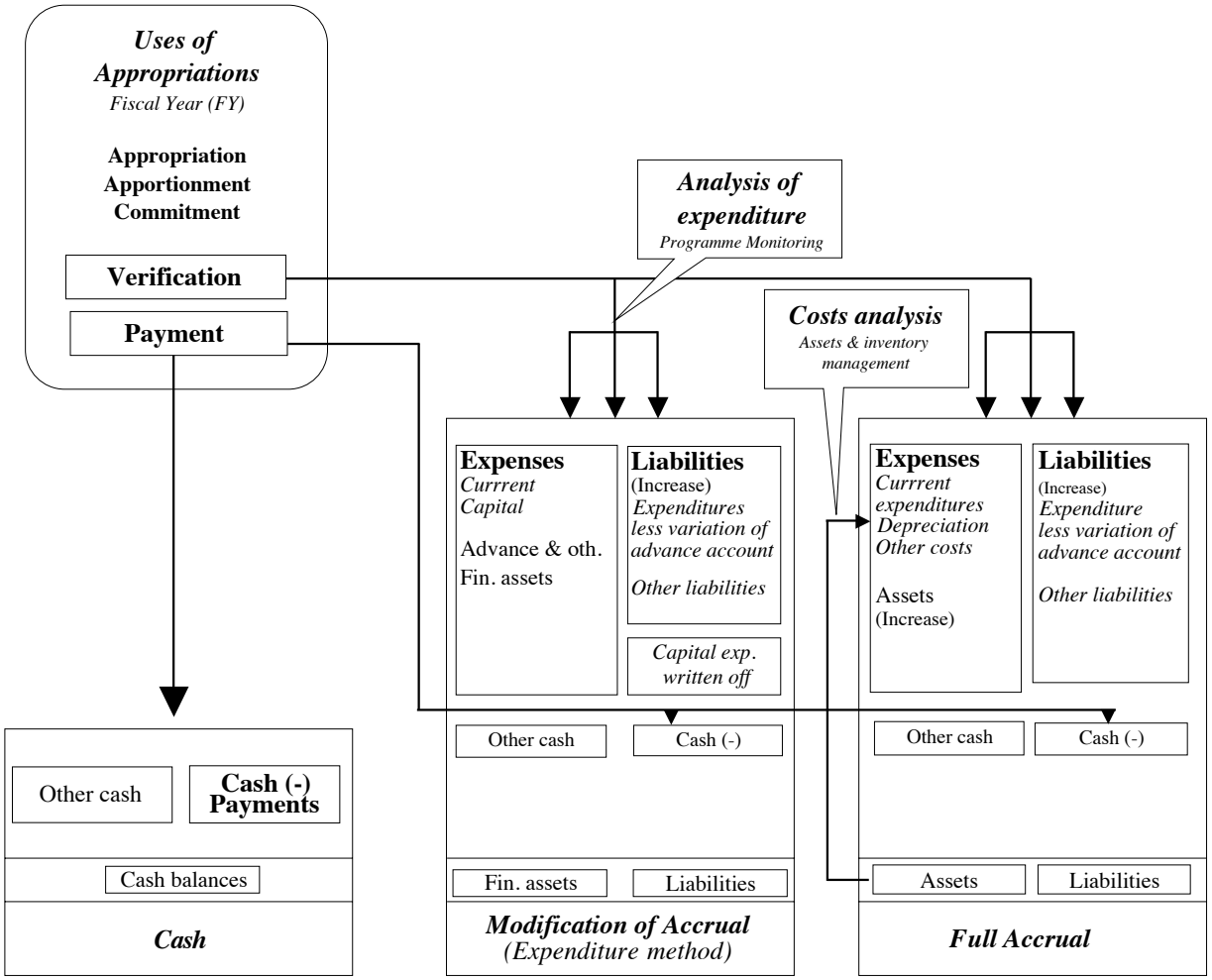
Box 11.1. **AN EXAMPLE OF A COMPARISON OF ACCOUNTING BASES** *(cont'd)*

Basis of accounting	Account	Debit	Credit
Year 1997			
Cash	**Expenditures on a cash basis**	**2,500**	
	Cash-Bank *(payments)*		2,500
Modification of accrual accounting: expenditure method	**Expenditures**	0	
	Variation of liabilities *(payment of deliveries made in 1996)*		2,500
	Cash-Bank *(payments)*	2,500	
Full accrual	**Expenses**	**1,100**	
	Use of stationery	*700*	
	Depreciation of equipment	*400*	
	Variation of physical assets		1,100
	Variation of liabilities *(payment of deliveries made in 1996)*	2,500	
	Cash-Bank *(payments)*		2,500
Period 1998-2001			
Full accrual	**Expenses**	**1,600**	
	Variation of physical assets (depreciation)		1,600

Figure 11.1 shows that accrual accounting requires an analysis of the invoices in order to identify: (i) the increase in physical assets (which can be immediately written off under certain modifications of the accrual basis of accounting); and (ii) other contractual payments (e.g. variations in the advance payments account). Whatever the accounting system, this exercise is required particularly for civil works, since the contractual payment schedule is generally different from the works schedule. Full accrual accounting requires a detailed analysis of costs. This needs an appropriate financial management system that does not rely only on traditional budget management information.

Accounting requirements depend on programmes and agencies. "Governments and their units might report on more than one basis to meet different needs. The most appropriate basis in a particular circumstance will depend on the nature and characteristics of the entity, and the type and purpose of the report. It will also depend on the costs and benefits of developing and maintaining financial information systems. Costs increase as one moves from cash to full accrual and those costs need to be weighted against the benefits to be gained from the information" (IFAC, 1991). A full accrual accounting system may be needed for an agency that delivers services or has commercial activities, or needs to fully account for its stewardship of state assets and its management of state liabilities. IFAC noted in 1991: "While the full accrual basis is an appropriate basis for reporting on performance in terms of asset management and cost efficiencies, it may not be the most appropriate basis for reporting if other performance criteria are determined to be more important. For example, emphasis on compliance with the entity's legally adopted budget [unless it was on an accrual basis] would place more importance on cash flows".

Figure 11.1. **CASH AND ACCRUAL ACCOUNTING OPTIONS**



As discussed later in this chapter, a comprehensive "budgetary accounting" (or "appropriation accounting") procedure covering the three stages of the expenditure cycle (commitment, verification and payment) should be the common denominator of every accounting system. In order to analyse the quality of an accounting system, it is necessary to review among many factors the following issues:

- How are the uses of appropriations tracked? At which stages of the expenditure cycle are they recorded in the accounts? What is the definition of a commitment?

- What transactions are recognised as expenditure, over the complementary period, if any? What are the procedures for keeping books open and for closing the books? Is a payment posted into the accounts at the date of payment?

- Does the accounting system cover all government agencies (including extra-budgetary funds if any)?

- What liabilities are recognised? Only those arising from budget execution, or other liabilities as well (e.g. superannuation liabilities and debt outstanding)?

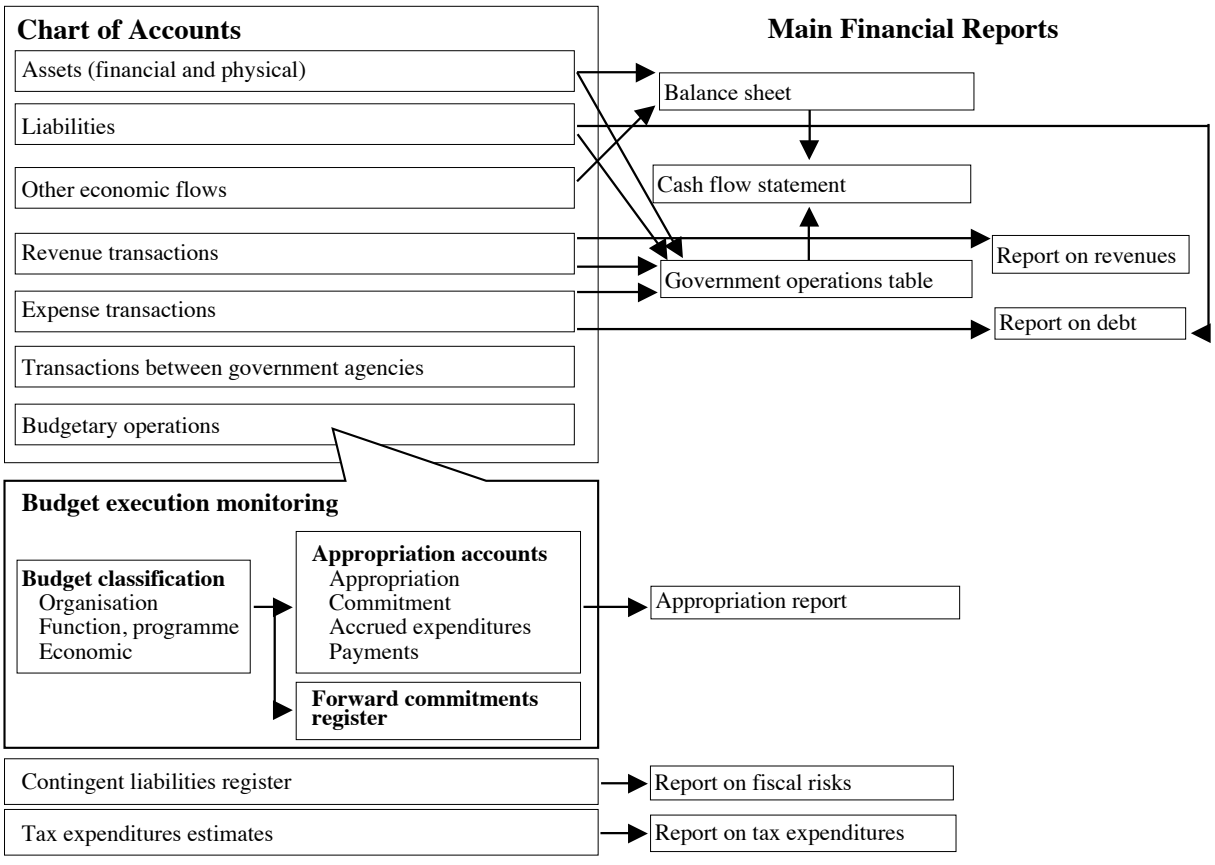
- Are contingent liabilities accounted for and disclosed?
- Are financial assets accounted for and disclosed?
- Are the government's physical and other assets and their uses registered?
- Are the accounting standards and procedures clearly specified?

3. Chart of accounts and general ledger

A chart of accounts is a classification of transactions and events (payments, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature. It defines the organisation of the ledgers kept by the government accountants. It is a framework for recording transactions and other events in order to provide an overview of operating results and the financial position of the government, and to create a necessary link with financial reporting requirements. The budget classification system reviewed in Chapter 4 defines the structure of the accounts or subaccounts of the chart of accounts that are related to budgetary operations. Figure 11.2 illustrates a chart of accounts and its relationships with the main financial reports reviewed in Chapter 12.

Under a cash accounting system, the chart of accounts is often limited to budgetary accounts for payments, a few accounts for posting internal financial transactions and financing operations, and

Figure 11.2. **CHART OF ACCOUNTS AND FINANCIAL REPORTS**



eventually a commitment account (or ancillary books for commitments). Under accrual accounting, expenditures at the verification stage are recognised as liabilities. Hence, they must be recorded in a ledger, which includes accounts for assets, liabilities, expenditures and expenses, revenues, etc.

Preferably, a chart of accounts should include accounts for assets and liabilities, even when the chart does not incorporate the full accrual basis of accounting. This information is needed to monitor financial assets and liabilities, and will facilitate possible future progress towards full accrual accounting.

Some transition countries already account for assets (although often roughly), and for expenditures (at the verification stage). However, their accounting framework is sometimes fragmented. For example, in some transition countries, a cash-based chart of accounts is managed by the treasury, while an accrual-based accounting system is maintained by the spending agencies. Thus, the treasury does not systematically report data on arrears, although expenditures at the verification stage are recorded by spending agencies. In such situations, a comprehensive chart of accounts would contribute to unifying the accounting system.

Financial statements are prepared on the basis of the categories defined in the chart of accounts. The set of books or the database where all the transactions are recorded, according to the specification in the chart of accounts (including the budget classification system) is called the General Ledger. With a computer-based integrated financial management system, each transaction and its attributes can be recorded in an accounting and budget execution system, or Financial Ledger System.

B. Accrual Accounting

A review of accrual methods gives direction and pointers to improving an accounting system. All transition countries should improve progressively their accounting for liabilities, according to accrual accounting principles, and central and eastern European countries should be able to estimate the fiscal deficits in accordance with the EU standards (ESA95). Nevertheless, implementing full accrual accounting for the government's financial reporting is not yet among the highest priority tasks for transition countries. Thus, for the moment at least, in a majority of EU countries, the central government financial reporting and accounting system is not on a full accrual basis, despite the fact that the national accounts are prepared according to the ESA95 standards, which are on an accrual basis.

1. Stocks and flows

Accrual accounting recognises stocks (assets and liabilities) and flows. Stocks refer to the holdings of assets and liabilities, and to the calculation of net worth, which is the difference between the total value of assets and the total value of liabilities. Flows reflect the creation, transformation, exchange or transfer of economic value, and either an increase or decrease in net worth. The SNA93 and GFS 2000 manuals distinguish two types of flows: transaction flows and other economic flows. Transactions may take place between organisations (e.g. two government ministries or agencies) or within a single organisation. An example of a transaction that involves a single organisation is the consumption of fixed capital. Transactions can be in cash or in kind, and include barter arrangements. "Other economic flows" include changes in the volume of assets and liabilities (such as the destruction of assets caused by catastrophic natural forces) and changes in their values (such as foreign exchange losses), which are termed "holding gains and losses" or "revaluations".

In GFS 2000, transaction and non-transaction flows are reported in two different financial statements. The term "revenue" is used to refer to the set of transactions that increases net worth, and the term

"expense" to the set of transactions that decreases net worth. However, the terms "expenses" and "revenues" are sometimes used for both transactions and other economic flows.[6]

In some countries that have an accrual accounting system, assets are valued at their historic cost less accumulated depreciation or they may be revalued periodically. When an asset is sold or transferred, there is usually some difference between the transaction price and the recorded book value. This difference is shown as a gain or loss on the sale. In contrast, the GFS 2000 requires that all assets and liabilities be valued at market value, and, therefore, revalued to current prices every year. As a result, in GFS statements, changes in value of assets and liabilities from one period to the next are treated as other economic flows, but not recognised as an expense or a revenue when an asset is disposed of or a liability is liquidated in a transaction (IFAC, 2000). Other allowable valuation methods used for assets are "replacement cost" and "value in use".

2. Revenues

In GFS 2000, revenue transactions include taxes, social contributions, grants received from other governments or international organisations, and other revenues such as sales of goods and services, interest, and fines and penalties.[7]

While cash accounting recognises the sale of assets as revenue, under full accrual accounting the sale of an asset is not a revenue transaction because it does not affect net worth. For example, the sale of an office building or the privatisation of a public corporation is not defined as revenue.

As noted above, the accrual basis of accounting recognises the effects of transactions and other events in the period during which they occur, regardless of the timing of the associated cash receipts. Thus, all taxes should be recorded along with the activities, transactions or other events that create the liability to pay taxes. For example, a tax on the sale of goods should be recorded when a sale takes place. Income taxes and social contributions based on income should be recorded in the period when the income is earned. However, a tax should be recognised only if it is probable that it will be collected and if its amount can be measured with reliability. To be recognised, the tax must be supported by appropriate documents (e.g. a tax assessment, invoice or declaration), and an estimate of when it is expected to be collected. However, because there may be a significant delay between the end of the accounting period and the time it is feasible to determine the actual tax liability, practical considerations may require that data for such taxes be compiled on a basis that does not conform fully to the accrual basis.

In industrialised countries that have an accrual accounting system, practices vary concerning the actual timing at which revenue transactions are recognised. In countries that experience tax collection problems and accumulate tax arrears, "it may be preferable for analytic and policy purposes to ignore unpaid tax liabilities and confine the measurement of taxes to those actually paid".[8] In many transition countries, revenues should preferably be disclosed in the financial reports on a cash basis. (Obviously, databases and systems for tracking taxpayers and tax arrears are also needed.) In every case, the basis on which tax data are compiled should be clearly indicated in the financial statements. When accrual accounting methods are used, revenues collected on a cash basis over the accounting period should also be disclosed, and accrued revenues should be compared to those actually collected.

Besides revenue transactions, other economic flows that increase assets or decrease liabilities include gains when selling assets (sale value compared with the net book value of assets), revaluation of assets, debts written off, etc.

3. Expenses

a. Main expenses

Expense transactions include the following items:

- Personnel costs, including pension liabilities.
- Goods and services used over the accounting period (including uses of capital assets, that is depreciation).
- Interest and other financial costs.
- Government subsidies, grants and transfers.

A capital expenditure is not an expense. Moreover, since payment schedules for construction works do not correspond systematically to the progress of the work, the accounting increase in the physical assets may differ significantly from the payments due over the period.

b. Pension expenses

The most common fiscal analyses treat pension contributions as a revenue item and pension payments as an expense. However, transactions in unfunded government pension schemes may have a significant future fiscal impact. Each year, government employees earn entitlement to future benefits, and the costs of providing for these future superannuation/pension benefits is recognised as an expense in a few countries. The pension liabilities are equal to the actuarial value of future pension payments (calculated under certain economic and demographic assumptions). If pension contributions are paid into a pension fund and are sufficient to cover the final employee benefits, the scheme is referred to as fully-funded, and for the government the accrued liability may be non-existent or negligible. If, instead, the government pays the pensions under a "pay-as-you go" system, or the system is partly contribution-based so that payments into the scheme are lower than the expenses, the scheme is referred to as an unfunded or a partially funded scheme. In such cases, the superannuation liability may be significant.

Assessing pension liabilities is important for policy formulation. It would reveal, for example, whether a fiscal deficit problem is merely shifted into the future instead of being resolved immediately. There is a temptation for hard-pressed governments to meet short-term cash deficit objectives by increasing their long-term liabilities. For example, in developed countries, governments sometimes promise pension increases in lieu of salary raises (see Hillier, 1997), or obtain revenues from public enterprises in exchange for the transfer of pension liabilities of these enterprises to the budget. However, in practice the recognition of pension liabilities and expenses poses problems. The estimation of pension liabilities needs adequate technical capacity and includes a large element of judgement, which make such calculations vulnerable to manipulation for political and other reasons. [9]

These remarks could suggest that transition countries should maintain the conventional methods of treating pension contributions as a revenue and pension payments as an expense, but in parallel should attempt to assess the value of their superannuation liabilities. If this assessment is reliable, then the superannuation liabilities could be disclosed in memorandum items to the financial statements together with explanations of the calculations and assumptions.

c. Uses of goods and services

Expenses include the uses of goods and services acquired over the period, the uses of inventories and the consumption of fixed assets (depreciation). Full accrual accounting is used to estimate the full costs of the services produced in order to assess efficiency in operations and service delivery. An assessment of the full costs, which includes depreciation, is necessary to estimate properly user charges, and, if any, the subsidy component of these charges, or the costs of capital intensive programmes. For other programmes, the benefits achieved in practice by recording and reporting full accrual information are sometimes questionable. The high collection costs of such information need to be weighed against the benefits to be gained from the data.

To assess properly the full costs of programmes, the costs shared by different activities and overheads must be allocated to each programme. (The issue of cost measurement is discussed in the last section of this chapter).

d. Transfers

The government's transfers include grants to government units or international organisations, subsidies and capital transfers to enterprises, and transfers to households or non-profit organisations. To recognise a transfer, it is necessary to assess whether there is in fact an obligation; whether the transfer is authorised; whether the beneficiary group can be identified, etc. These decisions are partly a matter of judgement. However, such assessments should be made at least for the most important transfers. Whatever the basis of accounting, it is necessary to assess the liabilities arising from external obligations (e.g. contributions due to international organisations), and the costs of existing policy commitments in areas such as social assistance.

Loans granted by the government often include an interest subsidy and might not be repaid. Under accrual accounting, the interest subsidy must be recorded and the risk of failure of the debtors to repay should be assessed. This method complements the suggestion made in Chapter 1 of including these loans in the budget, but is not a substitute for it. The loans should always be authorised by the legislature.

4. Liabilities

A liability is defined as "a probable future outflow or other sacrifice of resources as a result of past transactions or events".[10] Liabilities include, notably, the following categories: (i) accounts payable; (ii) other accrued liabilities, e.g. pensions; and (iii) debt outstanding. A commitment entails a liability when the other party has complied with the provisions of the contract.

Adequate management systems and procedures are needed to manage payables and take better account of unfunded liabilities in the budget. Issues related to debt management are reviewed in Chapter 9. Other liabilities covered by an accrual accounting system concern, notably, liabilities related to government pensions, including hidden liabilities related to independent pension schemes that the government will support if they cannot fulfil their obligations.

A contingent liability is a potential liability that depends on a future event arising out of a past transaction. Under accrual accounting, contingent liabilities are recognised as real liabilities when: (i) it is probable that future events will confirm that, after taking into account any related probability of recovery, an asset has been impaired or a liability incurred at the balance-sheet date; and (ii) a reasonable estimate of the amount of the resulting loss can be made.

Such an assessment can be difficult to make. The first step should be to publish the list of loans guaranteed. Then, the preparation of a more complete statement of contingent liabilities should be considered. These statements would include a schedule of payments related to the liabilities concerned and give some indication of the probable or most likely loss.

5. Assets

In principle, full accrual accounting could recognise the following categories of assets:

- Financial assets such as cash, revenues receivable, loans, etc.
- Physical assets such as property, plant and equipment, physical infrastructure, heritage assets, defence or military assets, and natural resources.
- Intangible assets, such as mineral exploitation or fishing rights (in theory at least).

Accounting for physical and intangible assets, where possible, increases fiscal transparency. Sales of assets made through a privatisation programme, auctions of government property rights or sales of gold reduce the cash deficit artificially. Sales of mineral rights are in some countries an easy way to "balance" the budget, to the detriment of future generations. Identifying losses or gains related to the sale of intangible assets is not an easy matter, however.

Information on assets and inventories is needed for preparing decisions on maintenance, or the acquisition of new equipment and supplies. Whatever the basis of accounting, most countries need to improve their asset management. Asset registers must be maintained, and subjected to periodic physical comparisons, beginning with sectors and/or types of assets for which asset management is crucial (e.g. road maintenance agencies, computers, cars). A full accrual accounting system provides a framework for setting up asset and inventory registers. However, assessing the value of all assets and recording them correctly in the accounts need time, and many countries have more urgent priorities. Thus, to improve asset management, it can be more cost-effective to begin with registering physical assets, rather than refining the accounting system. Transition countries that already account for their assets could improve their valuation methods, but at present they should focus on accounting for cash, financial liabilities and multi-year commitments.

To promote transparency, operations related to the sale of assets should be disclosed. Once-off operations should be separated from other transactions in the accounts and financial statements. Issues related to the valuation of national parks, museum and gallery collections, and other heritage assets are sometimes debated. Critics argue that there is no market for these assets and that, by definition, they are unlikely ever to be sold. Others (for example, the UK) make a distinction between operational heritage assets (i.e. those used for other purposes such as office buildings) and non-operational assets. Others argue that even if there is no market, such assets should be given a nominal value and that to include them in the valuation exercise is important from the standpoint of internal consistency. On such issues, standard working practices vary, depending on the nature of the asset and on the country concerned. There are also different views about the valuation of military equipment though in most countries such assets are now capitalised.

6. Financial statements

Under accrual accounting, the financial statements cover both stocks and flows, and demonstrate that all changes in stocks result from flows. In addition to disclosing flows on an accrual basis, information

on the sources and uses of cash must also be disclosed in order to assess the liquidity of the government sector and to strengthen expenditure control. The financial statements prepared under accrual accounting principles are presented in Chapter 12. The key indicators given by the financial statements are net operating balance, net borrowing/lending, policy and cash balance and the change in net worth. As noted, the net borrowing balance should be calculated in conformity with the ESA95 standards in every country in Central and Eastern Europe, even if a full accrual accounting system is not set up. This requires establishing a proper system of accounting for liabilities and financial assets.

C. Reforming an Accounting System

1. General approach

Reforming an accounting system requires, first, analysing its major weaknesses. For example, are liabilities arising from budget execution (arrears) completely and accurately monitored, payments reported in a transparent manner, accounting procedures clearly defined and enforced? Priority improvements in accounting should aim at consolidating the foundations for sound accounting.

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

- Effective procedures for bookkeeping, systematic recording of transactions, adequate security, and systematic comparison with banking statements. Computerising the accounts may help to improve accounting procedures, but the related security issues should be reviewed. Some countries have implemented or are implementing "light" computerised systems in order to facilitate the production of timely monitoring reports. Such systems can improve information dissemination, but often, data are not properly secured (backup procedures, control of access, etc.). In such situations, manual systems should not be abandoned completely.

- All expenditure and revenue transactions should be recorded in the accounts, according to the same methodology. This information should cover funds with earmarked revenues and foreign and domestic loans.

- A common set of expenditure classifications according to functional and economic categories.

- Clear and well-documented accounting procedures and clearly defined concepts (the notion of commitment, for example, can be interpreted in different ways).

- Financial reports and statements that are produced regularly.

- An adequate system for tracking the use of appropriations ("budgetary accounting"), at each stage of the expenditure cycle (commitment, verification, and payment).

- Transparent reporting of transactions made through "below-the-line", suspense or liability accounts.

- Whatever the basis of accounting, notes to the financial statements should indicate the main accounting policies and provide sufficient detail to permit correct interpretation of the information, and a statement of accounting policies.

Priority areas for improving an accounting system could be as follows:

- Implementation of a comprehensive system of budgetary accounting for tracking appropriations and their uses at each stage of the expenditure cycle. It should cover appropriations, apportionment, any increase or decrease in appropriations, commitments/obligations, expenditures at the verification/delivery stage, and payments. Budgetary accounting is only one element of a government accounting system, but it is the most crucial for both formulating policy and supervising budget implementation.

- Accounting for debt and disclosure of financial liabilities and contingent liabilities, in line with accrual accounting principles.

In parallel, asset registers should be set up and/or updated, starting with agencies where the need is more urgent.

2. Tracking the uses of appropriations

a. Weaknesses of existing systems

Weaknesses in tracking the uses of appropriations ("budgetary accounting") are common. Sometimes, "internal payments" (i.e. transfers of funds between government agencies) and "true" payments get mixed up. Line by line consolidation of expenditures, autonomous agencies, special accounts and expenditures of the consolidated or budgetary fund is required. Funds and autonomous agencies may have specific management procedures, but must report according to a common set of expenditure classifications. Supplementary estimates, transfers, releases, allotments, etc. are often followed up in a fragmented manner. In several countries, it is difficult to determine which budget is being implemented, since data on supplementary estimates and transfers are not brought together within a single document.

In countries with a cash accounting system, spending agencies sometimes keep commitment registers. However, information on commitments and expenditures at the verification stage is not systematically available at the level of the ministry of finance, which would need such data to supervise budget implementation. Suspense or "below-the-line" accounts may cover some outstanding liabilities, but make up only partly for a lack of satisfactory monitoring of expenditures (at the verification stage) and liabilities. Moreover, the use of suspense accounts is sometimes not transparent and corresponds to off-budget expenditure.

As indicated earlier, a number of countries use a "complementary period". This has the advantage of taking into account the time interval between obligations and payments. However, keeping open the books of the previous year can lead to questionable practices, such as executing two budgets at the same time.

Some countries account for expenditures on the basis of requests for payment sent by spending agencies to accounting offices or the treasury. When these countries face arrears problems, and accounting and budgetary procedures are unclear, these requests correspond neither to accrued expenditures nor to cash payments; this is because payment orders are not systematically issued when deliveries are verified, and not all issued payment orders are paid. Since private suppliers may request payment before delivering goods and services to a government that has the habit of accumulating arrears, payment orders are sometimes based on pro-forma invoices, although generally the financial regulations stipulate they should be issued when the goods and services are delivered. They are nevertheless entered into a liability account, where they sometimes stay for several months or even years. This account mixes true invoices, pro-forma

invoices, old vouchers for transfers to government entities, and subsidies that were budgeted but never paid. Budget execution reports show the requests for payments according to the budget classification. But the "real" budget execution consists of the selection of vouchers to be paid among the vouchers in the liability account.

More generally, all non-pure cash accounting systems pose problems when two sets of payments are made in parallel: one from the budget itself, and the other from the liability accounts or the suspense accounts that contain accrued expenditures of the previous year not yet paid. A number of countries with non-cash accounting systems do not disclose their payments in a transparent and comprehensive manner. (This among other factors explains the emphasis given to cash accounting in the budget reforms recently undertaken in many central and eastern European countries).

b. Main features of sound budgetary accounting

Whatever the basis of accounting, the following information is needed at each stage of the expenditure cycle:

- Confirmation of the legal basis for spending.

- Adequate recording of appropriations, revisions in appropriations, transfers between appropriations and apportionment is a prerequisite for good financial management. In countries with non-automated budget management systems, it is sometimes difficult to know exactly which budget is being implemented, because decisions concerning allocations and reallocations of appropriations are contained in various circulars and are not gathered into a single document. The budget implementation plan should be updated regularly to take into account decisions concerning appropriations.

- Accounting for commitments, including multi-year commitments, is essential for keeping budget implementation under control. Such information provides the basis for budget revisions. Decisions to increase or decrease appropriations and the preparation of cash plans must take into account commitments already made. For internal management, spending agencies need to follow up accurately orders made and the contracts that have been awarded.

- Accounting for expenditures at the verification stage is important to programme and agency management. It gives valuable information for assessing costs, although these data need to be combined with information on depreciation, inventories, etc. Expenditures at the verification stage show how far programme and project implementation has progressed. Recording expenditures is also required for managing payables and contracts, and assessing liabilities arising from budget execution (arrears).

- Transparency requires reporting all payments over the accounting period and the fiscal year in accordance with the expenditure classification system, including payments related to expenditures made in a previous period.

Transactions that are to be recorded must be clearly defined in the financial regulations. Sound budgetary accounting requires information to record transactions between budgetary accounts, namely, budgetary resource accounts (e.g. appropriations and apportionment/allotment); commitments; expenditures at the verification stage; and payment accounts. Obviously, double-entry bookkeeping systems are required from the stage at which the expenditure is recognised (verification in the accrual basis of accounting). In most countries, commitments are registered (if at all) in single entry books. However, including

information on commitments and appropriations in a double-entry bookkeeping system has the advantage of ensuring consistency of movements between budgetary accounts (particularly when budget execution is not fully computerised).

A sound system for recording transactions could be as follows:

- *When an order is placed*, it is recorded as: (i) an increase in commitments/undelivered orders; and (ii) a decrease in budgetary resources (or in forward commitment authorisations).

- *At the delivery/verification stage,* a transaction is recorded as: (i) an accrued expenditure/liability; and (ii) a decrease in commitments/undelivered orders.

- *At the payment stage,* a payment is recorded as: (i) a reduction in accrued expenditures/liabilities; and (ii) a reduction in cash.

In countries that only monitor payments, an immediate action should be to open an ancillary book for outstanding payments. However, assessing arrears from separate registers kept in parallel to the accounts is only a palliative measure.

In many transition countries, spending agencies keep books on an "accrual" basis (although not in conformity with generally accepted accounting principles), but there have been difficulties in the timely monitoring of payments according to the budget classification. Therefore, in many of these countries efforts have been made to implement a system of monitoring payments. Some aspects of the traditional accounting systems of these countries were purely formal. Nevertheless, these accounting systems have (or had) the advantage of registering expenditures at the verification stage (often named "actual expenditures"). Reinforcing cash accounting should not lead to the abandonment of monitoring "actual expenditures", which is particularly crucial in those countries that face arrears and a tendency to overcommit expenditures.

Each transaction should be accounted for at the actual date on which it is made. In the case of payments, there is a frequent problem related to the time lag between the date on which the cheque is issued and the date on which the bank account is debited. This problem can be solved if systematic reconciliations of the relevant bank statements are undertaken and reported and firm action is taken to clear long-standing balancing items. But, in addition to this common problem, there is sometimes confusion between procedures, plans, and accounting principles. For example, in one transition country the treasury branches account for payments on the date on which they are planned, not the date on which they are effectively made.

3. Disclosing liabilities

Improvements in accounting and reporting on liabilities and contingent liabilities are required in most countries. The following elements should be covered:

- The budget monitoring/accounting system, which should show the arrears that arise from budget execution (i.e. the difference between expenditures at the verification stage and payments).

- Any transactions that derive from the stock of arrears in the previous year.

- Debt accounting on an accrual basis.

- Accounting and reporting of unfunded liabilities and contingent liabilities.

4. Implementing full accrual accounting

Accrual accounting is standard practice for private sector activities and its importance within governments is increasing. Even when government administrative departments use cash accounting, full accrual accounting is desirable for agencies that perform commercial activities. The government is thus better able to regulate the management of these agencies.

However, caution is required before considering the implementation of a government-wide full accrual accounting system. Full accrual accounting requires a comprehensive registration of assets and a sound cost measurement system. Implementing such systems government-wide needs time and its cost-effectiveness needs to be carefully examined. Full accrual accounting would not contribute to the development of a performance-oriented approach to budgeting at the agency level if depreciation is roughly estimated. If accounting standards are not clearly specified and reported, accrual accounting leaves room for "creative accounting", through manipulating estimates of depreciation, provisions, recognition of losses, etc.[11] An effective external audit will help prevent this.

A gradual approach to implementing accrual accounting can be considered once a country has a sound and robust cash accounting system in place. It might start with those areas of government activity that require information on the value of physical assets, their uses and full costs (e.g. agencies that charge users for services provided). Taking into account the need to strengthen fiscal management, transition countries should focus first on implementing methods to better recognise financial liabilities in their accounts.

Making accrual accounting effective requires a true and fair recognition of expenses. Applying only formal accounting rules does not increase transparency. Accrual accounting therefore requires the availability of many highly skilled accountants both inside and outside the government. Accrual accounting can improve transparency but only if decision-makers and the public are well informed about the nature of the information provided and its financial implications. This is not always the case, even in many OECD countries where reporting by the financial media is often inadequate. For full transparency, governments should be prepared to encourage independent audit of its financial statements.

5. Administrative organisation of an accounting system

Two basic models can be considered for the organisation of accounting within the government:

- *Vertical model*. The accounts are prepared at the central level either by the treasury or a separate central accounting office. This organisational model fits the needs for controlling the execution of the budget. It has the advantage of centralising the storage of information, which is always difficult to achieve especially in a non-computerised environment. It can pose problems, however, since agencies often report commitments and liabilities only when they request payment. It does not encourage agencies to keep accounts, which is required for effective programme management.

- *Consolidation model*. Spending agencies prepare their accounts for consolidation at the central level. This model fits the needs of programme and agency management, but can lead to a loss of information when accounts are not consolidated in a timely manner. In a computerised environment, a comprehensive and timely monitoring of budget transactions could be ensured with adequate information systems recording transactions at each stage of the expenditure cycle, and appropriate electronic connections between the "ministry of finance" and line ministries.

The consolidation model seems preferable, but its implementation is in a large part linked to the computerisation of the expenditure cycle reviewed in Chapter 13.

D. Special Issues

1. Accrual budgeting

Including accrual accounting information in the budgetary documents is desirable, in principle. However, relatively few OECD countries (e.g. Australia, Iceland, the Netherlands, New Zealand, Sweden, and the UK) have moved in this direction. Of these countries, only a very few countries such as Australia, New Zealand and the UK have changed to or are in the process of changing to "full accrual budgeting", which consists of voting appropriations on an accrual basis. Indeed, there is a debate about the advantages and disadvantages of such a change, and systems that mix cash and accruals information are not uncommon. For example, the US has decided to retain its obligations-based system of budgeting in which information on cash transactions is supplemented by accruals information for certain categories of transaction, such as employee pension plans and interest expenses. The key issue is what system is most useful in relation to a country's objectives for strengthening the efficiency of budgetary operations, managerial accountability and full and accurate reporting of financial information.

Tables 11.1 and 11.2 show the current position for OECD countries.

In Iceland, appropriations are presented to the Parliament both on an accrual basis and on a cash basis. Such a presentation does not pose problems in relation to the classic rules of compliance described in Chapters 1 and 2. On the other hand, presenting an appropriation only on an accrual basis alters the usual parliamentary rules of compliance and accountability, since depreciation will become an element of the parliament's authorisation. Parliament may want to vote the allocations of cash resources by programme or agency. When appropriations are not cash-based, the preparation of cash plans and the control of cash releases need a stronger accounting system, and greater fiscal discipline, than in a cash budgeting system. Cash controls must be based on separate cash plans that are not directly derived from appropriations. The ministry of finance must have adequate technical capacity and authority to assess whether future depreciation would cause appropriations to be exceeded or not. Such a system could be difficult to implement in transition countries, especially in countries where the budget processes are dominated by bargaining.[12] To avoid these risks, transition countries should not abandon cash-based appropriations, whatever the basis of their accounting and financial reporting systems.

In a number of EU countries, the presentation of local government budgets in a balance sheet format is often stipulated by law or government regulations. In such cases, it is compulsory to include in local government budgets depreciation allowances and other reserves. This, together with other restrictions on local government spending and borrowing, is seen as an effective instrument to keep local government budgets under control.

2. Generational accounting

As noted earlier, net worth is a measure of the balance of assets and liabilities of the government. Some macroeconomists, following an orthodox monetarist approach, argue that the permanent income of the country, which depends on the net worth of the government, must be taken into account for the purposes of macroeconomic stabilisation. However, this is not a universal view and further economic research on the subject is needed.[13]

Table 11.1. **ACCOUNTING BASIS APPLIED FOR BUDGET APPROVED BY LEGISLATURE**

	Full Accrual Basis	Accrual Basis, except no Capitalisation or Depreciation of Assets	Cash Basis, except certain transactions on Accrual Basis	Full Cash Basis
Australia	X			
Austria				X
Belgium				X
Canada		X		
Czech Republic				X
Denmark			X(1)	
Finland		X(2)		
France				X
Germany				X
Greece				X
Hungary				X
Iceland		X		
Ireland				X
Italy		X		X
Japan				X
Korea				X
Luxembourg				X
Mexico				X
Netherlands				X
Norway				X
New Zealand	X			
Poland				X
Portugal				X
Spain				X
Sweden				X
Switzerland				X
Turkey				X
United Kingdom	X(3)			
United States			X(4)	

Notes:
(1) Denmark – Interest Expenses and Employee Pensions Treated on Accrual Basis.
(2) Finland – Transfer Payments Not on Accrual Basis.
(3) United Kingdom – Budget on Full Accrual Basis Effective Fiscal Year 2001-02.
(4) United States – Interest Expenses, Certain Employee Pension Plans, and Loan and Guarantee Programmes Treated on Accrual Basis.
Source: OECD (2000).

Several tools have been developed to evaluate the long-term impact of current policies on the net worth of the government (e.g. the measurement of contingent liabilities[14] and environmental accounting). Basically, this impact is estimated by the actuarial balance of flows of revenues, payments, depreciation of assets, etc., under different assumptions and for a given discount rate.

Generational accounting calculates, over a long period, the present value of public consumption, taxes, debt and intergenerational transfers (i.e. pensions) for a set of economic growth and demographic assumptions and for a specific discount rate. It takes into account government revenues and expenses on the basis of the generation to which these transactions are linked by adding up the present value of receipts less payments that a government expects to collect over the life span of the generation concerned.[15]

Table 11.2. **PLANS TO MOVE BUDGET TO ACCRUAL BASIS**

	Full Accrual Basis Budgeting to be introduced	Additional Accrual Basis information to be presented
Canada	X(1)	
Denmark		X
Germany		X
Korea	X(1)	
Netherlands	X	
Portugal		X
Sweden	X(1)	
Switzerland	X(1)	

Note:
(1) Under active consideration.
Source: OECD (2000).

Generational accounting is considered an important tool to describe the way the government budget affects the intergenerational distribution of income and wealth; and is an essential measure of the burden imposed by current and future budgetary policies on current and future generations. Likewise, it is an important indication of how the budget affects national savings and, thus, investment, interest rates, and economic growth.

Developers of generational accounting initially thought of it as an alternative to the traditional method of accounting for the government's revenues and expenses. They argued that the traditional approach focuses only on the very short-term, thereby creating a bias for fiscal policy, and fails to consider the future implications of government policies. They also believed that the conceptual framework underlying the traditional method of accounting for government revenues and expenses no longer exists and that classifications are "arbitrary" and sometimes manipulated for political reasons.[16]

Intergenerational equity requires that these flows be balanced in order to avoid creating a burden on future generations. Such calculations are made in several countries. The US was the first OECD country to use generational accounting by presenting such accounts in its budget for the fiscal year 1996. Several OECD countries followed, including Germany, Italy, New Zealand, Norway, Sweden, and most recently, the Netherlands.

Studies by the IMF and the OECD have concluded that, given the potential weaknesses of generational accounts as a measure of how the government budget affects intergenerational income distribution and savings, strong caution should be exercised in their use and interpretation. In the absence of an explicit consideration of the intergenerational implications of the government consumption programme, convincing evidence that the life-cycle model adequately characterises private consumption behaviour, and a fully articulated model of the general equilibrium repercussions of budgetary policy, what generational accounts are expected to indicate could be totally misleading. Generational accounting is used only as an analytical tool to illustrate the main trends of government policy.[17] As Premchand (1995) notes, generational accounts can serve at best only as analytical inputs, primarily because of the aggregate nature of the analysis and the imputations involved.[18] Moreover, to assume a significant impact of generational accounting on actual policy, politicians (and the public) around the world would need a far longer time perspective than is typically the case. As John Meynard Keynes remarked long ago: "In the long run, we are all dead."

It must be emphasised, however, that generational accounting is a very recent technique and in many respects is still undergoing enhancement. For instance, New Zealand has included education expenditures in addition to health care expenditures in its recently prepared generational accounts. In cases where a direct relationship between age groups and expenditures is hard to establish, certain expenditures are grouped as predominantly serving the young or the elderly, and use a per capita basis for distribution. Moreover, generational accounts can be enhanced by dividing more expenditure categories across generations and by incorporating a retrospective time horizon in which taxes and benefits are calculated not only for the remaining lifetime of each generation, but also in respect of the taxes paid and benefits received in previous years. This should provide for better comparisons between generations.[19]

3. Cost measurement

a. Full costs

The "full costs" of programmes include the costs of goods and services acquired and used over the period, and the consumption of fixed assets.

Cost information can be used in the following areas.[20]

- *Budgeting and cost control*. Information on the costs of programme activities can be used as a basis to estimate future costs in preparing and reviewing budgets. Once budgets are approved and executed, cost information can be fed back into the preparation of the next budget.

- *Performance measurement and programme evaluation*. Measuring costs is an integral part of measuring the efficiency and effectiveness of programmes.

- *Determining reimbursements and setting fees and user charges*. Setting prices that government agencies charge for services delivered (e.g. passports and company registrations) is partly a policy matter, but good measurement of the full cost of services delivered is needed to compare and evaluate different policy options.

- *Market testing*. Market testing requires comparing the costs of goods and services produced by government agencies with those produced by the private sector on a like-with-like basis.

Experiences in measuring central government costs on a wide scale date from 1949, when a comprehensive exercise of performance budgeting was launched in the US following the recommendations of the Hoover Commission. As discussed in Chapter 4, however, this experience was not successful. Difficulties that arose in measuring costs concerned both technical problems and the fact that "the government was more concerned with providing a service than recovering costs" (Premchand, 1993). Nevertheless, a new impetus has recently been given to cost measurement in several countries, aimed at setting-up instruments to improve the performance of government services. Box 11.2 provides a schematic comparison of cash payments and full costs.

For an assessment of full costs the following elements are needed: (i) a complete record of physical assets and inventories; (ii) estimates of depreciation; and (iii) sound cost measurement systems, since overheads and shared use of equipment by various programmes or activities must be imputed to each programme/activity.

Box 11.2. **COMPARISON BETWEEN FULL COSTS AND CASH PAYMENTS**

Cash payments (excluding capital expenditures)

+ Depreciation of physical assets over the period
+ Variations in liabilities over the period
  + *Unpaid deliveries of the period*
  – *Payment of deliveries of the previous periods*
+ Variations of advance accounts
  + *Supplies/works financed with previous advance payments*
  – *Advance payments made over the period*
+ Variations in inventories over the period
  + *Inventories consumed and losses*
  – *Increase in inventories*
+ Cost of services provided to other programmes/cost centres
– Cost of services provided to other programmes/cost centres

= Full costs

b. Cost measurement systems

Total costs comprise: (i) direct or variable costs that can be assigned to the goods and services produced, such as salaries and the cost of raw materials; and (ii) indirect or fixed costs (overheads) that are shared among several outputs. Within government departments, the problem of allocating overheads to outputs is particularly important, since the share of resources that cannot be assigned to a single output is generally significant. Often this allocation is arbitrary or derived from a simple ratio, for example, the direct labour cost of the output. Using arbitrary methods diminishes considerably the usefulness of cost measurement for management or decision-making.

Costing methods are elements of management systems.[21] They aim notably at addressing problems related to the allocation of overheads. Activity-based costing (ABC) has gained broad acceptance by the manufacturing and service industries. It is used by some governments, sometimes along with other costing methods.[22]

ABC systems trace individual costs back to the primary activity. This approach consists of the following steps:[23] (i) identifying activities within the organisational unit or the project; (ii) assigning resources to the activities (resource costs may be assigned to activities directly or may be estimated by the use of surveys and other techniques); (iii) identifying the outputs of the activities (the outputs can be products or services provided); and (iv) assigning activity costs to the outputs, through "cost drivers". A cost driver may be calculated in a number of ways: for example, the number of times an activity is performed in producing a specific type of output, or the length of time an activity is performed. An example of how ABC works in practice is shown in Box 11.3.

Costing methods provide tools for analysing costs, but operations and activities conducted within the organisation must be analysed in detail, appropriate accounting and information systems set up and

Box 11.3. AN EXAMPLE OF ACTIVITY-BASED COSTING

The Unit Cost of a Veteran's Benefit Check Processed for the Compensation and Pension (C&P) Service by the Finance Department (in US dollars)

• Direct labour cost incurred by the Finance Department in processing 700,000 C&P cheques	$700,000
• Cost of direct materials incurred by the Finance Department in processing 700,000 C&P cheques	$20,000
• Cost of indirect materials assigned to C&P based upon C&P's share of total cheques processed by the Finance Department. Assuming that the Finance Department processed 1,000,000 cheques during the fiscal year, 700,000 of which belonged to C&P, and that total indirect expenses incurred by the Finance Department during the current fiscal year amounted to $500,000, C&P's assignment of indirect costs is:	$350,000
• Total expenses:	$1,070,000
• Unit cost of processing one cheque ($1,070,000 divided by 700,000)	$1.53

In traditional US federal accounting systems, costs are calculated by object class categories such as salaries and benefits, office supplies, travel, and equipment. With ABC, costs are calculated by activity or process such as conducting biennial user fee reviews.

Source: United States, Chief Financial Officers Council (1997).

information updated regularly. The allocation of costs is not an objective science and the successful introduction of activity-based costing requires the active co-operation of management and staff.

c. Relevance of cost measurement

Currently, only a few countries are implementing cost measurement on a large scale. In New Zealand, for example, output budgeting implies a direct relationship between cost measurement and budgeting, but developing cost measurement systems needs time. In the US, the relationship between cost measurement and budgeting is indirect. Cost measurement is seen as a tool for improving performance, helping budget decision-making, and giving feedback, but appropriations for the operating costs of departments and agencies are cash- based.

To determine the extent to which cost measurement can be implemented within a government organisation, the cost effectiveness of carrying out this exercise must be assessed. In most transition economies, implementing a cost measurement system can be realistically considered only for special programmes or agencies, notably agencies that recover costs from the users by charging for services provided.

4. Capital charges

To account for the full costs of capital assets used in the provision of goods and services, it is necessary to take into account both depreciation and the remuneration of capital employed. Only a handful of countries have introduced a capital charge, explicitly shown as an expenditure item in the budget of ministries or agencies.[24] This capital charge is calculated by applying a charge rate to the assets that are owned or managed by the ministry or agency concerned.

Thus, in New Zealand, a charge for the use of capital was introduced in 1991. A charge rate of 13% was applied to the assets of agencies and departments, the payment of the charges being imputed to their budget (later a number of departments negotiated particular rates with the treasury) (Scott, 1996).

Introducing a capital charge can give incentives to spending agencies to use their capital more efficiently and can improve cost estimates, which are needed for establishing cost recovery. However, if applied without any change in cost management procedures, there is a risk that a capital charge would just be a formal procedure, compensated by an equivalent increase in budget appropriation. Its implementation requires appropriate systems for registering and valuing assets, and clearly delineating the organisation responsible for asset acquisition and disposal. The capital charge needs to be integrated within appropriate cost management and cost measurement systems. It is only one instrument among others to improve management and cost consciousness.

NOTES

1. IFAC (1991). IFAC (International Federation of Accountants) is an association of professional accounting bodies in 84 countries, which seeks to promote unified standards of accounting. Its Public Sector Committee (PSC) issues accounting standards for government and public entities.

2. Premchand (1993), page 267.

3. This method is termed "modified cash accounting" in IFAC (1991).

4. Or more simply, accrual accounting. In this book, the adjective "full" is added where appropriate to avoid confusion with the modified forms of accrual accounting.

5. For example, in IFAC (1991).

6. See definitions of expenses in IFAC (2000a).

7. In the 2000 version of GFS, the classification of revenue differs substantially from the classification adopted in the 1986 version of GFS. See Appendix I in International Monetary Fund (2000).

8. See SNA 1993, page 92.

9. Note that increases in liabilities that relate to government pension schemes are not included in the government operations table presented in GFS 2000.

10. United States FASAB (1995), Statement No. 5.

11. "[The scope for creative accounting] is greatest where there is trading, accrual accounting and ambiguity in the rules. It is least with cash accounting and clear rules. With commercial style accounts there are further pressures which reflect the much greater creative accounting possibilities of the private sector" (Likierman, 1993a).

12. Thus, in New Zealand, where appropriations for operating expenditures are on an accrual basis, both the Treasury and the Auditor-General perform an ex ante external control on cash flows. Such controls make use of accrual-based appropriations, a cash plan agreed between the Treasury and spending agencies, and monthly monitoring reports of the use of appropriations prepared by the departments and transmitted to the Treasury and the Audit Office. These ex ante controls cover the global cash needs of spending agencies, but are not specified by individual appropriations. See Scott (1996).

13. This issue is discussed in Buiter (1993).

14. See Towe (1993).

15. A generation is defined as persons born in the same year, differentiated into males and females. This differentiation recognises the different lifetime patterns of tax payments and benefit receipts for the two groups. For more discussion, see Buiter (1996).

16. See OECD (1997b), pages 14-15, for a more detailed discussion.

17. See Hagemann and John (1995).

18. An analysis of the conditions of validity of the generational accounting methodology can be found in Buiter (1996).

19. See OECD (1997b), pages 16-18, for further discussion of these issues.

20. Drawn in large part from the US Office of Management and Budget (OMB), "Managerial Cost Accounting Concepts and Standards for the Federal Government", *Statement of Recommended Accounting Standards, Number 4*, 1995.

21. Issues related to cost management systems and their application within government are reviewed in Premchand (1993).

22. As in the US and New Zealand.

23. OMB, "Managerial Cost Accounting Concepts and Standards for the Federal Government", *Statement of Recommended Accounting Standards, Number 4*, 1995.

24. In New Zealand, the capital charge is applied to all government agencies, in the United Kingdom to trading funds and the National Health Service. In the UK, capital charging will be extended to all areas of public expenditure when accrual budgeting is fully implemented in 2001-02.

CHAPTER 12

FINANCIAL REPORTING

A. General Principles

1. Objectives of reporting[1]

The essential purpose of a financial reporting system is to demonstrate how the government has managed its financial resources — revenues and expenditures, assets and liabilities. Ideally, therefore, it should answer the following questions:

- *Budgetary integrity*. Have resources been used in conformity with legal authorisations and mandatory requirements? What is the portion/part of appropriations not committed (i.e. not used)? What are the expenditures committed but not yet paid?

- *Operating performance*. How much do programmes cost? How were they financed? What was achieved? What are the liabilities arising from their execution? How has the government managed its assets?

- *Stewardship*. Did the government's financial position improve or deteriorate? What provision has been made for the future?

- *Systems and control*. Are there systems to ensure effective compliance with budgetary and financial regulations, proper management of assets and adequate performance?

Reports are an important instrument for planning and policy formulation. For this purpose, they should provide information on ongoing programmes and the main objectives of government ministries and agencies. Reports can also be used as a source of information for parliament and the general public. They give an organisation the opportunity to present a statement of its achievements, and to provide information for a wide variety of purposes.

Reporting must take into account the needs of different groups of users including: (i) the council of ministers, ministries, agencies, and programme managers; (ii) the legislature; and (iii) outside the government, individual citizens, the media, corporations, universities, NGOs and other interest groups, investors and creditors, IFIs and the financial markets.

According to surveys carried out in several countries,[2] many groups of users need comprehensive and timely information on the budget. The executive branch of government needs periodic information about the status of budgetary resources to ensure efficient budget implementation and to assess the comparative costs of different programmes. Citizens and the legislature need information on the costs and performance of programmes that affect them and their constituents. The financial markets use information on the

government's finances in order to assess the credit worthiness of a country and to make judgements about the value of its debt and the appropriate level of interest rates and exchange rates.

2. Principles of reporting

Reports prepared by the government for internal and external use are governed by the following principles:

- *Completeness*. The information, in the aggregate, should cover all aspects of the government's financial relationships.

- *Legitimacy*. The form and contents of financial reports should be appropriate for the intended users and comply with accepted standards.

- *User friendliness*. Reports should be easy to understand by well-informed and interested users, and should permit information to be captured quickly and communicated easily. They should include explanations and interpretations for legislators and citizens who are not familiar with budgetary concepts and methodological issues. Financial statements can be difficult for non-accountants; where possible, charts and illustrations should be used to improve readability.

- *Reliability*. The information presented in the reports should be verifiable and free of bias. Reliability does not imply precision or certainty. For some items, a properly explained estimate provides more meaningful information than no estimate at all (for example, tax expenditures, fiscal risks or superannuation liabilities).

- *Relevance*. Information is provided in response to an explicitly recognised need. The traditional function of year-end reports is to allow the legislature to verify budget execution. The broader objectives of financial reporting require that reports take into account the different needs of the various users. A frequent criticism of government financial reports is that they are both overloaded with information and difficult to interpret.

- *Consistency*. Consistency in the methodology, scope and coverage of financial reports is required not only internally, but also over time. Once an accounting or reporting method is adopted, it should be used for all similar transactions unless there is good cause to change it. If methods or the coverage of reports have altered, or if the financial reporting entity has changed, the effect of the change should be shown in the reports.

- *Timeliness*. The passage of time usually diminishes the usefulness of information. A timely estimate may then be more useful than precise information that takes longer to produce. However, the value of timeliness should not preclude statistical compilation and data checking even after the preliminary reports have been published.

- *Comparability*. Financial reporting should help users make relevant comparisons among similar reporting units, such as comparisons of the costs of specific functions or activities.

- *Usefulness*. Reports on the operations of specific ministries or agencies, to be useful both inside and outside the organisation, should contribute to an understanding of the current and future activities of the agency, its sources and uses of funds, the financial management of these funds, and its assets and liabilities.

A distinction between special purpose reports, prepared to meet specific needs, and "general-purpose" financial reports, prepared for a wider audience, can help to define the presentation and the mode of dissemination of the reports. For example, reports needed to monitor budget implementation are special-purpose reports, designed mainly for use within the government, while financial statements should be considered as general-purpose reports. However, the distinction is partly subjective and depends on the country context. Many governments have special reporting requirements, e.g. environmental reporting (resulting from environmental audits) or retirement fund reporting (for pension policy), and the like. This type of reporting is becoming more frequent as governments face the need to respond to pressures from various interest groups.

B. Main Reports

1. Budget execution reports

a. Managing budget implementation

For managing budget execution the following reports are needed:

- Daily "flash" reports on cash flows. These reports should distinguish inflows and outflows, but it is better for cash flow forecasting to have a breakdown of expenditure and revenue by broad economic categories (at least weekly).

- Monthly reports on budget execution based on the budget classification system. These reports specify:

  — Initial appropriations.

  — Revision of appropriations and supplementary appropriations.

  — Amounts apportioned.

  — Commitments, expenditures at the verification stage, and payments.

b. Appropriation accounts

An annual appropriation report (or budget enforcement report) must be submitted to the supreme audit institution (SAI) and the legislature. The production of such a report should be laid down in the organic budget law. The report should be forwarded to the SAI for audit purposes no later than two months after the end of the budget period. At the same time, the information should be released for public consumption. In addition to the annual appropriation report, the government should produce a statement of emergency procedures incurred during the year and the financial reports listed below.

2. Financial reporting

Regardless of the accounting system and the quality of the accounts and financial records, certain minimum reporting standards should be met in any country.

a. Minimum financial reporting requirements

The objective should be to produce the following reports, and to keep appropriate accounting books or ancillary registers:

1. Government consolidated operations table. The government should publish an analytical report on its consolidated financial operations. This report should consist of three tables showing the financial operations for (i) central government; (ii) local governments; and (iii) general government. Financial information on extra-budgetary funds (EBFs) should be consolidated into the accounts of the relevant level of government. In the GFS, the preferred treatment of social security funds is to classify them as a part of the level of government at which they operate. An alternative treatment is to present their financial information in a fourth table.

This report should be prepared in accordance with GFS standards. However, it is not expected that every country will adopt immediately a full accrual accounting system, as suggested in GFS 2000. Nevertheless, the presentation of the government operations table and the economic classification of transactions should be prepared in accordance with the GFS 2000 standards, whatever the basis of accounting. Ideally, this information should be prepared both on an accrual basis (or modified accrual basis) and a cash basis.

The report should cover at least two fiscal years to allow comparisons to be made. The information included in the government operations table should be derived from the government accounts. When additional accounting elements are introduced in the consolidated table, a double-entry procedure should be followed (e.g. both revenues and expenditures of an EBF should be included into the accounts). All tables or memorandum items required for comparison with the annual budget report and other reports (e.g. local government budget execution and funds management reports) should be annexed to this report.

2. Statement on stocks and flows of domestic arrears. This report distinguishes between arrears to the private sector, arrears to subnational government entities, and arrears to the non-government public sector.

3. Summary report on the execution of the government expenditure programme. This report covers expenditure from the budget and funds by broad function and programme (if any). It should distinguish between current and capital expenditures, show previous years for comparison, and give estimates for the following year if the country prepares multi-year estimates. The report should cover at least two fiscal years to allow the user to make comparisons. It should include a narrative statement on government expenditure policy.

4. Report on medium-term external debt. This report should include the following statements:

Debt outstanding and disbursed (DOD) for medium-term external public debt, classified into the following categories:

- DOD without arrears, with interest arrears, and with principal arrears.

- Directly contracted debt and guarantees.

- Broad categories of creditors (e.g. IFIs and commercial creditors).

- Broad categories of beneficiaries of guarantees (e.g. industrial and agricultural enterprises owned by the state).

- Debt instruments (loans and other obligations).

Projections of public debt servicing costs for the next five to ten years, distinguishing:

- Directly contracted debt, and guaranteed debt, by broad category of creditor.

- Projections on both an accrual basis and a cash basis for partly rescheduled debt.

- New borrowings.

- Debt rescheduling over the period.

5. Report on short-term borrowing. The format of this report depends on the level of development of the financial markets in the country. Depending on the composition of its debt and the organisational arrangements within the country, the report can be consolidated with the report on medium-term debt (item 4) or prepared separately.

6. Report on grants. This report should show donor pledges, disbursements and estimated receipts (see discussion below).

7. Report on lending and on-lending. This report shows loans contracted, interest and principal repayments over the period, and the stock and flows of arrears by major category of beneficiary. It should include a narrative on any problems met in collecting payments from debtors, and an assessment of future risks.

8. Statement of forward commitments. In order to meet its obligations of accountability to the legislature, this report should show forward (multi-year) commitments and the projected payment schedule by function or programme and by line ministry or agency.

9. Statement of cash flows. Like a normal commercial bank monthly statement, this statement shows flows of cash revenues and cash payments, and opening and closing cash balances. It covers all government cash and bank accounts, and is normally produced directly from government accounts.

10. Statement of tax expenditures. This report provides estimates of tax expenditures by sector/function and the type of concession or subsidy provided.

11. Statement of other liabilities and other contingent liabilities. If possible, in addition to the debt reports, a statement should be prepared to show other liabilities and contingencies, such as pension liabilities and insurance contingencies.

12. Statements of physical assets and investments for selected sectors/programmes. For the infrastructure sector, it can be useful to produce statements showing the most significant assets, capital investment on an accrual basis (i.e. the increase in physical assets, which can be very different from expenditures disbursed), and the costs of maintenance, including deferred maintenance. This statement can be included in the report on investment expenditures mentioned below.

b. Financial statements under an accrual accounting system[3]

Accrual accounting systems allow the preparation of statements that give a much more complete view of the financial situation of the government, and a consistent and comprehensive framework for preparing the reports mentioned in the previous section.

An accrual accounting system commonly entails the preparation of a financial position statement, or balance sheet, which shows the government's assets, liabilities and net worth; a financial performance statement, or operating statement, which shows the revenues and expenses during the fiscal year; and a statement of increase or decrease in net worth, which explains movements in the opening and closing balances. The accrual-based statements are supplemented by a statement of cash flows.

As noted earlier, GFS 2000 and SNA93 distinguish transaction flows from other economic flows. Thus, the analytical framework presented in GFS 2000 includes, inter alia, the following key statements (see also Figure 12.1):

- *The Government Operations Table*, which is a summary of the transactions of the general government in a given accounting period.

- *The Statement of Other Economic Flows*, which describes factors influencing the government's financial position other than transactions.

- *The Balance Sheet*, which records the stocks of assets, liabilities and net worth of the government at the beginning and end of each accounting period.

- *The Statement of Sources and Uses of Cash*, which should be supplemented by cash-accrual reconciliation items.

Movements in the opening and closing balance sheets are explained by both the transaction flows included in the government operations table, and the factors included in the statement of other economic flows.

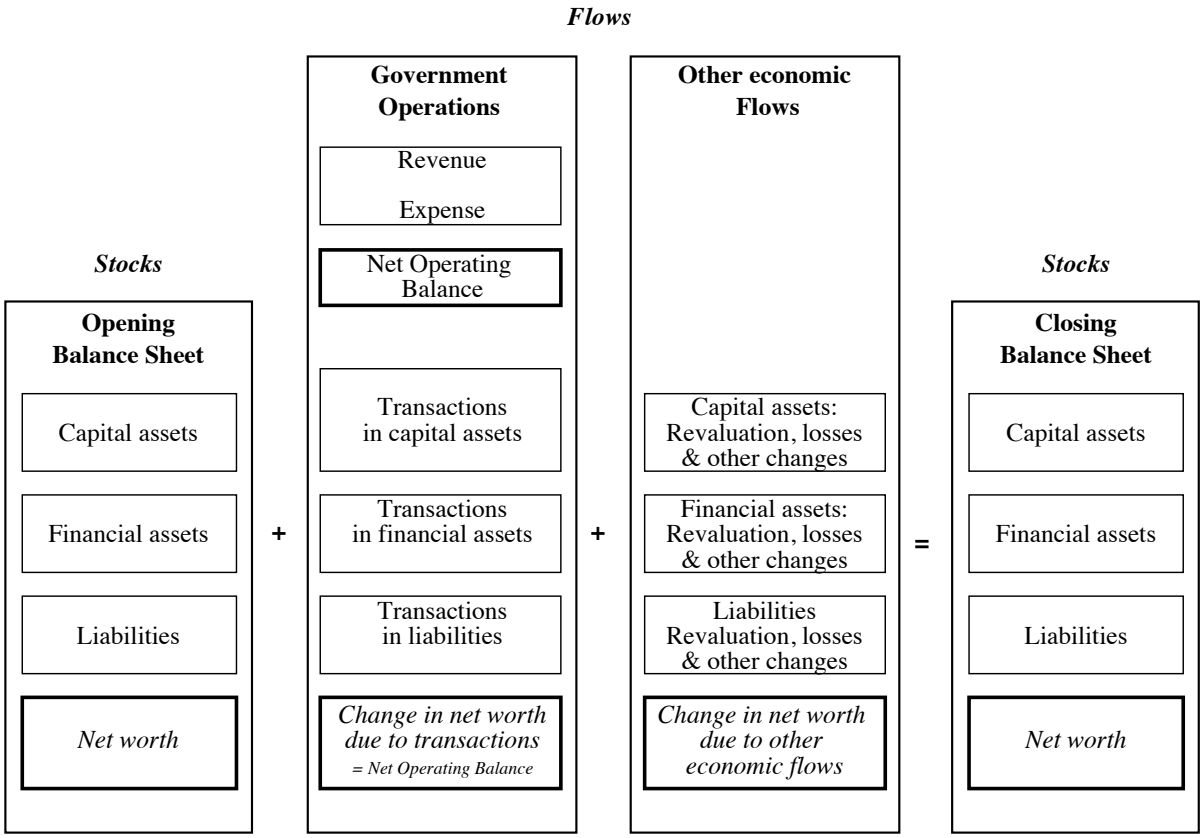
Notes to the financial statements should provide as much detail as needed to interpret the statements correctly and also a statement of accounting policies.

These statements should be complemented by the reports mentioned earlier for the fields they do not cover or do not cover in sufficient detail (e.g. commitments, contingencies, tax expenditures and details on debt and borrowing).

c. Coverage of financial reports within the government[4]

Financial reports should cover all government entities. Fund accounting poses a problem in many countries. These funds include both independent funds and special accounts managed by the ministry of finance or the treasury. When fund accounting is not consolidated line by line, the revenues and expenditures of the government are inflated by transactions between funds, which constitute instead a mere transfer within the government sector. Under accrual accounting, if the consolidation is not properly done, when revenues attributed to a fund are greater than its expenditure, the excess revenue is included as a liability on the government's books, while any excess or deficiency of expenditure appears as an asset (Ross and Kelly, 1997). When these funds, in the aggregate, have significant financial imbalances, the financial position of the government can be seriously distorted.

Figure 12.1. **GFS ANALYTICAL FRAMEWORK**



Source: GFS 2000.

Whether or not extra-budgetary funds are justified in a particular country, there is no reason to exempt them from the accounting and reporting obligations to which all other government entities are subject. All funds and accounts of all entities of the government must be consolidated. To make this consolidation possible, the chart of accounts of government entities and the economic and functional classification of their budgets must fit a common framework determined at the central level. Good financial reporting is required for accountability. However, the allocation of resources is made through the budget process, and implementing a sound financial reporting system for extra-budgetary funds does not affect the arguments for their retention or abolition.

d. Non-government public entities

While the scope of the budget is limited to the state government, as defined in Chapter 2, a broader scope should be considered for financial reporting. Entities controlled or owned by the government should produce regular financial reports. The accounts of entities carrying out commercial activities should be on a full accrual basis, and their financial statements should be those required under accrual accounting principles. These accounts should be consolidated by the government and published. Such information is needed by the public and for policymaking purposes, notably for an analysis of subsidies, financing capital expenditures of public enterprises, on-lending, etc.

Some countries have adopted the concept of "the government financial reporting entity" (see IFAC, 1991), i.e. the set of organisations, transactions, and activities for which the government is accountable and that are to be covered by government financial reports. Criteria for defining the boundaries of this broadly defined entity are financing, ownership and control. Control is the criterion that is more consistent with the objectives of financial reporting, since government should be accountable for the resources and entities it controls, regardless of the extent of government financing or ownership. However, application of this criterion requires a greater element of subjective judgement.

Rules for identifying the government entities that must produce financial statements are established either via legislation (as in France and Italy) or through accounting principles, such as the notion of control and the existence of users for which the information will be useful (as in Australia and New Zealand).

3. Line ministries' reports[5]

In some countries, reports are prepared showing the activities of line ministries and government agencies, and giving important information for deciding the intersectoral allocation of resources. If they are available before the start of budget preparation (which is desirable), they can be useful in preparing the initial budget ceilings. In some countries, these reports are discussed in legislative committees and made public.

Such reports might include some or all of the following elements:

- Major policy issues in the ministry or agency concerned.
- Goals and objectives of the ministry and policy measures undertaken or proposed to meet these objectives.
- Programmes, projects and activities of the ministry.
- Fiscal performance and financial statements.
- Estimated expenditures (current and capital) in future years.
- Performance indicators and targets.
- Other relevant information, e.g. loans, guarantees and tax expenditures in the sector concerned.

4. Reports on capital investment expenditure

a. Information requirements

The presentation of investment expenditures in a unified report or as an identifiable part of a line ministry's report is generally desirable. Reports on investment expenditures should show, by programme/project:

- Actual expenditures at the verification stage (not only the cash payments) during the fiscal year.
- Actual expenditures in the previous fiscal year.

• Estimated costs of ongoing programmes/projects for the next three or four years.

In a small country, investment expenditures are presented by project. In a large country, the report should be presented by programme. However, ongoing projects of national importance and significant size should be identified. For each of these projects, the report should indicate: (i) annual projected costs over a period of three to four years; (ii) total costs; and (iii) the estimated expenditure required to complete the project after the three or four-year period.

In addition, accrual-based information on the progress of projects is important, especially in the transport, communication and energy sectors and for other substantial public works projects, where payment schedules do not necessarily coincide with physical implementation. For large infrastructure projects, the increase in asset value can be presented, along with the indicators of physical progress. Performance indicators can be included, particularly in the social and agriculture sectors.

b. Special issues related to externally financed projects

In those countries that benefit from external aid, the report on capital investments should also cover the non-investment component of projects financed from external sources, so that the information can be used in discussions with donors. The investment and the current cost component of each project must therefore be separated.

Information on financing presented in the government accounts is based on disbursements. No matter how efficient the system of data collection within the country, there is always a time lag between drawings from loans and verified expenditures, and the length of the time lag depends largely on the procedures of the lender. Because the difference between drawings and expenditures may be large, these data must be compared and explained. Information on drawings and expenditures made from special funds should also be included in the report.

In principle, grants-in-kind should be reported at the time they are received. Discrepancies with information from donors should be identified and explained. In practice, however, many countries rely on donor information in order to estimate expenditures financed from grants-in-kind. This often leads to mixing cash-based information from some donors with commitments or "pledges" from other donors. Better monitoring of grants is generally needed. Except when special disbursement procedures have been established, this monitoring should be done at the project level, the only level at which expenditures financed by grants can be reliably estimated. Even then, data from donors must be collected and compared with the project data.

As discussed in Chapter 10, sources and uses of EU funds should be properly accounted for, disclosed and monitored.

NOTES

1. Drawn from United States, OMB, "Objectives of Federal Financial Reporting", *Statement of Federal Financial Accounting Concepts, Numbers 1 and 2*, 1993; Liekerman (1993a); and Premchand (1995).

2. For more details of these survey results, see Premchand (1995).

3. See IFAC (1991) and Premchand (1995).

4. The term "government" in this paragraph refers to any government authority which may be at the central or subnational level.

5. See Premchand (1995) and Liekerman (1993a).

CHAPTER 13

FINANCIAL MANAGEMENT INFORMATION SYSTEMS

Computer based information systems provide public sector managers with a set of tools to access reliable and timely information for decision-making in an environment that requires consolidation of large amounts of data across dispersed locations. Such systems can, therefore, contribute to both overall fiscal control and operational efficiency at the agency level. However, to fulfil effectively their functions, information systems must be appropriately designed and integrated. This chapter reviews some of the main features of an integrated approach to designing information systems for government financial management, and discusses key issues of implementation.

A. An Integrated Approach

1. General issues

Information systems for government financial management cover the various aspects of fiscal management. Often these systems are implemented through separate projects, responding to specific needs, but with little attention given to other areas and critical interrelationships. As a result the benefits from such reforms fall short of their full potential. Data are duplicated and difficult to reconcile, while some major areas are not covered by the systems.

As opposed to these fragmented approaches, the integrated model for financial management systems is sometimes described as follows:[1]

- A group of interrelated, interdependent and interacting financial management components.
- A group of procedures that has an in-built system of checks and balances which ensures transparency of operations and accountability of system managers.
- A group of procedures based on a decentralised approach to implementation within a framework of objectives and operating principles established by the centre.

Integrated systems are not monolithic and, for practical and cost-effective implementation, system elements must be developed in a modular way. In most transition countries, it would be illusory to achieve full automation of all financial transactions in the immediate term. However, it is important to place all system developments within a comprehensive and consistent framework and to ensure proper exchange of data between existing and future systems.

At the core of government financial management systems are the procedures for keeping the ledger in which all inflows and outflows are recorded, and for reporting such transactions. Under an integrated

approach, other information systems must be seen as supportive of these core systems and should adhere to their data exchange standards. Designing properly the core systems, and establishing requirements to ensure proper exchange of information between the core systems and the other systems that are maintained by either central or spending agencies, is the most important step in developing an integrated approach. Figure 13.1 presents schematically the main systems for government financial management and their main linkages.

A basic underlying principle for the design of integrated systems is that they should be structured on functional rather than organisational lines. There should be a single secure point of entry for commonly used data. This requires the creation of systems and databases in which the primary responsibility for provision of a particular subset of data resides with the organisation responsible for administering it. In a fully automated accounting system, accounting transactions progress through the system and data are entered only once. For example, detailed information on the budget code, key data on suppliers, order details, etc. are entered into the system when a commitment is made, after which transactions (recording expenditures at the verification stage, issuance of payment orders, and payments) are processed through the system.

Such integrated approaches eliminate the need for duplication in gathering and processing information, and enable all agencies to work with a common set of data. This eliminates the risk of data inconsistencies, which is inevitable if information is collected and recorded separately. Subject to appropriate security controls, data entered by one agency are accessible by the other agencies involved in budget management. For example, the budget department of the ministry of finance does not administer payments and commitments, but will nevertheless receive relevant information as soon as transactions are made.

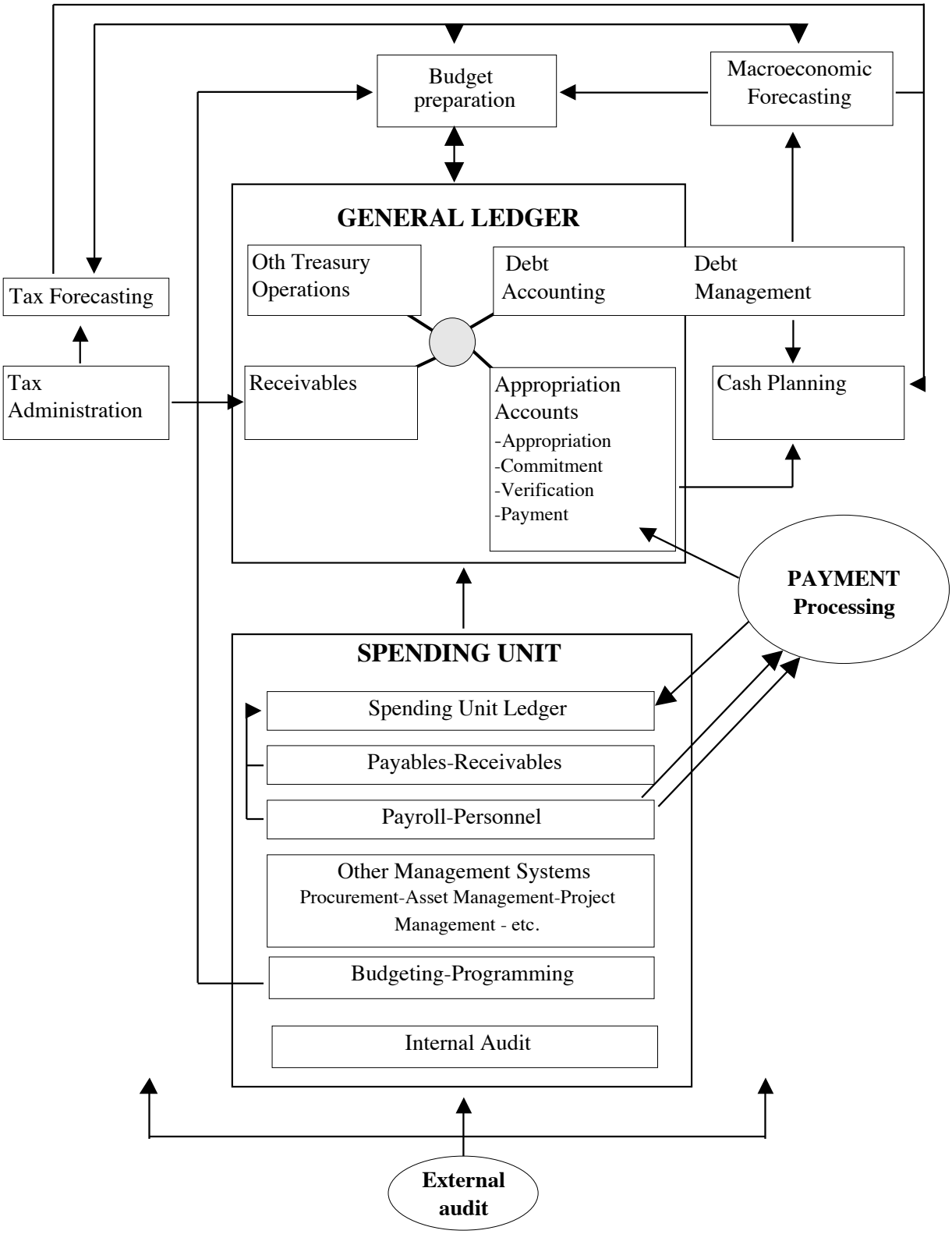
In principle, an integrated approach enables expenditures and revenues to be recorded at a very detailed level. Data recorded at the lowest level can be both used directly for programme management, and is amenable to cross-classification as required for financial analyses. In the absence of computerisation, cross-classification of data is very cumbersome and therefore should be carried out only occasionally. However, this does not necessarily mean that all transactions must be recorded in a single voluminous central database. In many cases, exchanges of data between systems can be limited to appropriate summary registers, provided that these are prepared on the basis of a common set of classifications.

2. Criteria for developing an integrated approach

The initial step in developing an integrated approach to managing information systems should be to develop standards for all systems, both in terms of reporting requirements and the classification of transactions. Often, issues related to standards are seen as technological issues (e.g. the choice of a data base management system or DBMS). In most cases, data can be exchanged easily from one DBMS to another. However, when the classification of transactions differs from one database to another, exchanges of data and integration can be problematic, even when all agencies use the same DBMS and operating system.

The budget classification system and chart of accounts are essential elements in linking or consolidating different databases. To benefit fully from automation, all the attributes of a transaction must be registered and kept as it is processed through the system. The system will then be able to produce reports according to different bases of accounting: for example, a report detailing expenditures by function, line-item, etc., at each stage of the expenditure cycle. Besides the fundamental aspects of the budget classification systems discussed in Chapters 4 and 11, the classification of transactions and their coding must also take into account the distribution of responsibilities in accounting and administering the systems. (For example, consolidating data from different subsidiary systems may need to include in the chart of accounts some suspense accounts to link the different accounting subsystems).

Figure 13.1. **FINANCIAL MANAGEMENT INFORMATION SYSTEMS**



Many agencies prefer developing their own systems to an integrated approach. They feel that a system prepared internally will fit better their needs than a system prepared by another ministry or agency. Indeed, systems prepared by a single agency often do not take into account the needs of other potential users. Preparing financial management information systems requires reviewing the needs of all potential system users, not only those of the agency where the systems will be implemented. Financial management involves a variety of actors (the ministry of finance, line ministries/agencies, the supreme audit institution, etc.). The ministry of finance should co-ordinate the implementation of the financial management systems and should be responsible for their regulation and overall effectiveness, but designing and implementing these systems requires the full participation of the line ministries and agencies concerned.

Before developing integrated information systems, it is generally necessary to review existing organisational arrangements and procedures in financial management. Automated management is different from the management of financial information using paper-based procedures. However, duplication of reporting systems and controls is sometimes unavoidable in a non-automated environment. Such duplication can and must be eliminated when developing integrated information systems.

The need to marry a fully integrated approach with existing procedures and organisational arrangements can make the process of integration very expensive, for example when the number of participants in budget management is high, as is the case in many transition countries. Sometimes, this may require the revision of some administrative arrangements and clarification of the distribution of responsibilities in order to make computerisation cost-effective. In other cases, the mode of integration of the various (sub) systems, automated or not, will need to be designed carefully.

B. Financial Management Systems[2]

Systems of financial management consist of procedures for forecasting expenditure and revenues, budget preparation, budget execution, accounting and financial reporting, tax administration, personnel and payroll management, programme management and auditing. Some systems perform very specific functions (for example, systems for tracking taxpayers or procurement systems). Core procedures for budget execution and accounting centralise data from other systems.

1. Budget preparation systems

As discussed in Chapter 5, budget preparation is an iterative process, which involves line ministries and the ministry of finance. It needs significant exchange of data, although the number of transactions is limited (compared to the thousands of transactions in budget execution).

Budget preparation systems have the following functions:

- Record the budgetary proposals and income estimates of all government agencies and any changes made during the budget preparation process. Evaluation of budget proposals requires various types of information, such as the number of personnel posts, physical progress of major infrastructure projects, programme profile forms (if any), etc. Ideally, systems for budget preparation should be able to process all data needed to evaluate budget proposals, and ensure appropriate linkages between financial data and the narratives included in the budget submission that explain the data.

- Prepare budget scenarios, compare them and produce summaries.

- After finalisation of the budget by the council of ministers, produce the draft documents to submit to parliament.

- Register the budget information and any revisions in the budget execution and accounting systems.

An important design feature of budget preparation systems is the organisation of the circulation of information between line ministries and the ministry of finance. Development of a government network and computerisation of spending agencies allows line ministries to register directly their budgetary requests in the budget preparation database.

Systems for budget preparation are linked to procedures for budget execution: data from the execution of the previous year's budget are analysed during the preparation of the current year's budget; and the budget and any revisions to it are entered in the budget execution system. To prepare budget scenarios, data must be exchanged with the forecasting systems that should be implemented in key areas, such as fiscal and macroeconomic forecasting and debt management, and with various other databases (e.g. on personnel expenditures).

2. Accounting and budget execution

Overall control of budget execution is supported by the core information systems of budget execution, accounting and financial reporting. These systems maintain data on approved appropriations and supplementary appropriations; virements; fund release (apportionment/allotment, warrants, cash plans, etc.); commitments; accrued expenditures; and payments against budgeted allocations and fund release. The systems maintain the ledgers, and also register data on revenues, debt and other liabilities, financial assets (and physical assets under full accrual accounting), and other financial transactions (such as internal transactions between government agencies). The functions of these systems are reviewed in more detail in Section C below.

3. Other systems

A number of systems that are required for special purposes are very important for both operational efficiency and fiscal control. Depending on the country context their implementation can have a higher priority than a fully automated system of expenditure transactions. For example, systems for tracking taxpayers are crucial in countries where there is significant tax evasion.

a. Debt management

Debt management systems are used for debt accounting, and are in this respect part of the core systems for accounting. They also have forecasting functions. They calculate and record projected payment schedules, and are used for preparing sensitivity analyses and scenarios. Preparing forecasts related to the current debt outstanding is one of the more important debt management activities (while forecasting the future total cost of debt service is essentially a macroeconomic forecasting activity). Debt management systems can also perform some administrative tasks, such as issuance of payment orders.

A debt management system provides a methodological framework for carrying out debt management activities, and is useful even when the number of loans and transactions is limited.

b. Cash planning

Systems to prepare and update cash plans (and budget implementation plans) are generally simple, but must use data from other systems and different databases, notably systems for budget execution,

accounting, debt accounting, tax forecasting, and short-term macroeconomic forecasting. Cash planning also needs additional data from line ministries, such as payment schedules related to ongoing commitments, at least for expenditures that are unevenly distributed over the fiscal year (e.g. investment expenditures).

When government transactions are not fully automated, it is also necessary for cash planning to use data from the banks that manage government accounts, and to set up a flash reporting system through fax or e-mail to provide daily or weekly reports from spending agencies or treasury branch offices.

c. Management of programmes and government agencies

Spending agencies must report on their financial activities and keep their accounts. Spending agencies' ledger systems should be very closely linked to the core accounting systems, in order to ensure full consistency of data. If the systems are fully integrated, the accounting systems of spending agencies can be part of the core accounting systems, but can have wider coverage. For example, an agency that delivers services may keep accounts on a full accrual basis, even when government accounts are on a cash or modified accrual basis.

In any case, implementing an integrated accounting system according to the principles discussed in Section C below must not lead to loss of responsibility of line ministries in budget management. In countries where line ministries and spending units keep their accounts, the objective should be to integrate agencies' accounting system into the core accounting system. Where accounts are kept only at the central level, the design of the information systems should be aimed at creating the conditions that enable the development, over the medium-term at least, of a more decentralised approach.

Management of payables and procurement systems must be implemented within spending agencies. They have the following functions:

- To maintain a database of suppliers.
- To manage orders and contracts and maintain a record of procurement requests, contracts, purchase orders (commitments) and reports on deliveries and certification/verification.
- To match requests, commitments, verified expenditures, advance payments and payments.
- To record the date of transactions, make cash requirement projections, generate reports, etc.

Personnel and payroll management systems keep data on the civil service (personnel information systems) and calculate and process information on salaries and other employment costs (payroll systems). The payroll systems should provide summaries to the central accounting system when the payroll is issued, then when it is paid.

Personnel and payroll management systems are important for expenditure control, in both budget preparation and execution. They provide information on the payroll due and paid, and facilitate operations, such as control of posts and comparisons between the payroll and the number of posts effectively occupied. Although some countries have more centralised arrangements, in general spending agencies manage their own personnel and payroll systems. Line ministries and spending agencies should be responsible for personnel management, but data required for the control of budget formulation and budget execution must be communicated to the ministry of finance.

In a number of countries, the organisational arrangements make it difficult and expensive to implement payroll systems. The payroll is prepared at the lowest level of government by accountants located in hundreds (or even thousands) of spending units. Establishing payroll-processing centres that process the payroll of groups of spending units would ease automation of the payroll. Interministerial centres can be established at the regional level. These centres should not interfere with agencies' personnel management procedures and should operate as service providers, the payroll being calculated on the basis of elements transmitted by spending units. Such organisational arrangements can be cost-effective. However, they often meet strong resistance from line ministries and spending units and are difficult to implement. As a minimum, standard "personnel files" should be prepared in electronic format. The consolidation of such files by the ministry of finance will provide useful information for budget preparation and for identifying anomalies in budget execution. However, its benefits are generally smaller than automation of the payroll.

Spending agencies also need specific systems for managing their programmes and projects. Several commercial project management software packages are available. These packages provide an effective tool for planning and controlling project implementation. Cost measurement systems allocate costs among programmes. Systems for assets and inventories keep physical assets registers. Systems for maintenance track maintenance works and future maintenance requirements.

Systems for programming and budgeting assist spending agencies in the preparation of the budget and sectoral programmes.

d. Revenues

Systems for revenue administration cover the processes associated with the collection of taxes and non-tax revenue. They assist the tax and customs their administration in their administrative and control activities, and can contribute to improved efficiency and effectiveness of these agencies and strengthened revenue collection. Such systems also assist in the formulation of tax and tariff policies and in tax forecasting. They provide summary information to the core accounting systems.

Receivable accounts systems can also be implemented within agencies that collect revenues (from fees and charges set so as to recover costs).

e. Other systems

Pensions systems are generally kept at the central level (treasury, pension fund, etc.). As in the case of payroll systems they can be designed to provide summary information to the core accounting systems.

Auditing systems assist the internal and external auditors, which should have access to all relevant databases of the systems described above.

Countries that prepare multi-year expenditure programmes or public investment programmes need systems to support this work. These procedures should be linked to the budget preparation system. Special purpose monitoring systems are sometimes set up to provide information on capital investment projects, aid-financed expenditures, and certain other expenditure programmes. Besides keeping information on the financial execution of the programmes concerned, such systems maintain data on the physical progress of projects and performance indicators. These systems are often not connected to the government's core accounting systems. It is difficult to achieve full integration of all special purpose systems, but financial data registered in such monitoring systems should be

consistent with accounting data, or at least compared systematically with them so that any discrepancies can be recorded in the monitoring reports.

C. Budget Execution and Accounting

1. Functions of the core systems for accounting and budget execution

The core functions of the set of government financial management systems cover the control of budget execution, accounting and financial reporting. These functions can be fulfilled by different systems or by a single system. For example, when payments are made by spending agencies, the systems for managing payments are separate from (but closely linked to) the system that maintains the central ledger at the treasury.

In a number of countries, the budget department in the ministry of finance manages the apportionment of appropriations and the budget implementation plan, and controls the transfers of expenditures within the initial budget appropriations (virements), while the treasury is responsible for other aspects of budget execution. Preferably, a common budget execution system at the central level should cover the activities of these two departments/agencies. If two separate systems are implemented, they must be very closely linked. This requirement is sometimes forgotten when implementing a treasury system. As a result, the full benefits of computerisation may not be achieved since the budget department continues to supervise budget implementation with its own procedures. (In one country, after a treasury system had been implemented through a project financed by an IFI, the budget department requested financing from another IFI for a budget implementation system, since the treasury system did not satisfy its needs.)

Many industrialised countries have integrated accounting and budget execution systems.[3] These systems are described under different names, such as "Core Accounting and Budgeting Systems", "Treasury Systems", "Financial Ledger Systems", or "General Ledger Systems". An accounting and budget execution system can perform the following functions:

a. Budget implementation

- Record initial budgets and distribute the budget appropriations, as approved by the legislature, to spending ministries. Keep a record of initial budgets, revised budgets, and budget transfers. The accounting and budget execution systems should be linked with the budget preparation system and the respective functions of the two systems must be appropriately defined in order to avoid any overlaps.

- Distribute appropriations and commitment authorisations to spending units.

- Distribute cash limits to spending units and keep a record of the amounts of these cash limits against the appropriations and any changes incurred.

b. Budget execution, control and monitoring

- Record commitments (contracts, orders, etc.) incurred by a spending unit against the approved limits and the appropriation during the course of a year. An ex ante commitment control should be carried out by spending agencies, but procedures for registering commitments in the central accounts are needed.

- Record verified expenditures and fund allocations or monthly cash limits.

- For cash management purposes, the system could also record the planned payment schedule associated with these commitments, at least for commitments related to investment expenditures (which are often unevenly spread over the fiscal year).[4]

- Record actual expenditures against commitments and funds allocations. As in the case of commitments, controls are carried out by spending agencies, but all data must be registered in the central accounts.

- If payment processing is centralised through the treasury department, record payment orders sent by line ministries to the treasury. The system will have facilities to check the availability of appropriations, commitments and fund allocations prior to approving a payment.

c. Payment administration

- If required, print cheques against payment instructions and/or make arrangements for the electronic transfer of payment information to a bank or other external paying entity.

- Print consolidated payment instructions for action by the banking system.

Box 13.1. EXAMPLES OF BUDGET EXECUTION AND ACCOUNTING SYSTEMS

Australia. The Accrual Information Management System (AIMS) is the central budgeting and reporting system. The spending agencies have their own management systems and post every month accounting summaries in the AIMS. The two key outputs of AIMS are the production of the Budget documentation, including the Appropriation Bills, and the production of monthly and annual financial reports.

France. Payment orders and all cash transactions go through the treasury system without exception. A budget execution system centralises data on commitments and payment orders. Both systems are linked with spending agencies.

Spain. All government transactions are processed through the system, which registers up to six different stages: budget allocation, commitment, verification (actual expenditures), payment request, payment order and payment. Budget preparation (with several rounds of interaction) also goes through the system. The system performs accounting and reporting functions. Electronic links are being established with all spending units.

United States. The General Ledger System registers expenditure at different stages in the budget cycle. Spending agencies have their own management systems that are linked to the general ledger and must comply with its standards. For budget preparation there is a separate system.

Sources:
Australia: http://www.dofa.gov.au/budgetgroup
France and Spain: Ter-Minassian, Parente and Martinez-Mendez (1995)
US: http://www.fms.treas.gov

d. Revenue accounting

- Record revenue and other receipts against appropriate budget items.

e. Accounting

- Consolidate data from the treasury system, ministries and spending agencies.

- Produce the commonly required accounting and management reports.

2. Organisational arrangements and control issues

The features and functions of the systems that have been implemented in different countries vary widely. For example, both the French and US systems register expenditures at every stage of the expenditure cycle, but while in France ex ante controls are carried out by the ministry of finance at the commitment stage, in the US the registration of commitments/obligations is automatic, provided that the spending limits are enforced. To a large extent, however, differences in budget execution management procedures are diluted when the expenditure cycle is fully computerised, databases shared and controls automated.

Several alternative arrangements for the organisation of accounting and budget execution systems can be considered:

- When payments are made through the treasury, spending agencies advise the treasury of commitments and accrued expenditures and send requests for payment to the treasury. Computerised spending agencies register directly their transactions in the accounting and budget execution systems administered by the treasury.

- When payments are made directly by spending agencies, all transactions are recorded by these spending agencies and electronic links are established between them and the ministry of finance. Without efficient, modern information systems, decentralised arrangements for budget execution can pose difficulties in supervising budget management. If an accounting and budget system is implemented, however, the ministry of finance can monitor and control budget execution in a timely manner. As noted by Premchand (1995): "the centralised system of control was based on two premises: (i) the finance ministry should exercise the control; and (ii) most control should be exercised through the traditional verification methods, at the payment stage. Although valid in earlier times, these premises are open to criticism in a context where modern technology has more instant information possible."

In principle, the introduction of automated accounting systems ensures completeness of data capture (no transaction being processed outside the system) and rigorous application of appropriate financial controls to all transactions processed by the system. As a transaction is processed, the systems can apply the necessary controls, e.g. ensure that a proper budget allocation exists prior to making a commitment or approving a payment. Manual intervention is only required in cases that justify an exception to the procedures. In such cases, the systems would keep an appropriate audit trail including details of the authorisation of the exceptional transactions. However, whilst such control mechanisms are useful in the case of transactions involving appropriations and cash limits, they should be used with caution in other cases. For example, if the information systems make compulsory procedural controls on expenditures already made, expenditures in excess of appropriations will not be systematically recorded.

Under reporting of accrued expenditures and arrears is a common feature of excessively procedural and centralised expenditure management information systems. Thus the role of information systems in compliance controls should not be overestimated. Computers can facilitate control, but are not a substitute for effective management control and internal audit systems. Process audits are required to ensure reliability of data produced by information systems. A number of integrated computerisation audits carried out in the 1980s in developing countries aimed at improving controls. However, the result was the multiplication of exceptional procedures outside the "compulsory" computerised expenditure cycle. This could also happen in some transition countries, where mechanisms for off-budget spending currently exist. Moreover, there are risks of under-reporting in countries that face fiscal problems, when the procedures are not carefully designed.

3. Implementation issues

One potential difficulty in implementing a fully integrated financial management information system is the relatively high cost both of the initial investment and the recurrent expenditure required to operate and maintain the system. In some transition countries, the number of spending units involved in budget management is very high. Providing every unit with computers, software, modems and printers may be beyond the immediate financial capacity of many such countries. It may be more realistic to implement modern accounting and budget execution systems gradually over a period of several years.

Limiting, at a first stage, the implementation of the system to the headquarters of the ministry of finance and the major spending agencies can yield significant benefits. In most countries, 60 to 80% of transactions (in monetary terms at least) are concentrated within a limited number of accounting centres. For non-automated agencies, transaction summaries can be reported into the systems until full automation is achieved.

Another approach frequently adopted consists of limiting the functions of the accounting-budget execution systems. For example, some treasury systems that are in the process of being implemented in transition countries cover only cash transactions. This requires maintaining a manual system for monitoring and accounting accrued expenditures, particularly in countries that experience problems of overcommitments and arrears. Computerisation should not lead to loss of information. For example, in the FSU countries, the traditional book keeping and reporting system used by spending agencies, which covers both cash payments and "actual" expenditures, should be maintained or revived, not abandoned, when automating cash transactions.

Subject to the banking infrastructure and organisational arrangements in a country, an initial approach to implementing a new financial management information system could consist of: (i) daily centralisation of aggregate cash information through the banking system (expenditures and revenues presented according to a few broad categories); and (ii) monthly consolidation of summaries presented on the basis of the chart of accounts (including the budget classification). Such an approach is cost-effective and would satisfy most needs for cash management and the supervision of budget implementation.

D. Technical Aspects

1. Architecture of systems

The design of the systems' architecture is an important factor in meeting the needs of users and defining an implementation strategy.

For the purposes of budget execution, a multi-tiered network is often to be preferred to a single central database into which all transactions are recorded. A multi-tiered network includes different "nodes". Individual transactions are registered at the lower level nodes. Summaries based on the categories in the chart of accounts are then transferred to the upper level nodes.

A multi-tiered network has the following advantages: (i) computing power is distributed in proportion to node requirements, making the system less vulnerable to malfunctions at the central site; (ii) in the absence of good telecommunication facilities, the data transfer between the nodes and the centre could be periodic in an off-line/batch mode; and (iii) it meets the needs of a gradual implementation strategy. For example, transactions of non-computerised agencies can be more easily registered at the nodes than in a central database. The organisation of the network depends both on technical issues and existing organisational arrangements.

Within a multi-tiered network, it is necessary to define where the "master" databases are located. These databases are kept under high security procedures and serve as a basis for audits, inspections, etc.

2. Applications development

In relation to the core systems for accounting and budget execution, there are two main options: (i) full application development; (ii) purchase of "off-the-shelf" software packages, customisation and additional development.

In principle, "off-the-shelf" software packages present a number of advantages: for example, faster implementation, continuing software support with periodic upgrades and good documentation. For accounting systems, "off-the-shelf" packages can be relatively easily customised. "Off-the-shelf" software packages for budget and payables management are used by spending agencies in several countries for their internal management purposes. In relation to management at the central level (e.g. release of funds or issuing warrants and appropriation management), budgetary procedures are often country-specific and, depending on the procedures and the software, the adaptation of an "off-the-shelf" package could be time-consuming and resource-intensive. Before purchasing standard packages a review of their functionality, the costs of their customisation and their cost-effectiveness is required.

The planning and implementation of new financial management information systems — whether or not these include ready-made elements — is a complex task, likely to take several years to complete. Projects of this kind may receive financial and/or technical support from donor agencies but, in addition, a substantial allocation of funds from the national budget is likely to be needed. Such projects should be managed and co-ordinated by the ministry of finance. In order to be implemented effectively, they require high level support for the government, at ministerial level, sound project management and active participation by all the ministries and agencies involved.

NOTES

1. See Asselin (1994). Integrated government systems are considered under various names such as Government Financial Management Information System (GFMIS), Integrated Functional Budget and Accounting System (IFBAS), Government Budgeting and Accounting Systems (GBAS), etc. There is no unambiguous definition of the functions of these systems and their coverage. For example, the term "GFMIS" may refer either to all systems of financial management, or only to the core budgeting and accounting systems.

2. More complete descriptions of financial management systems may be found in Davies, Hashim and Talero (1993).

3. See examples in Ter-Minassian, Parente and Martinez-Mendez (1995).

4. For a further discussion of this aspect, see "Use of the System in Financial Planning" in Appendix 1 of Ter-Minassian, Parente and Martinez-Mendez (1995).

CHAPTER 14

EXTERNAL AUDIT

Auditing, together with internal controls and evaluation, consists of processes and mechanisms that are designed to ensure that planning, budgeting and use of public resources conform to a country's laws, pursue the objectives defined by parliament and government and are linked to the real world of programme operations. Without these mechanisms, there is a considerable risk that policy decisions will be based on flawed information, that resources will be mismanaged, and that policy decisions will be ignored by the relevant operating organisation. Audit in the public sector also has the important function of giving the ultimate decision-makers (parliament and government) and/or citizens regular assurance of the quality of reports of how taxpayers' money has been spent, and the management of assets and liabilities under public control.

There is an important and fundamental distinction between so-called external and internal audit. The distinction concerns basically the degree of independence the auditor or the organisation responsible for the audit has in relation to the audited entity and to whom the results of the audit are addressed. In order for the external audit process to function effectively and be trusted as an objective mechanism, it should be fully independent of the auditee and its reports should be addressed to entities that are separate from the bodies being audited. This does not preclude close links facilitating the practical work between the two types of audit organisations. Both external and internal audit mechanisms are today established within the public sector in most countries of the world.

The Lima Declaration of Guidelines on Auditing Precepts, published by the International Organisation of Supreme Audit Institutions (INTOSAI), opens with the following statement:[1]

"The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent — or at least render more difficult — such breaches."

Effective auditing can contribute in several important ways to the management of a government's finances as well as giving the parliament and citizens an objective description of how public funds have been spent. It can:

• Detect irregularities involving the misuse of public funds and identify related weaknesses in management controls that may imperil the integrity of the organisation and the effective implementation of budgetary and other policy decisions.

• Determine the reliability of reports on budget execution and other financial data.

- Identify instances and patterns of waste and inefficiency that, if corrected, will permit more economical use of available budget resources.

- Provide reliable data about programme results as a basis for future adjustments in laws, policies, and budget allocations.

This discussion focuses primarily on the role of the organisations that are responsible for auditing the government as a whole. They have many different names but, collectively, these organisations refer to themselves as supreme audit institutions (SAI). State audit has a history of several hundred years in most European countries. Inevitably, most SAIs have undergone major changes in their structure, remit and powers at some time in their history and usually at times of constitutional change or when the administration of the respective state was being reformed.

There are, broadly speaking, three main types of SAIs in Europe.[2] All are also found within the European Union. These are, first, the 'court' with judicial functions (e.g. *Cour des Comptes* of France, *Corti dei Conti* in Italy, *Curtea de Conturi* in Romania). The second type is the 'collegiate' body without judicial function but with collegiate decision procedures similar to those found in courts (e.g. *Nejvyssí kontrolní úrad* in the Czech Republic, *Bundesrechnungshof* in Germany, *Algemene Rekenkamer* in the Netherlands). The SAI of the European Union, the European Court of Auditors, is also shaped according to these lines. A third type is the monocratic audit office[3] headed by a sole Auditor General (e.g. *Rigsrevisionen* of Denmark, *Riigikontroll* in Estonia, National Audit Office in the United Kingdom). The judicial functions of the "courts" vary but imply generally the obligation to judge and punish those the court finds guilty of violations of financial regulations. It should be noted that several SAIs in Europe that still have "Court" as a part of their official name have very limited judicial functions or none at all. Box 14.1 lists the recommendations for the establishment and proper functioning of an SAI recently promulgated by the Presidents of Central and Eastern European SAIs and the European Court of Auditors.

While this chapter focuses on the role and functions of the SAI, much of the discussion is also applicable to other audit organisations, such as the internal audit units of government ministries and commercial auditors who may be hired under contract to perform audits of government entities. Throughout, the reader should keep in mind that even the most rigorous audit provisions are not always a guarantee against malpractices. In Sweden, for example, laws and regulations provide the foundation for that country's government management control systems by requiring annual audited statements of all government organisations' revenues, expenditures and performance reports. This is reinforced by statutory requirements governing the accounting activities of ministries and agencies and, for example, by the mandatory separation of contracting and disbursement functions. Even so, failures can occur. For example, the Swedish National Audit Office has found significant overpayments of social security benefits and insufficient revenues from taxes and custom fees that arose, in part, because officials did not understand the requirements of the systems in place.

A. Prerequisites for Effective Auditing

INTOSAI has promulgated principles and standards for the audit of government organisations and operations. These principles and standards, or national standards that are equally or more rigorous, have been adopted around the world, by virtually all SAIs. They have also been further developed by EUROSAI, the European branch of the INTOSAI, and by the European Court of Auditors, the external auditor for the European Union in co-operation with the SAIs of the Union.[4] A requirement to conform to such principles and standards is sometimes laid down in a country's constitution and usually further elaborated in special audit laws.

Box 14.1. RECOMMENDATIONS FOR THE ESTABLISHMENT AND PROPER FUNCTIONING OF AN SAI

At a meeting in Prague in November 1999, chaired by the Polish Supreme Chamber of Control, the Presidents of central and eastern European SAIs and the European Court of Auditors agreed upon a document which points out key areas important for the establishment and the proper functioning of an SAI, and especially for ensuring the competent, efficient and effective use of public resources. The eleven recommendations laid down will assist the SAIs in fulfilling their important role preparing their countries' audit systems for EU membership. They will also help to bring the SAIs into line with European and international practice benchmarks and enable them to help and advise their respective governments on achieving similar standards of control as in existing EU Member States.

The eleven recommendations are as follows:

1. The supreme audit institution should have a solid, stable and applicable legal base that is laid down in the constitution and the laws, and complemented by regulations, rules and procedures.

2. The supreme audit institution should have the functional, organisational, operational and financial independence required to fulfil its tasks objectively and effectively.

3. The supreme audit institution should have the powers and means, clearly stated in the constitution and the laws, to audit all public resources and operations (including EU resources), regardless of whether they are reflected in the national budget and regardless of who receives or manages these public resources and operations.

4. The supreme audit institution should undertake the full scope of government external auditing, covering both regularity and performance audits.

5. The supreme audit institution should be able to report freely and without restriction on the results of its work. Reports may be submitted to parliament and be made public.

6. The supreme audit institution should adapt to suit local conditions and formally adopt, promulgate and disseminate audit standards, compliant with INTOSAI Auditing Standards, the European Implementing Guidelines for INTOSAI Auditing Standards any relevant public sector auditing standards issued by IFAC and accepted for application in the EU. Audit standards should be applied on a consistent and reliable basis to the work of the SAI to ensure that audit work is of an acceptable quality and competence. The SAI should therefore develop audit manuals and detailed technical guides to help promote the practical use and achievement of the standards.

7. The supreme audit institution should ensure that its human and financial resources are used in the most efficient way to secure effective exercise of its mandate. To this end, SAI management will need to develop and institute appropriate policies and measures to help guarantee that the SAI is competently organised to deliver high-quality and effective audit work.

8. The supreme audit institution should develop its internal organisation as a supportive structure for the proper conduct of work related to the requirements of the pre-accession period.

(cont'd)

Box 14.1. **RECOMMENDATIONS FOR THE ESTABLISHMENT AND PROPER FUNCTIONING OF AN SAI** *(cont'd)*

9. The supreme audit institution must ensure that its staff are competent, capable and committed to help guarantee that effective audit work is produced in conformity with international standards and good European practices.

10. The supreme audit institution should develop the technical and professional proficiency of its staff through education and training.

11. The supreme audit institution should focus on the development of high-quality, effective management (internal) control systems in audited entities.

For more information, see the SIGMA audit and financial control web pages at http://www.oecd.org/sigmaweb.

The nature and functioning of external audit is not strictly a part of the so-called *acquis communautaire*, namely the laws, regulations and procedures which together constitute the European Union. However, following the criteria laid down by the Copenhagen Summit, all Member States and candidate countries will need to adhere to additional political and economic conditions which require, amongst other conditions, that the candidate has achieved stability of institutions guaranteeing democracy and the rule of law. These criteria include the existence of an effective SAI. In a more practical manner, the EC Treaty implies the existence of such institutions and their capacity to co-operate with the European Court of Auditors (Articles 246-248). Moreover, the general financial control standards for the management of EU funds and own resources (e.g. customs duties and value added tax) require an effective external audit of all public sector resources and assets, and that this should be carried out in a continuous and harmonised way.

Among the most important of the auditing standards are those dealing with independence, audit coverage and professional skills. These three issues are dealt with below.

1. Independence

The independence of the auditing organisation and its auditors is essential to ensure that its work will not be influenced by any relationship it might have with the entity being audited. Independence is also a necessary condition for internal audit, whereby the entity responsible must not be part of the finance or treasury function of the ministry or agency concerned, but must report directly to the senior manager overseeing financial transactions. In the Lima Declaration, INTOSAI made the following statements about the independence of the SAI:

1. Supreme audit institutions can fulfil their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.

2. Although state institutions cannot be absolutely independent because they are part of the state as a whole, the supreme audit institutions shall have the functional and organisational independence required to fulfil their tasks.

Independence of the external audit process is typically accomplished by creating the SAI as an organisation apart from the government with its mandate and scope of work laid down in the constitution or law. Usually, the SAI reports to and is accountable only to the national legislature. This is the arrangement in most countries in Europe. Another way of securing independence from the auditee, the government, is to make the appointment of the head of the SAI, and for the members of SAIs, a matter for the legislature or the legislature together with the government. This is the case for example in Bulgaria, Germany, Norway and Slovenia. Independence is often further safeguarded through the independent and established (i.e. non-dismissible) status of the heads, members or auditors of the SAI.

It is essential that the institutional independence of the SAI be genuine. The constitutional or statutory basis for the organisation should be clear. The SAI should have the right to make requests directly to parliament on funding issues. It should have unquestionable statutory authority to determine the scope of audits, to obtain any documents and records relevant to the audit, and to exercise its judgement as to the audit results to be reported. Audit reports should in principle be public documents, and this is the practice in many countries.

Not only must the SAI be independent, the individual auditors must also be independent with respect to the audits on which they are working. This matter is usually handled through internal regulations promulgated by the SAI, but may also be covered in various laws, including those that are generally applicable to the civil service. For example, it may be appropriate to have laws and regulations requiring that an individual auditor is not an investor in an entity that might be affected by the results of the audit. Such potential conflicts of interest arise more often than one might suspect. If the SAI is auditing the operations of a government computer system, for example, the auditors on that assignment should not have a personal interest in, or contractual relationship with, the firms that might compete to supply replacement computer equipment.

Other requirements may be imposed to avoid any likelihood that the audit work will be (or might appear to be) subject to improper influence. Public sector auditors are in some countries prohibited from active participation in political parties. They may be prohibited from auditing an entity in which a close relative by blood or marriage holds a position of responsibility. The decision-making procedures used by many SAIs with a court or member structure avoid to a certain extent these kinds of problems by separating the decision on an audit from the auditing activity itself. Rules to avoid such conflicts of interest are often inconvenient, but the independence of the auditor is central to an SAI's credibility and the inconveniences must be tolerated.

2. Audit coverage

To meet the objectives of government auditing, all revenues, expenses, assets and liabilities of the state sector must be effectively audited. The Lima Declaration of INTOSAI contains the following statements:

- All public financial operations, regardless of whether and how they are reflected in the national budget, shall be subject to audit by the supreme audit institution. Excluding parts of financial management from the national budget shall not result in these parts being exempted from audit by the supreme audit institution.

- Supreme audit institutions shall be empowered to audit taxes as extensively as possible and, in doing so, to examine individual tax files.

- Enterprises established under private law shall also be subject to audit by the supreme audit institution if the government has a substantial participation in them — particularly where this is a majority participation — or exercises a dominating influence.

- Supreme audit institutions shall be empowered to audit the use of subsidies granted from public funds. When the subsidy is particularly high, either by itself or in relation to the revenues and capital of the subsidised organisation, the audit can, if required, be extended to include the entire financial management of the subsidised institution.

In many countries, vital public services are performed by organisations whose activities are not fully reflected in the national budget. These include extra-budgetary funds, partially or wholly state-owned enterprises, and ostensibly private organisations financed by state subsidies. This is particularly common in transition economies, where the boundaries of the state sector are further complicated by the existence of state-owned organisations that are not always well-defined as legal subjects but conduct commercial or industrial operations that, in other circumstances, might well be carried out by privately-owned business firms. Such organisations should either be converted into corporate bodies, if their actrivities are deemed to be a continuing responsibility of the state, or privatised. In the period up to privatisation, however, they must be effectively audited by the SAI.

There are several reasons for requiring effective audit coverage of these organisations. They were often created by state law to carry out a state-mandated public function. Their resources are collected under authority of the state. Thus, regardless of their relationship to the national budget, these are public organisations using public funds and the state has the same responsibility to safeguard these funds as it has for the resources of any line ministry or agency of the government. Yet the risks of waste, fraud, abuse and mismanagement are often even greater than for a typical ministry because of the absence of effective direction and supervision by the government and parliament. Improper management can cause such organisations to fail to carry out properly the functions for which they were created or to create an unnecessary budgetary burden for the state. Effective auditing can help reduce these risks.

Special issues are involved in state-owned enterprises that are planned for eventual privatisation. These should be of concern to the state and warrant careful auditing. While such enterprises remain in state ownership, the state's interests are to maintain the assets and to maintain or increase efficiency, both to minimise the potential budget burden and to increase the potential value when the entity is sold. Experiences in several transition countries, however, provide ample evidence that the current managers of such enterprises may have a different set of interests. There are examples of the improper divestiture of assets and other actions that reduce both current operational efficiency and the potential sales value of the enterprise. Effective government supervision and strong management controls, along with auditing by the SAI, are essential to prevent such wastage of state assets.

The process of privatisation, itself, also warrants audit oversight by the SAI. Here, too, there are examples from many countries of state-owned enterprises being sold for considerably less than their market value, although this has not been decided by parliament, with consequent losses to the state and the taxpayer. It could be the SAI's responsibility to examine the government's sales procedures and the implementation of those procedures to ensure that due consideration is given to legitimate social and other policy objectives, and that proper value is obtained in any sale of state assets.

There are other circumstances in which it is important to ensure effective audit coverage, but in which this may pose special difficulties. For example, all nations have organisations engaged in activities which the parliament and government are unwilling to expose to public scrutiny. Those activities are usually

(but not always) involved in national security matters. Auditing these organisations presents special problems because of the need to maintain the secrecy of sensitive information. However, experience demonstrates that the existence of a secrecy shield can create the opportunity to use that shield to hide improper and/or illegal activities from public exposure. To minimise this risk, it is highly desirable that the SAI has full authority to audit such secret organisations. In this case, special arrangements will likely be needed to safeguard information that is properly deemed secret, such as a requirement that anyone who is involved in the audit or is privy to the audit results has an appropriate security clearance. If the SAI does not have such audit authority, the responsibility for assuring the probity of such organisations falls entirely on the government, which would be well-advised to take special steps to ensure an effective internal audit unit and strong internal controls.[5]

3. Professional skills

Auditing is a profession that encompasses a wide range of technical skills, mirroring the types of audits and auditees that the SAI may be required to face. Few, if any, auditors possess the entire range of skills that may be needed by an SAI. For each individual audit, however, it is essential that the audit

Box 14.2. TRAINING OF AUDITORS: SWEDEN

All SAIs must invest substantially in training to ensure the skills of the auditors are regularly updated and meet the needs of the different audit assignments. In 1998, the Swedish National Audit Office (SNAO) revised and put in place a new programme for developing the competencies of staff in the financial audit department.

The programme defines a long-term training strategy, using a "stepladder" course of training that successively raises competence while, at the same time, carefully selected audit assignments provide practical experience. All training is based on a *competence profile* for each individual, established through *tests*, describing how that person meets the requirements of different audit assignments. The training covers areas such as auditing, accounting, role of the auditor, government administration, the budget process, information technology, financial management, and public and commercial law.

A *competence development plan* is then designed for each person, laying out the needs for additional training and practical experience. There are three levels of training: Basic, Further and Specialist Education. Self-study, outside office hours, is required. Basic courses involve 80 hours per year for five years covering, as needed, each of the topics in the profile. Further Education involves 40 hours per year after the first five years. Specialist Education is designed to meet the needs in specific areas such as audit of IT systems and accounting, and supplements the Basic and Further Education courses.

Tests are used at the end of each stage to ensure that the auditor has a thorough knowledge of auditing and state accounting. Successful tests lead to *certification* of the auditor. These tests were developed with the help of the Swedish Association of Authorised Auditors, the most prominent private auditors association. Trainers and training materials are to a substantial extent drawn from organisations outside the SNAO.

team, as a whole, possesses the knowledge and skills required for that particular audit. If the SAI is auditing the financial statements of an entity, the audit team must include (and preferably be led by) a fully qualified financial auditor. In some countries, this ability is evidenced by some type of certification, usually one that is issued following successful completion of a course of study and a related examination. There may also be a required period of practical experience. If the SAI is auditing a government computer system (or an activity that is highly dependent on computer support) the audit team should include individuals who are knowledgeable about computers and experienced in auditing such systems. This, too, may be evidenced by a special certification of competence. (See Box 14.2 for a Swedish example on training of auditors).

From time to time, an SAI will encounter a situation in which it must carry out an audit for which no one on the permanent staff has the requisite knowledge and skills. When such situations arise, the SAI must be able to obtain the needed skills elsewhere. The most common solution is to hire consultants who can help plan and guide the audit and interpret the data resulting from the audit work. In other circumstances, the SAI may contract a private firm to carry out all or some part of an audit for which it lacks the necessary resources or specialised skills.

Such consultants and contractors can be an important supplement to the SAI's own staff, but great care must be taken in using them. The outside expert or firm may perform the work, but the SAI remains responsible for the results. Thus the SAI should require the experts and contractors to adhere to the same standards of objectivity and independence, including avoidance of conflicts of interest, which the SAI's own staff is subject. In addition, the SAI should maintain sufficient oversight of the work performed by others, to confirm that it was done competently before approving any findings based on that work. In some circumstances, the SAI may need to seek advice from other experts in assessing the quality and reliability of a contractor's work.

Using the work of others as a basis for reaching audit conclusions is the subject of much discussion among auditors. The previously mentioned European Implementing Guidelines issued by the European Court of Auditors addresses this issue at some length. The International Federation of Accountants has also studied this topic.

B. Types of Audit

Many different kinds of work are subsumed under the term "auditing". Most SAIs are authorised to perform any of these activities. The SAI may develop a strategic plan that will allow it to carry out any mandatory audits while also using its available resources in a cost-effective way on other types of audits. There are five broad categories of audit, described below.

1. Ex ante audit

In this type of auditing, also called "pre-audit" or "a priori audit", individual transactions are examined for propriety before they are completed. That is, a payment may not be made until the auditor has approved the related voucher after examining the supporting documents. Centralised ex ante auditing by the SAI is still practised in a number of countries. In other countries, however, such audits are seen as an element of the management control structure, and therefore a responsibility of management, not of the SAI. In these countries, ex ante auditing by the SAI has been largely abolished, with the SAI focusing instead on the reliability of the measures taken by each ministry to avoid illegal or improper payments and other transactions.

2. Ex post audit

For countries in the European Union, the main focus of the SAI has shifted from ex ante audits to ex post audits — the examination of events after they have occurred.

The INTOSAI Auditing Standards state (paragraph 38) that "the full scope of government auditing includes regularity and performance audit." The standards go on to say (paragraph 39) that:

"Regularity audit embraces:

1. Attestation of financial accountability of accountable entities, involving examination of financial records and expression of opinions on financial statements.

2. Attestation of financial accountability of the government administration as a whole.

3. Audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations.

4. Audit of internal controls and internal audit functions.

5. Audit of the probity and propriety of administrative decisions taken within the audited entity; and

6. Reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed."

In addition, as noted earlier, an annual appropriation report must be submitted to the SAI.

Within this broad range of regularity audits, there are two primary types, which have differing objectives. One of these, referred to here as "compliance auditing", seeks to identify any instances of illegal or improper transactions. The purpose of such an audit is to determine whether or not the accountable entity has properly discharged its responsibilities. The other type of procedure, referred to here as "attestation auditing", seeks to determine the accuracy of the data contained in financial statements and reports. The purpose is to assess whether or not the reader of those statements can have reasonable assurance that they properly depict the financial activity and condition of the entity.

There is some overlap between the two types of regularity audit. A well-conducted attestation audit should reveal weaknesses in internal controls that might permit improper payments and other irregularities. Similarly, a thorough compliance audit, by assessing the overall probity of the accountable entity, can provide useful clues about the likely validity of financial reports issued by that entity. However, the sharp differences between the two types of audit must be kept clearly in mind in judging which procedure is more appropriate in any specific situation.

3. Compliance audit

This form of auditing involves checking individual transactions after the fact, to ensure that the appropriate authorisations and documentation are present. The focus is on determining the legal propriety of the individual transaction.

An SAI that does a substantial amount of compliance auditing needs a strategy for that work. It might decide, as others have, to delegate that responsibility to the ministries concerned. However, this may not be a practical solution in a country where management controls in government entities are weak and unreliable. The SAI may be the only institution capable of detecting and halting irregularities. If that is the case, the SAI should carefully consider how to use its resources with greatest cost-effectiveness.

Few, if any, SAIs have enough staff resources to examine every transaction in every unit of government. It would be wise for an SAI, preferably in co-operation with the ministry of finance and the internal audit units of the operating organisations, to use its available auditing resources as part of a co-ordinated strategy for strengthening the management controls that can prevent irregularities and other sources of waste of budget resources, rather than in an ultimately futile effort to detect and correct every irregularity. By the strategic use of compliance audits, the SAI can identify the control weaknesses that permit the irregularities and demonstrate the need to correct those weaknesses. The ministry of finance or other central management agency can then use this information to emphasise the necessity of improving controls and, in particular, of strengthening the internal audit units that are an essential element in building and maintaining effective control structures.

There are several ways of implementing such a strategy. One approach would be to concentrate on areas where frequent irregularities are known to occur. This might include wages and salaries or routine supply purchases. The individual irregularities may be small but their total amount may be large. Furthermore, they may create a climate of tolerance which, over time, can weaken the integrity of the entire organisation.

Another approach would be to focus on specific areas of government activity, where there is judged to be high risk of major irregularities. Many SAIs, for example, have recognised the risks of large procurement transactions and have concentrated resources on audits of such transactions in an effort to strengthen the procurement system.

In either of these strategic approaches, if large or wide-spread irregularities are found, additional audit work is appropriate to correct the problem. This might well take the form of a performance audit, as discussed later in this chapter, focusing on the procedures and controls that are needed to prevent a recurrence of the problem.

The real purpose of a strategic approach to compliance auditing should be to strengthen the systems to prevent irregularities, not just to detect past errors. Most SAIs have found the practice of routinely auditing individual transactions to be a very inefficient way of seeking better management of state resources. Identifying individual errors may correct that particular error, but experience shows that, unless compliance auditing is part of a broader strategy to overcome the sources of irregularities, detecting an irregularity is unlikely to prevent a similar error from arising in the future.

4. Attestation audit

Many SAIs are required to perform annual audits of the national budget or other government financial reports. The audit report may be required before the legislature can close the accounts on the budget year in question.

In some countries, the SAI's audit report on the national budget is a true attestation audit, as discussed in this section. In others, however, it is primarily a compliance audit, aimed as detecting irregularities, such as overspending or the diversion of budget resources to activities not authorised by the parliament.

Such audits can be useful in judging the integrity of the government's financial administration, but they are of little help in assessing the overall financial condition of the state sector.

The objective of a true attestation audit is to render an opinion as to whether the reader of the statement or report can be reasonably sure that the information contained in the report is correct. SAIs have taken various approaches to satisfying such requirements, some more successful than others. One technique is to examine a few of the transactions that are included in the report, on a sample basis, relying on the auditor's judgement in selecting those transactions. If no errors or irregularities are found in the selected transactions or in the way they are reflected in the report, the report is considered accurate and that conclusion is reflected in the audit report.

Users of financial report should view an audit conducted in this manner with considerable scepticism. If there is no valid statistical basis for assuming that the sample is representative of the entire body of transactions, one can have little confidence in conclusions reached about the overall report, even if the sample was drawn by an experienced auditor.

An alternative is to examine a sample of transactions that is statistically representative of the entire body of transactions. Such an audit demands the assistance of skilled statisticians, who should also be involved in interpreting the results. If such an audit is performed properly, the user can have relatively high confidence in the results. However, the results apply only to that specific report and the full sample audit must be repeated for any subsequent reports.

In some countries, the SAI's attestation audits use a basically different approach, modelled on the techniques used in auditing the financial statements of commercial enterprises. Such an audit starts by examining the accounting and other systems used to compile the data and the controls that are intended to prevent irregularities and ensure the proper reporting of transactions. If these are deemed to be well-designed, a relatively small sample of transactions is examined to test if the systems and controls are operating as designed. Thus the audit focuses on the reliability of the systems and management controls underlying the statements and reports. If these examinations are satisfactory, the auditor can provide reasonable assurance that the reports flowing from those systems are accurate.

This approach has advantages. Once the systems and controls of the audited entity have been thoroughly examined, tested, and judged adequate, future audits can be performed much more efficiently. They need not repeat all the steps of the previous audit and can focus primarily on any changes in the systems and controls that may have occurred in the meantime and on limited testing to ensure that they continue to operate properly. However, an SAI undertaking this type of audit must invest in staff with the required skills, which are considerably different from those needed for compliance auditing.

SAIs may need to outsource some of their attestation audit work because of limited audit resources. Each SAI must determine how best to meet its responsibilities in this area. It needs to make a strategic judgement as to the extent of outsourcing required and how it will ensure itself that applicable standards will be followed, if the work is to be done by others. In any event, the SAI must equip itself with staff who are sufficiently skilled in this type of auditing to assess the quality of the work, even if that work is to be outsourced.

5. Performance audit

This type of audit has become increasingly common among SAIs. A performance audit examines an entire entity, activity or programme in order to suggest ways of improving the efficiency of those operations. The auditor searches for areas of waste and mismanagement which, if eliminated, would

permit the same policy or programme objectives to be achieved at less expense, and for areas where the same resources, used differently, would produce greater value for the same cost. This type of auditing can make a major contribution to increasing the efficiency of government. Audit reports with useful recommendations in this area are typically quite popular with those who are trying to deal with difficult budgetary problems, such as ministries of finance and committees of parliament with budget responsibilities. Performance audits may also be designed specifically to address the adequacy of management controls, as part of a broader strategy for strengthening such controls.

However, performance auditing is quite different from compliance auditing and attestation auditing. It requires the ability to analyse operations in a way that is more often associated with the profession of management consulting than with traditional auditing. SAIs wishing to begin this sort of auditing must make a strategic decision about how much they are prepared to invest in training to build a staff with competence in this work.

Boxes 14.3, 14.4, 14.5 and 14.6 give examples of performance audits from Denmark, France, Sweden and the UK.

Box 14.3. **DENMARK: MANAGEMENT BY PERFORMANCE-BASED CONTRACTS**

In 1993, the Danish government decided to employ performance-based contracting as a permanent tool for managing state agencies. The objective was to improve the conditions for political management and to contribute to a more effective operation of government agencies. Agencies and other bodies included in the scheme were given greater management autonomy in return for improved performance.

In 1998, the Danish National Audit Office (DNAO) decided to assess the results of this initiative. The audit objective was to determine if the use of performance contracts had contributed to improved operational efficiency and effectiveness by government agencies, including measurable performance improvements. Data was collected by the use of file examination, surveys and interviews. Quantitative measurements of goal-achievement and productivity were based on data from performance contracts, activity charts of the national budget and the central accounting database.

The DNAO found that, with one exception, none of the contracting agencies had met all performance targets, and that only 64% of them met 75% of the targets. Taking into account over-performance on some targets, 71% of the agencies had a goal-achievement of 90% or above.

In addition, despite an earlier recommendation from the Public Accounts Committee, the financial and/or administrative consequences of incomplete goal-achievement were not specified in the contracts.

However, comparing the change in productivity in contracting agencies with that in a "control" group of government agencies, the DNAO found that performance contracting seemed to have had a positive effect on agencies' productivity.

The DNAO concluded that the initiative had supported the government's performance-based management approach. Moreover, the DNAO recommended that the ministry of finance should ensure that the budget allocations to agencies participating in the scheme, and other government bodies reporting on performance, were linked to the results achieved.

Box 14.4. FRANCE: HIGHWAY CONSTRUCTION POLICY

The network of highways and motorways has expanded rapidly in France in recent decades. This expansion has been made possible by using the so-called "concession regime" which permits the use of toll revenues to cover the cost of new construction work.

While recognising the potential benefits of this scheme, the French *Cour des Comptes* also stressed its risks. The Court decided to carry out a performance audit of the highway construction policy in order to assess its effectiveness (*La politique autoroutière française*, 1999). The audit was done in co-operation with the regional *cours*, which are responsible for audit at the local level. It updated findings and recommendations from earlier audits and analysed studies made by other control bodies. Additional information was gathered via questionnaires and interviews. In parallel, a financial audit was carried out of relevant organisations.

The audit reached the following conclusions:

- The development of the transport system needs to take into account all possible modes of communication and transportation needs.
- To avoid distorting competition, the calculation of costs and benefits needs to be improved. The calculations should take into account the external costs and benefits of the different modes of transportation.
- Concessions should be awarded on a competitive basis.
- The *Assemblée Nationale* needs better information on the road programmes and the financial situation of the companies holding the concessions.
- A new traffic-forecasting model should be developed to produce more robust profitability estimates.
- It would often be more cost-effective to improve the existing road network rather than building new highways.
- Greater attention should be given to the impact of the highway construction programme on the environment.

A key conclusion of the audit was that the funding scheme has been a decisive factor in the choice of the type of infrastructure. As a result, many highways have been built on routes with very limited traffic flows, making it difficult to recover costs and creating a risk of financial problems.

Most of the conclusions of the audit have been endorsed by the Finance Commission of the *Assemblée Nationale*.

Box 14.5. SWEDEN: SCHEMES TO REDUCE UNEMPLOYMENT

The economic recession in Sweden that started in the early 1990s had severe consequences for employment, particularly in the construction sector. The Swedish National Audit Office (SNAO) audited two schemes that were adopted in 1994 by the Swedish parliament to reduce unemployment in the construction sector. The costs of these schemes totalled 4 billion SEK. The SNAO's audit objective was to assess: (a) whether the schemes had contributed to a *net* increase in employment in the construction sector; and (b) how cost-effective these schemes were in creating new jobs. Data was collected through questionnaires. One questionnaire was addressed to a random sample of 800 recipients; another to all the construction companies which, according to the grant recipients, undertook projects that would not have been executed without grants. The SNAO found that:

- More than half the money went to projects that would have been implemented even without the grants. The net benefit was thus less than 50%. Three quarters of the beneficial impact was due to the starting date of projects being brought forward, and one quarter to the impact of new projects.

- Each "net grant-aided project" represented less than 10% of the construction companies' overall business during the period. 60% of these companies stated that their workforce would have remained the same without the grants.

- The cost to the government of creating each *new* job was 50% of the salaries paid to the workers in one of the schemes and 200% in the other. The first scheme was consequently more cost-effective than the other.

The SNAO concluded that the two schemes had a very limited effect on employment and had a low cost-effectiveness. The government subsequently terminated the two schemes.

Box 14.6. UNITED KINGDOM: PROCUREMENT OF EQUIPMENT FROM RESEARCH GRANTS

This performance audit study examined grants to universities for research equipment by the Engineering and Physical Sciences Research Council (EPSRC) totalling £38 million in 1997-98.

The National Audit Office (NAO) examined 68 of these grants and found that:

- Grants were calculated using estimates of the cost of equipment. On average, actual costs were 16% less than the grant amount. Generally, universities used the remaining funds to purchase additional equipment. Improved estimating could yield £6 million a year for the Council to fund approved research, which otherwise might not have been funded.

(cont'd)

Box 14.6. **UNITED KINGDOM: PROCUREMENT OF EQUIPMENT FROM RESEARCH GRANTS** *(cont'd)*

- Many universities purchase equipment at competitive prices. But insufficient use is made of competitive purchasing, which could yield savings of £2.7 million a year.

- Other areas of best practice were not being applied. For example, the technique of whole life costing was not being followed and alternatives to outright purchase, such as leasing, were not considered.

The NAO recommended that the EPSRC:

- Encourage universities to improve their estimation of equipment costs by requiring proposals for equipment funding to be fully documented, thus recognising the effort required in preparing such proposals.

- Make applicants aware that, for research proposals of equivalent quality, those that have well supported and realistic assessments of equipment costs are more likely to be funded.

- Encourage universities to follow best practice procurement procedures; and

- Identify opportunities for co-ordinated purchasing between universities.

C. Reporting Audit Results

Requirements for the distribution of audit reports are often specified in the laws establishing an SAI and defining its authority and responsibilities. In many countries, all audit results are required to be reported to the parliament. The reports may be forwarded individually, or may be provided in a summary report at specified intervals, perhaps annually, or both. Often, reports to the parliament are automatically delivered to a single committee with responsibility for overseeing the work of the SAI, such as a public accounts committee. Typically, however, requirements such as these describe only the minimum permissible distribution of audit reports. Most SAIs have considerable discretion to distribute additional copies of their reports as they deem appropriate.

The general rule for distributing audit reports should be to provide copies to those organisations and persons with an interest in the topic and especially to those who are responsible for acting on the findings and recommendations contained in the reports concerned. For example, the entity that has been audited should always be informed of the results and the ministry of finance should be routinely informed of reports that have implications for budget allocations or the management of budget resources. If the audit shows the need for new or revised legislation, the SAI should bring this to the attention of the parliamentary committees that would consider such legislation and the ministry that would be responsible for proposing or implementing it.

The SAI and other auditors should also recognise that, in a democracy, the general public has a legitimate interest in the results of audits of public entities and the use of public funds. In many countries, all SAI audit reports are made available to the public unless they must be restricted for national security

reasons. Auditors should also recognise the role played by the media in informing the public about government operations and should take steps to ensure that media representatives are aware of significant audit reports. A competent and proactive media is crucially important for the effective implementation of audit results, as the public at large is most unlikely to be interested or directly competent to interpret the audits.

D. Acting on Audit Results

Some SAIs are empowered to order corrective actions of certain kinds when irregularities are found during an audit. When an overpayment is discovered, for example, these SAIs may issue an enforceable order to recover the excess payment. However, this authority is usually available only with respect to illegal acts and many SAIs lack such authority even in these matters.

For the most part, auditors are authorised only to report what they have found. They must rely on others to correct the reported problems. This is especially true with respect to the matters on which modern auditing tends to concentrate: the reliability of financial data and reports; the adequacy of management controls; and the economy, efficiency, and effectiveness of programmes and operations. Some SAIs are empowered to issue binding directives, but this is typically limited to recovering funds that have been misspent. If the problem is more complicated than this, solving it may require action by the parliament, the government, a line ministry, or an operating agency. Typically, the auditor cannot force any of these institutions to act. However, the auditor bears considerable responsibility for encouraging an appropriate response to audit findings and for facilitating needed corrective action. There are several things an auditor should do to meet this responsibility:

- *Clear findings*. General observations such as "money was wasted in programme X" are not especially helpful. Auditors must state as clearly and specifically as possible the nature of the problems they find and the consequences. Which management (internal) controls were absent or failed and how much money was wasted or misappropriated because of that failure? Which specific policies or procedures caused the observed inefficiencies and what was the financial and organisational impact of the inefficiency? It is the auditor's responsibility to ensure that the reader of the audit report can easily grasp the nature of the problem and the importance of correcting it.

- *Convincing evidence*. The evidence supporting the findings must be relevant and credible and must be presented in a clear and persuasive fashion in the audit report.

- *Cost-effective recommendations*. If an auditor identifies a problem, it is normally useful if he/she suggests a reasonable solution for that problem. As with findings, general remarks about solutions are not helpful. If there was a failure of controls, the audit report should specify the actions needed to prevent a recurrence. If changes are needed in laws, regulations, or administrative procedures to achieve greater efficiency or effectiveness, these should be described with as much precision as possible. It is also essential that the recommended corrective actions be legally and administratively feasible and that the costs of implementing them are not disproportionate to the problem. The goal should be to convince the reader of the wisdom of correcting the problem.

- *Effective communications strategy*. The best-written audit report serves no purpose unless its contents are made known to those who can act on its findings and recommendations. The auditor should think carefully about who needs to read the report and how best to ensure that they give it the attention it deserves. Merely sending the report to someone may not be sufficient. Parliamentarians and

government officials are busy people and typically receive far more written material than they can find time to read. A brief, well-written executive summary accompanying the report can help, as can follow-up conversations with the official or with key members of his staff. It is often useful to work with others, such as officials of the ministry of finance, who may be in a position to encourage appropriate action. In addition, if the media gives attention to a report, this can be a helpful stimulus to corrective action.

In many cases, audit units issue "audit observations". These are based on evidence and advise the auditee that corrective action is needed (specifying the nature of the corrections). The auditee has the opportunity to make changes before the final audit report is written; the report would then contain information on the audit observations and on actions taken or not taken on them. Such dialogue is often more effective than fault-finding, and is far more constructive for building institutional capacity. The cases described in Boxes 14.3 to 14.6 illustrate a variety of useful audit findings.

E. Audit Limitations

1. Reasonable assurance

The external audit prouss has strengths, but there are limitations as well. No reasonable auditing procedure can be sure of finding every error or irregularity. The prevention and detection of errors and irregularities is, first and foremost, the responsibility of management, not the auditor. If problems are discovered later, the auditor should be held responsible only for conducting a proper audit in accordance with auditing standards. It is in the nature of auditing that some mistakes — only minor ones, it is hoped — will escape the auditor's attention.

For example, in auditing the financial statements of an entity, the auditor can provide only "reasonable assurance" that the statements are reliable. Neither the auditor nor the reader of the audit report should believe that such an opinion is an absolute guarantee that there are no material errors in the statements. The limitations discussed in Chapter 10 on internal controls apply to audits, as well. If there is collusion among key individuals in the entity being audited, or if there is an intentional effort on the part of the top managers deliberately to conceal facts, there can be no absolute assurance that the auditor will detect the resulting distortion of the truth. Thus, the phrase "reasonable assurance" in an audit opinion must be taken seriously by the reader of that report, and it is the SAI's responsibility to stress this point.

2. Access to data and records

Auditors can audit only that which they can observe. If the management of an entity maintains secret records involving matters that are material to the audit, and to which the auditor is not permitted access, the audit will have no credibility and should not proceed. In government auditing, these cases arise most frequently with regard to agencies involved in national security activities. However, auditors may also encounter situations in which access is restricted or denied in an apparent attempt to avoid disclosure of illegal, corrupt, or politically embarrassing activities. In these circumstances, the auditors should report the facts to others, such as the parliament, who may be able to facilitate the required access or take other appropriate action.

NOTES

1. The Lima Declaration was released in October 1997 at the 9th INTOSAI Congress and restated by INTOSAI in 1998. Available on the INTOSAI web site, http://www.intosai.org.

2. There are considerable variations between the SAIs when it comes to audit remit and scope of the audit. Many SAIs combine characteristics of different models. For a description of the SAIs in the European Union see United Kingdom, National Audit Office (1996).

3. Finland and Sweden have currently a unique system that combines an SAI within the structure of the government with an audit body appointed by the parliament. However, the Finnish system is likely to be changed to the conventional model of an audit body reporting to the parliament.

4. See, Auditing Standards issued by the Auditing Standards Committee of INTOSAI in 1992, amended in 1995. The INTOSAI standards and the EUROSAI guidance are available from the INTOSAI secretariat in Vienna (http://www.intosai.org). The European Court of Auditors in Luxembourg published the "European Implementing Guidelines for the INTOSAI Auditing Standards" in 1998 (see http://www.eca.eu.int). For more information on auditing standards see also SIGMA's audit and financial control web pages at http://www.oecd.org/puma/sigmaweb.

5. Different solutions on how to organise the audit of such organisations are described in SIGMA (1998) *Central Bank Audit Practices* and SIGMA (1997b) *Effects of European Union Accession. Part I — Budgeting and Financial Control*.

CHAPTER 15

PERFORMANCE MEASUREMENT AND EVALUATION

This chapter deals with performance measurement and monitoring, and programme evaluation. These instruments and techniques have common purposes: improved programme management, increased accountability and better decision-making, as they feed back information on the outcomes and outputs of existing government policies and programmes in order to improve the design and implementation of such programmes in the present and the future.

A. Performance Measurement

1. What is performance measurement?

Performance measurement is an instrument for assessing progress against stated programme goals and objectives, assuming that the strategic objectives are known. It consists of the following activities:

- Documenting the "production process", which consists of processes and activities used to turn *inputs,* which are the resources used by the programme, into *outputs,* which are the goods and services directly produced by the programme.

- Assessing the *outcomes* — the broader economic or social changes resulting from a policy or programme — and comparing them with the programme objectives.

Performance measurement may indicate in general terms the result of a policy measure or programme, but does not analyse why it has occurred or what changes may need to be made to activities or programme objectives. For this purpose, an in-depth assessment of the programme is needed. Programme evaluation, which is reviewed in Section B, extends beyond the tracking and monitoring of performance measures into an examination of the ways in which outcomes are affected by the programme concerned. Whilst performance measurement focuses on efficiency and effectiveness, evaluation covers in addition issues such as utility, relevance and the sustainability of the programmes concerned.

More specifically, it is often said that performance measurement covers the following five dimensions of performance (OECD, 1994):

- *Efficiency,* which is the relationship between the goods and services produced by a programme or an activity (outputs) and the resources used to produce them (inputs), and is measured by the cost per unit of output. Efficiency must be assessed against some benchmark, e.g. the unit cost of the activity in a previous period or the unit cost of carrying out a similar activity in another agency or establishment.

- *Effectiveness,* which is the extent to which programmes achieve their expected objectives, or outcomes. Effectiveness is the most important element of value for money in the public sector. Goods or services may be provided efficiently but if they do not achieve their intended objectives, and give satisfaction to the users of public services, the resources used will be largely wasted.

- *Economy,* may be defined as "the acquisition of the appropriate quality and quantity of financial, human and physical resources at appropriate times and at the lowest cost concerned"[7], and may be assessed through input measures, and comparisons with norms and standards.

- *Compliance*. Agencies must comply with the budget or appropriation act and other laws/regulations e.g. in relation to the management of cash flows and timely payment of creditors. A tax collection agency, for example, may have specific performance targets (such as the amount of tax arrears collected). Such measures of financial performance are sometimes more related to efficiency than to compliance.

- *Service quality*. In its broader sense, service quality refers to effectiveness. However, it is generally used in a narrower sense relating to the more immediate needs of users, such as timeliness, accessibility, reliability and continuity of services. As such, it refers to the quality of service delivery rather than of service outcomes. Development of a responsive client/consumer-oriented culture in public service delivery is on the reform agenda of most OECD countries and many others.

"Performance" is an amalgam of all these dimensions. Some individual dimensions interact and may conflict with each other. For example, it may be possible to improve service quality or compliance but only at higher cost and lower efficiency.

2. Performance measures and indicators

a. Types of measure or indicator

Performance can be measured through measures or indicators. Measures correspond to direct records of inputs, outputs and outcomes. Indicators are used as a proxy when direct measures are difficult or costly to obtain (e.g. the "street" price of illegal drugs as a measure of the outcomes of an anti-drug programme). In practice, as well as in this chapter, the terms "measures" and "indicators" are used interchangeably.

The categories of performance measures that support the assessment of the dimensions of performance enumerated above are as follows:

- *Inputs*. Measures or indicators of inputs concern the use of personnel, equipment, materials, etc. Inputs are usually expressed as the amount of expenditure or staff time. Measures of inputs concern the *economy* with which resources are used to deliver outputs and outcomes.

  When expressed as a ratio of outputs and outcomes, input indicators are used to measure *efficiency* and *cost-effectiveness*. Inputs should include both current expenditures and the use of capital goods and, ideally, costs should be estimated on an accrual basis. For example, for a road maintenance programme a cost-effectiveness analysis should take into account the depreciation of equipment, which accounts for a significant share of the full costs. However, although the operational cash costs do not measure the full costs of a programme, generally the trend in such costs does not differ much from the full costs of the programme (Premchand, 1993).

- *Outputs*. Outputs refer to the goods and services produced by a programme or an activity (e.g. kilometres of road build, number of children vaccinated, etc.). Output indicators are used to assess *efficiency*. Efficiency can be measured by the ratios of inputs to outputs often expressed as the number of employees or amount of employees' time per unit of output, and referred to as *unit cost (*e.g. the number of days expended per repair made, or the cost per kilometre of roads that were repaired to a satisfactory condition). *Productivity* is usually measured as the ratio of the amount of output to input, e.g. the number of prisoners transported divided by the cost of transportation. (Sometimes, however, productivity may refer to the ratio of outcomes to inputs). Workload or activity level measures are often used as a proxy for output measures (e.g. the number of inspections carried out).

- *Outcomes*. Outcomes correspond to the ultimate policy purpose, or the desired ends of a policy, that are achieved by producing the outputs (improved accessibility of remote areas, the reduction in the number of cases of a particular disease, etc.). Measures of outcomes concern *effectiveness*.

- *Intermediate outcomes* are expected to lead to the ends desired, but are not in themselves ends. In many programmes a progression or sequence of intermediate outcomes occurs. For example, in the case of an environmental programme the sequence of intermediate outcomes could be as follows: law passed; number of businesses that change their behaviour; reduction of hazardous wastes and pollutant counts. There are various terminologies that seek to capture similar distinctions. For example, the term "result" can be used in a similar sense to "intermediate outcome", while "impact" may be used to describe results and (end) outcomes collectively. A recent guide published by the European Commission uses the term "impact" to describe the effects of a programme on society, and refers to "initial impact" as "results" and "long-term impacts" as "outcomes".[2]

Concerns about the quality of public service delivery are measured by indicators of *customer satisfaction* (e.g. the number of complaints received, surveys, and participative processes). *Service (delivery) quality* indicators measure the timeliness, accessibility, reliability and accuracy of services (e.g. police response time, compliance with transport timetables, hospital waiting times, etc.). Service quality often depends on processes.

Work process measures are indicators of the way work gets done in producing the output at a given level of resources, efficiency and effectiveness. Processes consist of a chain of activities or work practices, such as procurement procedures, technological processes for producing goods and peer reviews for policy formulation.

Process indicators help in evaluating performance in areas where outputs or outcomes are difficult to measure and have also by themselves an independent value, notably for assessing the quality of public service delivery. In certain areas, where output indicators are not very meaningful and outcome indicators difficult to measure, performance is sometimes assessed through process measures. For example, peer reviews can be used to evaluate the process of providing policy advice to ministers. In some areas of public activity, such as law or politics, "due process" is a key element of good governance.

As indicated earlier, the *impact* of a policy measure or programme is often synonymous with its outcome. Sometimes, however, the term impact has a more precise definition. Sometimes a distinction is made between *gross outcomes* and *net impacts*. The net impacts are the outcomes truly attributable to the programme. They do not include the effects of factors external to the programme, and are estimated through the evaluation methods reviewed in Section B. Impact analysis refers to the assessment of the

effects of an intervention on its surroundings (e.g. an environmental impact study), or shows the extent to which a programme actually produced certain effects on client populations. Sometimes, impact measures refer to how the outcomes of a particular programme affect other programmes or an organisation's mission.

Social indicators may be used to assess the broad impact of certain government policies. They consist of measures at a highly aggregated level, such as infant mortality rates and adult literacy rates. In practice, it is not easy to use social indicators to assess the performance of a particular programme. There may be problems, for example, in determining causality (e.g. reductions of infant mortality may be due to a clean water programme, an immunisation programme, a nutritional programme, or to external factors that are not attributable to government policies). Programme outcome indicators are designed to focus on more detailed aspects of performance. Social indicators nevertheless provide useful background information for policy decision-making.

Performance measures may be either *quantitative* or *qualitative*. Qualitative measures can be transformed into quantitative ones by surveys, report cards, and other techniques of assessing the opinion of users. For example, the quality of education can be in part quantified by measuring the percentage of parents who are "fully satisfied" with their children's school.

The ultimate purpose of the government's programmes is to produce outcomes. However, defining outcomes and developing outcome measures can present difficulties. Sometimes, outcomes occur only after many years. Often, a programme is only one of many influences on an outcome. Attribution, which consists of determining how much of the outcome is truly attributable to the programme rather to other influences, is a challenging task. Compared to output indicators, outcome indicators are more relevant in assessing the achievements of programmes, but output indicators are generally easier to define and measure.

In some sectors, output measures can be used as a surrogate outcome indicator. For example, for a road construction programme, the number of kilometres built, which is the output of the programme, can be used for assessing its effectiveness. Nevertheless, in other sectors, notably the social sectors, outcomes can sometimes be so remote from outputs that the latter are not reliable indicators of the former. For example, an increased number of medical visits does not necessarily imply reduced illness. To provide useful feedback to decision-makers intermediate outcomes (i.e. results) should also be measured.

b. Performance as a relative concept

Performance is only a relative concept. By definition, assessing effectiveness requires comparing measures of outcome or output to the programme objectives. In practice, to assess whether results are good, bad or indifferent, every performance measure should be compared against some base or standard. Thus, performance is often measured against:

- What has been achieved in the past. Time series statistics are very useful, but do not take into account changes in efficiency or productivity due to technological factors.

- What other comparable programmes or organisations are achieving, or national/international standards in the field. The activities of other organisations provide useful benchmarks. The problem here is to find a strictly comparable organisation.[3]

- Targets set in the budget or other policy statements by the government.

Comparisons should be made only on a like-with-like basis. This requires defining properly the indicator and the basis of comparison. For example, in comparing the performance in examination results of different high schools, it may be appropriate to correct the gross measures (e.g. the ratio of exams passed per student) by various factors, such as differences in the social origin of students.

Although they have a useful role to play, performance measures and indicators need to be handled with care. Their meaning and interpretation must be systematically questioned and, if not used carefully, they may seriously distort the behaviour of organisations, managers and employers (see Likierman, 1993b). For example, a rigid focus on a small range of performance measures, with no provision for dialogue on their interpretation, may successfully achieve certain targets, whilst distracting attention from the attainment of broader organisational goals and objectives.

3. Functions of performance measurement

a. Different measurement systems for different purposes

The development and implementation of performance measurement should be adapted to local circumstances and concerns. The substance of performance measures differs according to the responsibilities of those whose performance is being measured and the requirements of those using the information. At the operational level, measures and indicators should be related to issues such as the management of resources and production processes. At a higher management level, the information should be related to issues of programme effectiveness, in order to inform decisions on policy formulation and resource allocation.

b. Organisational learning and programme management

Performance measurement is useful for evaluating administrative performance and organisational learning. It can be used to improve the operational efficiency of a complete organisation (e.g. a ministry or public agency); or by individual managers within an organisation to evaluate and strengthen the performance of a department, division, unit or other subdivision of that organisation.

Performance measurement can be a useful tool for managing entitlement programmes and investment projects or programmes. Performance information can help ensure that such programmes are implemented in conformity with their objectives, and in preparing new programmes. For example, in the road sector, performance measures covering issues such as mobility/accessibility, traffic flows, and safety and environmental factors can be useful in both preparing and supervising the implementation of programmes.

c. Performance contracts and agreements

Performance measurement can be used as an instrument for strengthening managerial accountability. Results-oriented management systems attempt to link the performance of managers to explicit or implicit contracts, which generally include performance targets. In theory, contracts should provide for both penalties and rewards. However, in most cases only rewards are included in the contracts, for example, the possibility of managers retaining some or all of any efficiency savings made; flexibility in resources (e.g. in staffing numbers); or a performance-related element in the pay of senior management and unit heads.

The dimensions of performance to be measured in defining such contracts are necessarily narrower than for programme evaluation. For example, it is possible to hold managers accountable for the output of a vaccination programmes, and to reward them accordingly. However, it is difficult to hold them

responsible for the outcome of improving health, which may depend on factors outside their control, such as the quality of water or changes in tobacco consumption. Performance measures used for the purpose of accountability and control focus by necessity on inputs and outputs rather on programme outcomes.

Even where budget funds are provided on the basis of a contract or a performance agreement, the link between performance and resource allocation remains indirect. In most cases, the release of budget funds or grants is not conditional upon delivery of agreed performance results.

Contracts may offer a way of supplementing the over-formal nature of targets and indicators, since they place more emphasis on managing relationships than on simply collecting quantitative information about achievements (see Trosa, 1996a). However, generalising a contractualist approach beyond a few programmes or organisations would be difficult to apply in most transition countries at the present stage of their development.

Performance-related pay systems link some elements of remuneration to a specified level of activity or output and can contribute to improving operational performance. In transition countries, such systems could perhaps facilitate switching from an administrative culture based on command and control of the economy to a customer-oriented culture. However, extreme caution is required before considering whether to implement such systems. Selecting relevant indicators is a tricky issue. Making staff accountable for elements that are not fully under their control is questionable. But focusing on results more directly attributable to the efforts of staff and managers can encourage them to develop short-term responses that trigger rewards, to the detriment of actions that achieve wider programme and organisational objectives. Whether or not performance-related pay schemes actually improve performance is debatable. Motivational theories stress intrinsic motivation (i.e. the job itself, or the ethos of public service in some countries) rather than extrinsic motivation (money and benefits). Moreover, results-oriented personnel management systems may lead to undesirable outcomes where patronage or political considerations are dominant, since politicians and managers will tend to reward "their" people, rather than the best performing individuals.

d. External accountability

In some EU Member States, performance information is published to improve accountability to parliament and taxpayers, and to facilitate value for money audits. For example, in the UK, agencies are required to provide, in annual performance agreements with the minister concerned and in their published annual reports, data on performance spanning a number of years so that comparisons over time can be made. In several countries, the supreme audit institutions comment on the progress of performance measurement and its appropriateness, but in a majority of cases do not comment on the results themselves.

Caution is required before considering the publication of performance information for a wider audience. On the one hand, publication can be useful for both control purposes and its educational role, since it contributes to introducing a performance culture. On the other hand, there are risks of incorrect use of information, if its inherent limitations are ignored, and of demotivating staff by unfair criticism. Publication of performance information favours competition among similar organisations and therefore efficiency. However, it can also contribute to aggravate the gaps between good performers and weak performers, notably in the education and the health sector, by driving resources and the most socially favoured students and patients towards the schools and hospitals that appear to perform best.

4. Effective performance measurement

a. The need for caution

Using performance measures as a performance management tool (e.g. for contracts) or as vehicle for public and political accountability can be dangerous. The experience of centrally planned economies shows that the imposition of norms and standards tends to make the officials concerned focus too rigidly on the achievement of the specified targets. Quality can be sacrificed and the vital link between objectives and performance itself may not get the attention deserved. When standards are maintained regardless of resource availability, the likely result is a weakening of fiscal control. Standards and indicators should not be considered as immutable.

These problems are not exclusive to centrally planned economies and examples of undesirable outcomes in using (or misusing) performance indicators in market economies are numerous. The "law of unintended consequences" states that attempts at modifying behaviour may produce unintended behaviour, which may conflict with the goals and objectives of the policy or programme concerned. For example, if hospital subsidies are based on the length of patient waiting lists, hospital managers and doctors will have an incentive to keep non-critical cases waiting as long as possible whilst focussing their efforts on other cases (higher-quality care for some, little for others); if performance is assessed instead by number of patients treated, the overall quality of care may suffer.

Depending on the way they are set up and used, performance indicators present the following potential dangers:[4]

- *Tunnel vision*, or emphasis on only the quantifiable, neglecting unquantifiable aspects of performance.
- *Measure fixation*, or concentration on what is being measured rather than the service that is being carried out.
- *Short-termism*, failure to attend to legitimate longer term objectives; and *suboptimisation*, or the production of a lower quality of service by concentrating on narrowly defined activities rather than wider organisational objectives.
- *Misrepresentation or deliberate corruption of data*; and misinterpretation or uncritical acceptance of the results of performance measurement.
- *Strategic management of behaviour* including deliberate under-performance in order to engineer targets that can be easily achieved.
- *Inflexible pursuit of defined performance objectives* set at one particular time.
- *Demoralisation* or loss of confidence and commitment amongst workers delivering services that are deemed less important than those targeted for performance measurement.

b. Criteria for good performance measurement systems

To avoid such pitfalls, some general guidelines and criteria can be used when setting up performance indicators (Shand, 1998):

- *Relevance and usefulness*. The measures should be defined properly in relation to the programme to which they relate and reflect the main goals and objectives of the programme. A manager's performance should be measured only for those areas over which he or she has control.

- *Clarity and understandibility*. Performance measures should be simple, well defined and be easily understood by users.

- *Cost effectiveness*. Performance measures must be established at reasonable cost. Data collection costs of introducing performance measures, and managing the system, must be assessed realistically and weighed against the expected benefits.

- *Capacity to monitor results*. As noted earlier, performance is a relative concept, and the measures must be applied consistently over time and between units in order to allow performance to be assessed in a systematic way.

5. Benchmarking

Benchmarking is a technique used in both the private sector and the public sector for comparing the performance of one organisation against a standard, whether absolute or relative to the performance of comparable organisations. It can be used to:

- Assess performance against the defined standard(s).

- Expose areas where improvement is needed.

- Identify processes activities that are carried out better in other organisations.

- Test whether measures taken to improve the efficiency or effectiveness of programmes have been successful.

There are two main techniques of benchmarking within the government sector:

- *Process benchmarking* applies to the processes and activities used to turn inputs into outputs. It consists either of benchmarking processes used by the organisation concerned against processes used in comparable organisations, or against processes as defined in a standard.

- *Results benchmarking* applies to actual results (outputs and outcomes). It consists of comparing the actual performance of different organisations using performance indicators, or of comparing actual performance against certain performance standards.

The two main types of benchmarking (process benchmarking and results benchmarking) are increasingly seen as complementary methods that can be used to reinforce each other. For example, results benchmarking can be used to identify discrepancies in results and process benchmarking can help explain why these discrepancies exist. Process benchmarking without results benchmarking tends to become inward-looking, leading to a focus on enhancing processes for their own sake, without checking whether or not the changes are relevant for users of public services and stakeholders.

Benchmarking may be used as a tool both for evaluation and continuous improvement. It is related to a number of management techniques, such as total quality management and process re-engineering,

and for performance comparisons and programme evaluation. Using benchmarking on a selective basis should be considered by transition countries. However, since benchmarking can involve a heavy investment in time and resources it is sensible to focus first on a few key organisations or processes.

Box 15.1 presents some examples of performance indicators used in the UK health sector.

Box 15.1. **PERFORMANCE INDICATORS IN THE UK HEALTH SECTOR**

Areas and categories covered	**Indicators**
I. Health improvement	
The overall health status of the population, reflecting social and environmental factors and individual behaviour as well as care provided by the NHS and other agencies i. Deaths from all causes (people aged 15-64)	i. Deaths from all causes (people aged 15-64) ii. Deaths from all causes (people aged 65-74) iii. Cancer registrations
II. Fair access	
Access to elective surgery	i. Surgery rates
Access to family planning services	ii. Conception rate for girls aged 13-15
Access to dentists	iii. People registered with an NHS dentist
Access to health promotion	iv. Early detection of cancer
Access to community services	v. District nurse contacts
III. Effective delivery of appropriate health care	
Health promotion/ disease prevention	i. Disease prevention and health promotion ii. Early detection of cancer
Appropriateness of surgery	iii. Inappropriately used surgery iv. Surgery rates
Primary care management	v. Acute care management vi. Chronic care management vii. Mental health in primary care viii. Cost-effective prescribing
Compliance with standards	ix. Discharges from hospital

(cont'd)

Box 15.1. **PERFORMANCE INDICATORS IN THE UK HEALTH SECTOR** *(cont'd)*

Areas and categories covered	**Indicators**
IV. Efficiency	
Maximising use of resources	i. Day case rate ii. Length of stay in hospital iii. Unit costs iv. Generic prescribing
V. Patient/career experience of the NHS	
Accessibility	i. Patients who wait more than 2 hours for emergency admission ii. Patients with operations cancelled for non-medical reasons on the day of, or day after, admission
Co-ordination and communication	iii. Delayed discharge from hospital for people aged over 75 iv. First outpatient appointments for which patient did not attend
Waiting times	v. Outpatients seen within 13 weeks of written referral vi. Inpatients admitted within 3 months of a decision to admit
VI. Health outcomes of NHS care	
Success in reducing level of risk	i. Conception rate for girls aged 13-15
Success in reducing level of disease, impairment and complication of treatment	ii. Decayed, missing and filled teeth in 5 year olds iii. Avoidable diseases iv. Adverse events/complications of treatment
Success in optimising function and improving quality of life for patients and careers.	v. Emergency admission to hospital for people aged improving quality of life for patients and over 75 vi. Emergency psychiatric readmission rate
Success in reducing premature death	vii. Infant deaths viii. Survival rates for breast and cervical cancer ix. Avoidable deaths x. In-hospital premature deaths

(cont'd)

Box 15.1. **PERFORMANCE INDICATORS IN THE UK HEALTH SECTOR** *(cont'd)*

Areas and categories covered	Indicators
VII. Example of breast cancer disease	i. Cancer registrations ii. Cancer registrations plus interval cancers by stage at first diagnosis
NHS success in reducing level of disease, impairment and complications of treatment	iii. Incidence of avoidable complications — (recurrence, complications of therapy, etc.)
NHS success in restoring function and improving quality of life of patients	iv. Measured using a self-assessment questionnaire or other appropriate measure
NHS success in reducing premature death	v. 5 year survival vi. 5 year survival standardised for age and stage of disease

B. Programme Evaluation

1. Definition and objectives[5]

a. What is programme evaluation?

Programme evaluation focuses on the assessment of a programme's achievements against its objectives. The term "policy evaluation" is also used but this has a wider scope, since it can cover several programmes, the regulatory framework, the analysis of interrelations between programmes and regulations, etc. However, many of the issues described below also apply to policy evaluation. Indeed, some countries do not distinguish programme evaluation from policy evaluation[6].

Programme evaluation can encompass different stages in a programme life-cycle:

- *Ex post* evaluations are carried out when the programme has been in place for some time to study its effectiveness and judge its overall value. These evaluations are typically used to assist in allocating resources or enhancing accountability. Questions of outcome and the overall relevance of the programme are expected to be addressed.

- *Intermediate* evaluations are usually undertaken during the implementation of the programme. The purpose is to support and improve the management and implementation of the programme. Emphasis is put on operational questions.

b. Objectives

The goal of evaluation is to improve decision-making and resource allocation by providing reliable data about the effects of policies and programmes. Uses of programme evaluation may cover the following:

- *Assisting in resource allocation and identifying desirable policy changes*. Evaluation provides information on the impact of existing policies. It therefore assists policy makers in assessing the value of public programmes and identifying areas where policy changes and/or shifts in the allocation of resources between different programmes may be necessary.

- *Improved programme management and organisational learning*. As noted earlier, feedback mechanisms contribute to the learning process of those managing and implementing programmes and can be used to improve their operational performance.

- *Enhancing public accountability*. Evaluation can improve transparency and accountability by shedding light on the impact of government policies.

c. Evaluation, monitoring, and audit

Evaluation is different from other feedback mechanisms such as monitoring and performance measurement, since it is generally conducted as a single exercise and gathers information in greater depth. While performance measurement focuses on efficiency and effectiveness, and often even narrower issues, evaluation studies assess also whether the programme complies with the needs and socio-economic problems it was designed to address. Evaluation studies often include a detailed review of attribution and causality issues, while performance measurement deals with more roughly assessed outcome or output indicators.

However, regular monitoring and performance measurement systems can provide useful information for successful evaluation. For example, some programmes include pre-determined milestones that record the achievement of certain goals and objectives, these can be used as "anchors" for a more detailed examination of the achievements and failures of the programme.

Evaluation and external audit are historically separate functions carried out by separate institutions. Audit is closely related to the parliamentary oversight function, and underlines the importance of legal compliance and the accountability of public organisations. As discussed in Chapter 14 the independence of supreme audit institutions is crucial, while evaluation is generally an activity carried out under the responsibility of the executive. Although its uses for enhancing accountability are increasing, evaluation is primarily an instrument for strengthening programme management and supporting decision-making. However, in practice, the boundaries between evaluation and audit are becoming blurred, since traditional financial audits are being supplemented with value for money audits, which are similar in methodological terms to programme evaluations.

2. Key evaluation issues

a. The programme logic

A key issue in programme evaluation is to examine the programme's "intervention logic" (i.e. the basic rationale for analysing a programme in order to examine to what extent it has achieved its goals and objectives); some manuals on evaluation refer to the "programme theory".

Programmes are always conceived with a given set of needs in mind. These needs are the socio-economic objectives and issues that the programme seeks to address, expressed from the point of view of its particular target population. According to the logical framework approach adopted by the European Commission[7], these objectives can be divided into:

- *General objectives*, which are expressed in term of end outcomes.
- *Specific objectives*, which are expressed in term of intermediate outcomes.
- *Operational objectives*, which concern planned inputs and outputs.

A structured approach should consist of the following steps: (i) description of the programme; (ii) clarification of its objectives, and the needs that the programme is aimed at addressing; (iii) identification of the possible causal relation between programme activities and effects; (iv) identification of the possible level of outcomes that can be evaluated (intermediate outcomes and/or end outcomes); (v) identification of outcome indicators and the criteria that will be used to assess effectiveness; and (vi) identification of the factors that may effect the outcomes. Box 15.2 shows an example of such a logical framework approach for an evaluation study, based on the EC's methodology.

As in the case of performance measurement systems described in Section A, relevant indicators must be set up. Similar problems can arise to those discussed in that earlier section. The attribution problem,

Box 15.2. **EXAMPLE OF A LOGICAL FRAMEWORK APPROACH TO EVALUATION**

	Intervention Logic	**Verifiable indicators**
End outcomes	Modern, private and transparent banking sector, characterised by a sound risk-reward proportionality	Performance rating of commercial banks
Intermediate outcomes	Restructuring and reorganisation of commercial banks into viable institutions, and preparation for subsequent privatisation	Number of banks privatised Prudential and performance ratios of banks, bad debt ratios, levels of provisioning, etc. Acceptance of guarantees Implementation of corrective action plans Organisational structure of the banks

(cont'd)

Box 15.2. **EXAMPLE OF A LOGICAL FRAMEWORK APPROACH TO EVALUATION** *(cont'd)*

Operational objectives	Trained management and staff	Functioning equipment
Outputs	Manuals	Restructuring plans available and discussed
	New organisational structure	Organisational structure accepted by management
	Installed equipment	
	Corrective action plans	Number of staff trained
	Restructuring action plans	
Inputs	Technical assistance (training, pre-privatisation support, etc.)	Number of days of technical assistance by contractors and consultants

Source: Commission of the European Communities, evaluation of a Phare banking programme, 1998

which is related to determining whether and to what extent the programme concerned caused the effects observed, is particularly crucial for evaluating programme outcomes. The evaluation of a programme requires the comparison of results with the targets established in the programme design, or with specific benchmarks. If the programme goals and objectives are stated clearly, when formulating budget policies, their evaluation is significantly easier.

b. Other key issues

Figure 15.1 shows the logical framework and the main issues to be addressed in performance evaluation studies. These key issues can be grouped into the following categories:

- *Continued relevance*. The extent to which a programme is relevant to government priorities. To what extent are the objectives and mandate of the programme still relevant? Are the activities and operational outputs consistent with the programme's mandate and plausibly linked to its objectives and other intended results?

- *Utility*. How does the intended impact of the programme compare with the needs of the targeted population?

- *Sustainability*. To what extent can any positive changes arising from a programme be expected to last after the programme has been terminated?

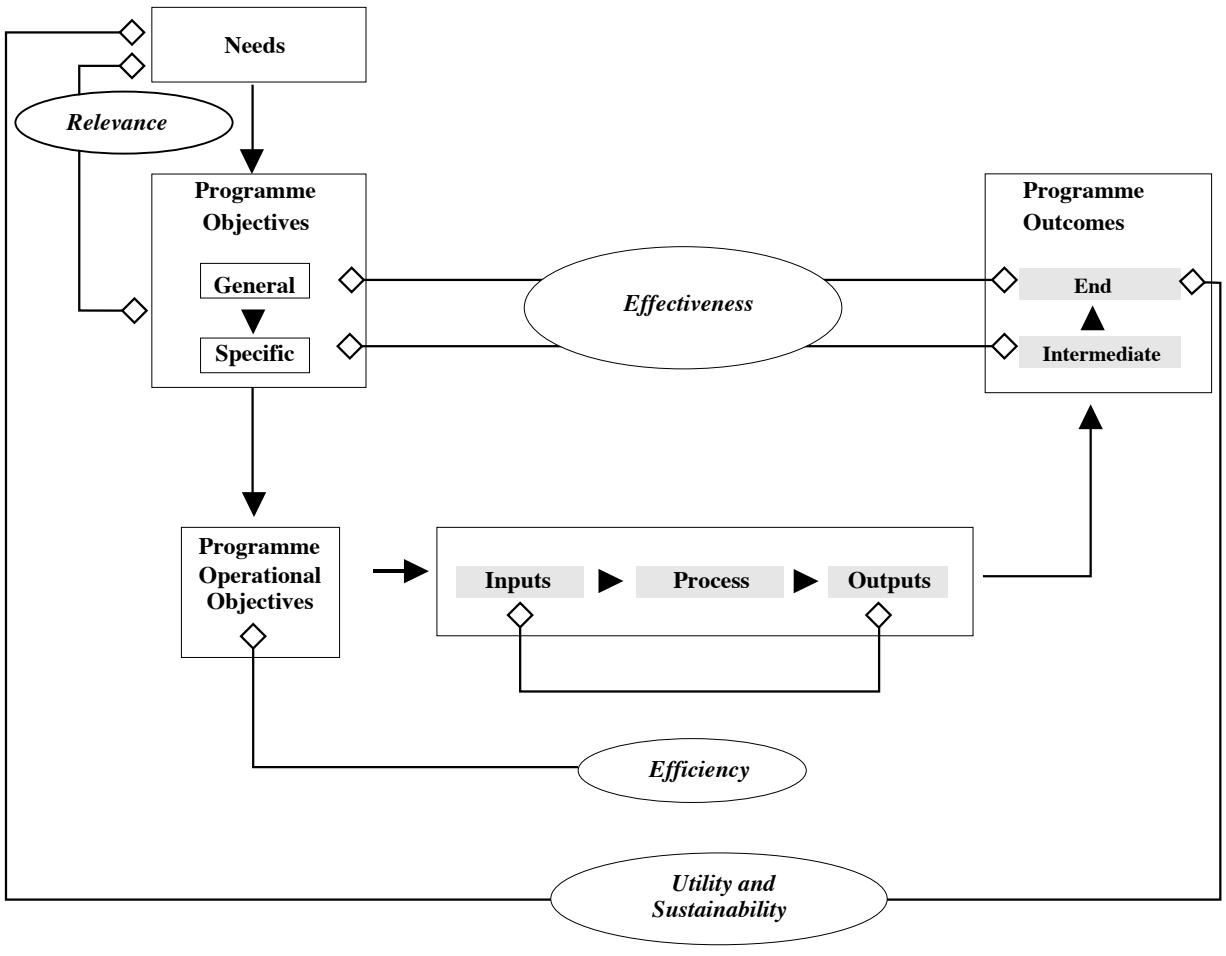
- *Efficiency*. How economically and efficiently have the various inputs been converted into outputs?

- *Effectiveness*. Were programme objectives achieved? What client benefits and what broader outcomes, both intended and unintended, resulted from carrying out the programme? Does the programme complement, duplicate or overlap with other programmes?

- *Cost-effectiveness*. Are there alternative solutions or programmes that might have achieved the desired objectives and intended results more cost-effectively? Are there more cost-effective ways of delivering the existing programme?

In addition to these issues, an evaluation study should also assess whether a programme has resulted in negative effects or inefficiencies, technically referred to as the effects of "deadweight", "displacement" and "substitution". Deadweight refers to effects which would have arisen even if the programme had not taken place. For example, a retraining programme aimed at the long-term unemployed may benefit some people who would have undertaken training even without the programme. Displacement and substitution are used to describe situations where the benefits of a programme on a particular individual, group or area are only realised at the cost of disbenefits to other individuals, groups or areas. For example, in the

Figure 15.1. **PROGRAMME LOGIC, PERFORMANCE MEASUREMENT AND EVALUATION**



case of a programme to provide employment subsidies, substitution will happen if, in the enterprises that benefit from the programme, subsidised workers take the place of unsubsidised workers. Displacement will occur where an enterprise benefiting from employment subsidies wins business from other firms that do not participate in the scheme. Thus, the jobs created in the participating firm may be offset by job losses in other firms.

3. Preparing an evaluation study

There are two major phases of an evaluation study:

- *Design*. Identifying the main issues and questions to be addressed and developing a methodology for gathering and analysing information.

- *Implementation*. Collecting and analysing data, drafting a report that presents the findings of the study and makes recommendations.

Most evaluation guides emphasise the importance of the design phase. The key steps in preparing an evaluation study are the following:

- *Identify the goals of the evaluation.* An important initial question is: for what purpose is the evaluation being launched? To improve management? To improve policy decision-making? To improve accountability?

- *Define the scope of the evaluation.* When a programme includes several objectives and target groups, it can sometimes be cost-effective to restrict the evaluation to some particular aspects of the programme.

- *Identify the questions to be asked*. If the purpose of the study is mainly to improve management, it should focus on screening programme implementation and service delivery. If the issue of accountability is being evaluated, the study should focus on the effectiveness of the programme. To provide feedback to decision-makers, the evaluation may need to include a cost-effectiveness analysis and an assessment of the continued relevance of the programme and its utility.

- *Establish the programme logic*.

- *Set benchmarks*. Evaluation is about assessing the "value" of a programme. This involves making judgements on the degree to which the programme's performance has been "good" or "bad". Predetermined and transparent benchmarks are needed to ensure that such value judgements do not become arbitrary.

- *Draw up the analytical agenda*. The agenda consists of defining the evaluation design, the data collection methodology and the data analysis techniques. An evaluation design describes the methods that will be used to gather information and draw conclusions on the results that can be attributed to the programme. The design framework depends on both the type of information to be retrieved and the type of analysis to which this information will be subjected.

- *Take stock of available information*. For most programme evaluation work, the monitoring system should be the first source of information. However, this information may need to be supplemented with a review of other statistical sources, questionnaires, user surveys, etc.

- *Prepare a work plan and estimate evaluation costs.*
- *Prepare the terms of reference.*
- *Select the evaluator.*

4. Evaluation design

a. Is there a golden rule?

There are several ways of carrying out an evaluation study. Reviewing them is necessary in order to define an appropriate strategy for evaluation. Literature on evaluation contains many debates on the advantages and disadvantages of particular evaluation methods or approaches. However, as Cheminsky (1995) puts it:

The choice of methods for evaluation and of instruments and data depends more on the question being asked than on the qualities of a particular method. Does the question involve description? Or does it involves reasoning from cause to effect? In a descriptive study, we would not need to worry about the problems of, say, experimental methods because they would not be appropriate. In a cause-and-effect study, many different methods might be applicable depending on the policy question. This centrality of the question, rather than the method, pushes us in the same direction we had to take because of the weaknesses of individual methods: toward complementary and reinforcement. For example, we mitigate the superficiality of a survey by adding case studies, we humanise a time-series analysis by conducting a survey or a set of interviews, and we integrate a process evaluation within an outcome study. Focusing on the question rather on the method has liberated us somewhat with regards to our methodological choices and brought a new emphasis on pluralism that sits rather uneasily with the evaluation chapels of our recent past.

Or as the EC evaluation guide (Commission of the European Communities, 1997) succinctly puts it: "golden rule: there is no golden rule".

Possible approaches to the design of an evaluation study and methods for data collection and analysis are reviewed briefly below. More technical and detailed reviews of evaluation methods will be found in the abundant literature on the subject.

b. Experimental and quasi-experimental designs[8]

Evaluating a programme requires understanding what results the programme has caused. For this purpose, the most common approach is to assess the effects of a programme against what would have happened in the programme's absence, i.e. a counterfactual. Because this hypothetical outcome cannot be directly observed, however, the evaluator must apply some techniques to identify the counterfactual against which programme impact is to be measured.

Experimental evaluation techniques are aimed at better identifying the results that can be directly attributed to the programme. They apply the methodology of the natural sciences to public programmes (notably, to social programmes). The experimental design involves randomly assigning programme beneficiaries to two groups. This process is intended to make the two groups as similar as possible in all respects. One of the groups, called the "experimental group" or the "treatment group", participates in the programme under examination. The other group, called the "control group" does not participate. In a properly constructed experiment, the differences in outcomes between the two groups can be attributed to the effects of the programme or policy.

An evaluation study based on an experimental (randomised) design has the advantage of producing results in which there should be a high degree of confidence. Unfortunately, it is often very difficult to obtain such reliable results. Full comparability of control and treatment groups is hard to achieve. Experimental designs must be implemented from the start of the programmes concerned, otherwise differences will exist between those who have benefited from the programme and those who have not. The notion of control groups can pose ethical problems. For example, it can be illegal or unethical to grant social benefits to one group and not to another group.

These difficulties led to the deployment of quasi-experimental techniques, of which there are several types. The more "robust" quasi-experimental design consists of pre-programme/post-programme comparisons with a non-equivalent (non-randomised) control group. This approach is broadly similar to the experimental design method described above. However, the method of selecting the control group is less rigorous, and statistical techniques may be used to adjust for any initial differences between the two groups. Other techniques that can be used include time-series analysis and post-comparisons between several groups. The first of these techniques involves the collection and analysis of time-series information in order to identify changes or trends in behaviour that may be attributable to the policy or programme under examination.

c. Causal model approaches

An alternative approach to the experimental models described above involves the use of causal models. Such models attempt to measure the impact of a range of factors (independent variables) on the outcomes of a government policy or programme (dependent variables). The programme itself is only one of the factors that determine these outcomes. Different sorts of model may be used, when appropriate, such as simulation models; input-output models; microeconomic models; macroeconomic models; and statistical models. For example, several models are or have been used to assess the effects of the EU Structural Funds policy. Computable General Equilibrium Models (CGE) are sometimes used to assess the impact of tax policies or programmes on income redistribution. Causal models tend to be used in situations where there is already evidence of a relationship between the independent and dependent variables. However, using such models presents risks and should be used with care. When the model is not well specified and coherent, and not based on a sound analysis of the relationship between the variables and parameters, its results are often misleading. Generally, causal models should be used as a complement to other evaluation methods.

d. Economic evaluation

Economic evaluation introduces information on costs and benefits into the evaluation methodology. It is either conducted separately or as a complement to other evaluation methods. Thus, cost-benefit and cost-effectiveness analysis methods can be used ex post, to assess whether the actual costs of the programme were justified by the actual benefits.

e. Non-causal approaches

In some cases, there is a problem of circularity that makes it difficult to establish a direct relationship between a programme and its effects. The identified outcomes may be due partly to the programme's influence, but the programme can also be influenced by the external factors that contributed to these outcomes. For example, it is often found that cities served by a motorway experience more rapid economic development than other cities. However, this may be due to the fact that the motorway route was designed in order to serve cities with the highest potential for economic development. Neither the experimental approach nor the causal model approach can deal with this problem of circularity.

In such cases a pragmatic approach is often adopted. The evaluation does not attempt to find a counterfactual, but provides a thorough description of the programme and makes extensive use of interviews with stakeholders, case studies, analysis of documents, assessments by experts, etc. Identifying the behaviour of different stakeholders and explaining how it affects programme processes and outcomes can cast light on the underlying causal relationships and is important for successful achievement of policy objectives.

In evaluating Research and Development (R&D) programmes, it should be recognised that by their nature the outcomes of such programmes are uncertain — indeed, were the outcomes ensured in advance, there would be no need for the research. Peer review is commonly used as an evaluation technique in this field and can contribute to an ex post assessment of whether the appraisal of risks against potential benefits was reasonable.

Naturalistic (or qualitative) evaluation methods are based on the principle that the world is socially constructed and constantly changed by the interaction of individuals. Such an approach may be appropriate where the evaluator is not committed in advance to a particular set of values or outcomes and is prepared to work with stakeholders to identify those values and the relevant "facts" that are not objectively based or causally determined. In this approach, evaluation cannot provide objectively "correct" answers but instead can act as a facilitating mechanism to produce a consensus among stakeholders. Naturalistic evaluation methods include participant observation, ethnographic methods, informal interviewing procedures, case studies, etc. In public sector applications, the importance of the political dimension in decision-making complicates the issue of identifying the role of different stakeholders so that making use of elements of the naturalistic approach alongside other methods may be more relevant than a pure naturalistic study[9].

Assessing the views of programme beneficiaries is increasingly used in evaluation studies. It consists of participant observation, qualitative interviewing and related techniques to gauge beneficiary values and preferences. Such approaches can derive information on many factors at the household and community levels that would be beyond the scope of more quantitative techniques.[10]

5. Data collection and analysis[11]

Once the general approach and design of an evaluation study is agreed, the next step is to define the data needed to obtain the necessary information. Data are facts and statistics that can be observed and recorded. Deciding which data are most relevant raises the questions of measurement and attribution discussed earlier, in Section A on performance measurement.

If reliable data cannot be obtained from a secondary source, primary data collection becomes necessary. Primary data collection, however, will generally cost more than reliance on secondary data and should therefore be avoided if possible. A plan to extract primary data typically involves selecting a collection technique (such as natural observation and surveys), developing measurement techniques (such as questionnaires, interview guides and observation record forms) and preparing a sampling plan.

Case studies may be used when it is impossible, for budgetary or practical reasons, to choose a large enough sample, or when in-depth data are required. Such studies allow the evaluator to perform detailed analysis and, therefore, can generate valuable information and explanatory hypotheses for further analysis. Case studies may also be used to examine a number of specific activities or projects, through which the evaluator hopes to reveal information about the programme as a whole. Alternatively, a case study may be chosen because it is considered a particularly relevant example, or to compare the functioning of an organisation or the implementation of a programme with "best practice."

Depending on the type of analysis required and the availability of data, specific data analysis methods must be determined (such as cost-benefit, multiple regression, analysis of variance). Statistical analysis involves the manipulation of quantitative or qualitative data to describe phenomena and to make inferences about relationships between variables. Non-statistical analysis is carried out, for the most part, on qualitative data—such as detailed descriptions of activities or processes or the transcripts of group discussions. Several types of non-statistical analysis exist (content analysis, inductive analysis, etc.). Non-statistical data analysis relies on the evaluator's professional judgement to a greater degree than is the case with statistical analysis.

Reporting the findings of evaluation studies often involves the presentation of a large volume of data in a concise manner. Statistical tabulations, graphical displays and simple statistical analysis, such as the mean or the variance, can be used to highlight key characteristics of the data.

6. Evaluation reports

An example of the information that should be included in an evaluation report is given in Box 15.3. However, the structure of these reports needs to match the particular goals of the evaluation study and the needs of report users: there is no universally applicable model.

7. Problems of method and implementation

Methodological problems are intrinsic in all approaches to evaluation, but can be dealt with when the limitations are recognised and the issues are properly addressed. This requires specific knowledge and skills that can be gained by training staff and commissioning external expertise to conduct evaluations. However, such problems do not imply that carrying out evaluation studies is a worthless activity. Even if evaluation cannot provide definitive answers, it can add useful information to the discussion about the design and implementation of government policies and programmes.

a. Difficulties and threats

Problems related to causality are common to social sciences in general. Conclusive evidence of cause-effect relationships can rarely be established, since controlling all relevant variables is seldom possible. Experimental evaluation design is often difficult, expensive and lengthy, if not impossible to apply in practice. Even if experimental evaluation design is used, generalising the results beyond the conditions of the experiment is usually uncertain. Causal relationships between a programme and an observed outcome often cannot be unequivocally proven, mainly because of the intractability of the measurement and attribution problems discussed earlier.

Another difficulty is deciding whether to focus only on the officially recognised objectives of a programme (i.e. those included in statements of government policy) or to take a broader view and study all the effects of the programme. The latter approach gives a more comprehensive picture of the outcomes of the programme but is more complex and time-consuming. Setting an appropriate time period over which the programme is evaluated is difficult but critical, as relevant outcomes should have sufficient time to mature. However, the information's usefulness may diminish if the evaluated programme is changed before the evaluation report is finalised or the evaluation findings can be applied.

Assessing whether evaluation findings can be generalised is of particular importance when evaluation is expected to contribute to future policy decisions. However, the conditions under which the programme took place are not necessarily representative of future conditions.

Box 15.3. **AN EXAMPLE OF AN EVALUATION REPORT STRUCTURE**

Executive summary

- An overview and summary of the entire report.
- A discussion of the strengths and weaknesses of the chosen evaluation methods.

Introduction

- Description of the programme in terms of needs, objectives, delivery systems, etc.
- The context in which the programme operates.
- Purpose of the evaluation in terms of scope and main evaluation questions.
- Description of other studies that have been done.

Research methodology

- Design and implementation of the research and collection of data.
- Analysis of data.

Evaluation results

- Findings.
- Conclusions.
- Recommendations.

Annexes

- Terms of reference.
- Additional tables.
- References and sources.
- Glossary of terms.

Source: Commission of the European Communities (1997).

b. Criteria for successful evaluation

The conclusions of an evaluation study should be based on a comprehensive coverage of the relevant issues. The evaluator should try to get as accurate a picture as possible of the issues of concern and explore them as far as time and financial resource constraints allow. However, a focus on breadth is important. If breadth is sacrificed for greater depth of analysis in the issues covered, the conclusions reached may be narrowly accurate but lacking in perspective.

Given that evaluation is an aid to decision-making, the criteria for selecting an appropriate evaluation method must ensure that useful information is produced. This implies an understanding of the decision-making environment to which the evaluation findings will be introduced.

In developing an evaluation method, it is necessary to take into account basic considerations such as practicability, affordability and ethical issues. An approach is practicable to the extent that it can be applied effectively without adverse consequences and within time constraints. Affordability refers to the cost of implementing an evaluation study. Implementing the method most appropriate to a given situation might be unrealistically expensive. Objectivity is of paramount importance in evaluative work. It should always be clear to the reader what the conclusions are based on, in terms of the evidence gathered and the assumptions used. Evaluation information and data should be collected, analysed and presented so that if others carried out the same exercise and used the same basic assumptions, they would reach similar conclusions. Evaluators may frequently be called on to provide advice and recommendations to the client who commissioned the study. In these circumstances, it is important to maintain a distinction between the objective findings of the study, and programme recommendations derived from the evaluation itself or from other sources of information, such as policy directives. When conclusions are ambiguous, it is particularly important that the underlying assumptions are spelled out.

Resistance may be encountered to making full use of evaluations. Politicians are often reluctant to allow sensitive areas of policy to be evaluated, discuss findings of evaluation studies, or to formulate policy goals precisely. Managers may fear to be criticised. In most countries, evaluations have to gain support and need champions. This requires dialogue with decision-makers and stakeholders when carrying out evaluation studies. The stakeholders are those with an interest in the outcome of the evaluation, such as those operating a programme under examination. They should be consulted in defining the issues at stake and planning the evaluation, as they are typically expected to supply data to the evaluator and often play a major role in interpreting the results and implementing the recommendations. However, stakeholders sometimes feel that their interests are threatened by an evaluation. If they become actively opposed, they can sometimes sabotage the project.

8. The role of evaluation in transition countries

Developing an evaluation culture needs time, and the development and the development of such work in OECD countries is uneven and not systematically carried out. It is not therefore recommended that transition countries should set as an immediate objective the development of a comprehensive system of evaluation; these countries have higher priority tasks in related areas such as building up an effective system of external audit.

However, transition countries need generally to make shifts in the composition of their expenditure programmes, and evaluation studies could provide information and analyses that are useful in preparing the ground for such changes. Thus, in a number of countries, the preparation of evaluation studies in areas such as social assistance, health or education could be desirable.

Institutional arrangements for carrying out evaluation studies vary from one country to the other. Box 15.4 shows some examples of the arrangements in some EU Member States. In transition countries, it might be possible to establish a small unit at the central level, perhaps in the ministry of finance, to provide expertise and methodological guidance to line ministries, and to assist them in the preparation of their evaluation work and in drafting the terms of reference for the studies.

Box 15.4. INSTITUTIONAL ARRANGEMENTS FOR EVALUATION

France. A National Council of Evaluation was established in 1999 and is responsible for preparing an annual evaluation programme on the basis of proposals formulated by line ministries and local governments. This Council is composed of scientists, other experts and representatives of local authorities. The evaluation studies are financed by a National Fund for Evaluation, and are published. Besides the activities co-ordinated by the National Council, line ministries and sector evaluation committees also carry out evaluation studies.

Netherlands. Budget directorates within line ministries are responsible for co-ordinating the programme of evaluation studies and ensuring that necessary advice, guidance and research expertise is provided. They draw up evaluation programmes for individual projects, encourage the periodic evaluation of policies and monitor the quality of the analyses carried out and its application. Other directorates provide support on issues such as personnel and organisational management, auditing and legislation. The Court of Audit reviews the quality of the evaluation methodology and the organisation and management of evaluation studies, and publishes reports on these matters.

United Kingdom. Organisational arrangements for evaluation are diversified and have a "polycentric" character. The National Audit Office, the Audit Commission, HM Treasury, line ministries, executive agencies and many local authorities undertake evaluation studies. There is no single organisation that is responsible for supervising or co-ordinating this work, though the Treasury has published some guidance documents. Evaluation is well developed in some areas and findings of evaluation studies are used in setting (and adjusting) policy priorities and in budget management.

Sources:

France: Conseil Scientifique de l'évaluation (1998).

Netherlands: OECD (1999).

United Kingdom: Joint seminar of the Tavistock Institute and the Conseil Scientifique de l'évaluation, Paris, January 1998.

NOTES

1. Canadian Institute of Chartered Accountants, 1995.

2. "Evaluating EU Expenditure Programmes". European Commission, 1997.

3. Where government programmes are operated through a network of comparable institutions in different regions or localities (e.g. schools or social security benefit offices), "internal" benchmarks can be established, i.e. school A can be compared with schools B and C. This technique has been used in countries such as the UK to create an internal market, promote competition and raise service standards in areas such as health care, education, tax collection and the payment of social benefits.

4. Drawn up from Tilley (1995). See also Likierman (1993b).

5. See OECD (1999).

6. E.g. in France "public policies evaluation" refers to both programme evaluation and policy evaluation. (Conseil Scientifique de l'évaluation, 1996).

7. Commission of the European Communities (1997).

8. See Canada, Ministry of Public Works and Government Services (2000) and Valadez and Bamberger (1994).

9. See, for example, Weiss (1998), especially Chapter 11 on "qualitative methods".

10. Squire (1995) has argued that, to constitute an evaluation, such information would have to be used in the context of either an experimental or quasi-experimental evaluation.

11. Canada, Ministry of Public Works and Government Services (2000).

SUMMARY — PART IV

A. KEY POINTS

1. Accounting

Efficient accounting and reporting systems are crucial for budget management, accountability, and policy decision-making.

The basis of accounting refers to the accounting principles that determine when transactions 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 cash accrual accounting.

Cash accounting recognises expenditures at the payment stage and focuses on cash flows and cash balances. Cash accounting systems are generally supplemented with commitment accounting, and debt accounting on an accrual basis and, therefore, fit the basic needs of compliance control and macroeconomic stabilisation. A common modification to the cash basis of accounting consists of holding the books open for a "complementary" period (e.g. 30 or 60 days) after the close of the fiscal year.

Full accrual accounting is similar to the accounting systems of commercial enterprises and recognises all liabilities and assets. The costs of assets are recognised as an expense when they are used to provide a service. Thus, depreciation and losses are accounted for.

Accrual accounting methods are necessary to assess the full costs of an expenditure programme, which include the costs of goods and services acquired and used over the period, and the uses of inventories and assets (i.e. depreciation). An assessment of full costs is desirable for agencies that perform commercial (or quasi-commercial) activities or recover some of all of their costs through user charges.

Assessing the full costs of a programme requires inputting the overhead costs that may be shared with other programmes. But very few countries are currently attempting such an exercise on a government-wide scale.

In practice, many modified versions of accrual accounting exist. This is because, in addition to other difficulties, requirements to implement full accrual accounting are heavy. Thus, some countries have adopted the accrual basis of accounting for liabilities, but physical assets that will provide services in the future are "written off" as soon as they are acquired. This modification of the accrual accounting basis cannot be used to assess the full costs of programmes, but it is easier to implement that full accrual accounting. Compared to cash accounting, it has the advantage of accounting for payables at the time they are incurred, not at the time they are paid, and, more generally, it provides a framework to assess liabilities. Such an approach fulfils the basic requirements of a government accounting and reporting system that conforms with international standards.

The recognised national accounts standards (SNA93 and ESA95) are on a full accrual basis, and the EU Member States prepare their national accounts according to ESA95. However, at the moment, full accrual accounting is not systematically used for presenting government financial reports in EU countries. In practice, governments adapt their government accounting systems to their own needs and concerns, and a variety of accounting methodologies and systems can be found.

Whatever its methodological basis, the accounting system should have the following features:

- Adequate bookkeeping procedures, systematic recording of transactions, adequate security, and systematic comparisons with banking statements.
- Recording of all expenditure and revenue transactions in the accounts, according to the same methodology, including, notably, expenditures from funds and autonomous agencies, and foreign financed aid (including from the EU budget).
- A common set of classifications for expenditure into functional and economic categories.
- Clear and well-documented accounting procedures.
- Regularly produced statements.
- Systems for tracking the use of appropriations ("budgetary accounting"), at each stage of the expenditure cycle (commitment, verification, payment).
- Clear procedures and full disclosure of operations made "below the line" or through liability accounts.

A chart of accounts is a classification of transactions and events (assets, liabilities, expenditures, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature. It defines the organisation of the ledgers kept by the accountants. Setting up a comprehensive chart of accounts is required to consolidate data from the different agencies.

A proper system for tracking the uses of appropriations ("budgetary/appropriation accounting") must be in place. It is necessary to record transactions at each stage of the expenditure cycle. This involves tracking movements between budgetary accounts: namely, budgetary resource accounts (e.g. appropriation and apportionment/allotment); commitments; expenditures at the verification stage; and payment accounts. All transactions should be categorised according to the budget classification system, at each stage of the expenditure cycle. Expenditures must be accounted for as soon as the deliveries are verified. At least for multi-year contracts and contracts of a significant size, the commitments should be distinguished from the expenditures in the financial reports. In addition, all orders, delivered or not, should be monitored.

A comprehensive registration and disclosure of information on liabilities, contingent liabilities, and financial assets is required. For this purpose:

- Debt accounting should be on an accrual basis, in conformity with GAAP.
- Arrears must be followed up (in countries that do not have a proper accounting system, this requires setting up ancillary registers to monitor such arrears, but this should be seen only as a temporary measure before the implementation of a system that accounts for expenditures at the verification stage).

- Besides debt and arrears, other liabilities must be registered and disclosed (e.g. superannuation liabilities).

- Contingent liabilities should be disclosed, and the fiscal risks assessed.

- Financial assets (e.g. loans) must be registered.

Asset registers should be set up and regularly updated, whatever the basis of financial reporting.

2. Reporting systems

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

- Budget management reports showing all movements in appropriations and line-items (allotments, supplementary estimates, transfers, etc.). These reports should be published monthly.

- Accountability reports to the legislature, in particular the final report that must be submitted to the supreme audit institution.

- Financial reports, which should include at least: the consolidated accounts of the general government, statements of arrears, and reports on debt and contingent liabilities, lending and multi-year commitments.

- Reports assessing the outcome of budgetary policies, including reports by line ministries and public agencies on their financial performance; and special reports on investment expenditures.

3. Financial management systems

Management information systems form a key element of management controls, and assist ministries/agencies in managing their programmes efficiently and effectively, and in accordance with the law. They must themselves be efficient and cost-effective.

At the core of these systems are the procedures for accounting and reporting that constitute the ledger into which all inflows and outflows of funds are recorded. Under an integrated approach, other information systems should support these core accounting systems by adhering to their data exchange standards.

4. External audit

External auditing is essential in government financial management and should cover all public financial operations by public authorities whether included in the budget or not. It is aimed at (i) determining the legal propriety of transactions and detecting irregularities involving the misuse of public funds; (ii) determining the reliability of reports on budget execution and other financial data and the management control systems in place; (iii) identifying instances and patterns of inefficiency; (iv) providing reliable data about the operations and financial performance of public sector entities, activities or programmes; and (v) more broadly, commenting on whether public expenditure is delivering "value for money". The auditor may make recommendations for strengthening operations and systems in these areas.

Effective audit requires: (i) the independence of the auditor, to ensure that its work will not be biased by any relationship it might have with the entity being audited; (ii) professional skills in the various areas covered by the audits; (iii) audit standards that conform with international norms. Independence of supreme audit institutions is usually accomplished through making the SAI responsible directly to parliament and with its mandate, remit and scope of audit work laid down in the constitution and law.

The different types of audits are the following:

- *Compliance audits*, which involve checking individual transactions after the fact, to ensure that the appropriate authorisations and documentation are present. These audits could be performed by internal auditors, but the government could invite the SAI to prepare standards in this area, and the SAI should verify the effectiveness of the audit procedures.

- *Regularity audits*, which embrace attestation and financial audits and audits of management controls and internal audit. These types of audit consist of reviewing the end-of-year appropriation accounts and the other financial statements of the government, or to render an opinion as to the accuracy of the government's financial reports.

- *Performance audits*, which examine an entire entity, activity or programme to suggest ways of improving the economy, efficiency and effectiveness of these operations.

5. Performance monitoring and evaluation

The essential purposes of both performance measurement and programme evaluation are improved programme management, and increased accountability and better decision-making, by feeding back the results of programme implementation into programme formulation.

Basically, performance measurement is aimed at assessing the efficiency and effectiveness of programmes or activities. Efficiency is the relationship between the goods and services produced by a programme or an activity (outputs) and the resources used to produce them (inputs), and is often measured by the cost per unit of output. Effectiveness is the extent to which changes brought about by the programmes (the "outcomes") achieve their expected objectives. Development of a responsive client/consumer-oriented culture in public service delivery is on the reform agenda of most OECD countries, and several of these countries have developed practical measures of service quality.

Performance measurement can serve a variety of purposes, such as continuous management improvement, supervising programme implementation, and internal and external accountability. It provides valuable feedback to decision-making, but it cannot be used directly to make resource allocation decisions.

Performance is measured through a mix of inputs, outputs, outcomes and "process" indicators. (Process is the manner by which inputs are turned outputs). The selection of performance indicators depends on the specific objectives of measuring performance. These indicators should be compared with some benchmark (e.g. planned objectives, or indicators for a similar programme or organisation).

If performance measures are used in results-oriented management systems (e.g. for contracts or a performance related pay system) or for accountability purposes, caution is required. It is essential to think carefully about the impact on actual behaviour of using any specific indicator of performance. The experience of both centrally planned economies with norms, and of market economies with performance

measurement, show that badly designed indicators tend to cause "short-termism" and "tunnel vision", which impede the achievement of good performance instead of promoting it.

Performance measurement may indicate that a programme has certain weaknesses but does not necessarily provide information on why such problems have occurred or what changes need to be made to activities or programme objectives. For this latter purpose, an in-depth assessment of the programme is needed. Programme evaluation is aimed at assessing the effectiveness and efficiency of the programme, its continued relevance, utility and sustainability. Programme evaluation deals also with the perverse effects of the programme (e.g. when the effects of a programme on a particular group are only realised at the expense of other individuals, groups or areas).

Programme evaluation requires a formal structure or programme logic which consists of the following elements: (i) description of the programme; (ii) clarification of its objectives, and the needs that the programme is aimed at addressing; (iii) identification of the possible causal relationship between programme activities and effects; (iv) identification of the possible level of outcomes that can be evaluated; (v) identification of outcome indicators and the criteria to assess effectiveness; and (vi) identification of the factors that may affect the outcomes.

There are many evaluation methods, but there is no golden rule for deciding which one should be chosen. This choice should be tailored to the purpose of the evaluation study.

B. DIRECTIONS FOR REFORM

1. Accounting-reporting system

Needs in the area of accounting systems differ from country to country, but in many transition economies priority areas for reform include the following:

- Consolidating fund operations (if any) and ensuring that all public entities submit reports based on the same set of classifications.

- Implementing a comprehensive system for tracking appropriations and their uses at each stage of the expenditure cycle, and tracking multi-year commitments.

- Developing a system to recognise and report liabilities, contingent liabilities, and financial assets.

In parallel, asset registers should be set up and/or updated, starting with agencies where the need is more urgent.

A comprehensive chart of accounts must be set up.

Consideration should also be given to improving or implementing progressively methods for the valuation of physical assets, beginning with agencies where this is most useful (agencies that recover costs through user charges or which are a high consumer of assets, e.g. road maintenance programmes).

2. External audit

In the external audit field, the priority areas for reform are likely to include the following:

• Establishment of a supreme audit institution, independent of the executive branch of the government; and ensuring that this body is adequately funded and equipped and that staff are trained in modern audit techniques.

• Systematic audits of the end-of-the-year accounts and presentation of audit reports to parliament.

• Implementation of value for money audits.

3. Performance monitoring and programme evaluation

To improve the effectiveness and technical efficiency of programmes, the first essential steps are to implement a sound budget process as discussed in Part II of this book, and effective management (internal) control systems as discussed in Part III. Provided that these prior conditions are met, performance monitoring can contribute to better budget management. It could be developed progressively according to the following lines:

• Setting up performance indicators by programme with a view to feeding back information on programme implementation to those involved in budget formulation at the spending ministry/agency level, and to a smaller extent at the central level.

• Setting up within a few selected sectors or programmes, appropriate performance indicators for specified activities. At a first stage, this work might focus on the quality of public service delivery.

Developing an evaluation culture needs time, but the implementation of evaluation activities can be progressive beginning with a limited number of key programmes (e.g. social assistance, health care, education and special investment programmes). A small unit could be established at the central level, to provide expertise and guidance to line ministries, assist them in the preparation of their evaluation programmes and draft the terms of reference for the evaluation studies.

ANNEX I

QUESTIONNAIRE ON PUBLIC EXPENDITURE MANAGEMENT SYSTEMS[1]

A. Introduction

This questionnaire is designed to help evaluate the technical efficiency of government budgeting systems in transition countries. Some separate questions are included on issues that relate to membership of the European Union. The questionnaire is intended as a tool for budget reformers, primarily officials in the finance ministries, to analyse their current arrangements and to plan improvements. The questionnaire can be used informally to help think about the problems; it can be used as the basis for a formal review of the system; or individual sections of the questionnaire can be used to evaluate specific budgeting subsystems. (Some overlap and duplication of questions among sections is deliberate, to facilitate the third approach. Questions preceded by an asterisk are for systems that are more "advanced".)

The questionnaire design is action-oriented. That is to say, most questions demand a "yes or no" answer, and a negative answer suggests that action should be considered to produce the situation described in the question. This would be a one-step approach. However, a more rigorous two-stage approach might be used: the first stage would be to fully document the existing system using the headings and issues of the questionnaire; the second stage would assess each element of the system, using this book and other materials, and design improvements according to national priorities.

Because it attempts to cover the subject comprehensively, the questionnaire may appear too prescriptive. Readers and users are asked, therefore, to note that the concept of best practice needs to be interpreted in the national context, taking account of political priorities and technical and resource constraints. Some questions describe specific elements, which are desirable but not essential for every government; other questions, identified in the questionnaire as "advanced",[172] could be considered for later implementation after the basics are in place. National experts are best fitted to judge whether one or another element is desirable and timely in their own country, provided they take the trouble to review the lessons of international experience as summarised in this book.

Although intended to accommodate widely differing national systems, the questionnaire is believed to be faithful to the great principles of government budgeting. In the words of Schick (1999), "the basic principles have been elaborated and refined over the years, but they have remarkable staying power. They include comprehensiveness (the budget should include all revenue and expenditure); accuracy (the budget should record actual transactions and flows); annuality (the budget should cover a fixed period of time, typically a fiscal year); authoritativeness (public funds should be spent as authorised by law); and transparency (the government should publish timely information on estimated and actual expenditures)."

A government which implemented improvements based on the use of this questionnaire would have all the technical tools needed to improve its budgetary performance and enforce disciplined financial management. On the other hand, technical tools alone do not guarantee improvement; the other key ingredients are well-trained and highly motivated staff and, above all, political will and strong and focused leadership.

B. The Questionnaire

The questions listed below are divided into the following sections:

a. Budget legislation.

b. Parliament/executive relationships.

c. Scope of the budget.

d. Measurement and monitoring of government deficit and government debt.

e. Medium-term fiscal and budget frameworks.

f. Budget process.

g. Preparation and management of capital investment programmes.

h. Budget execution and monitoring.

i. Accounting and reporting.

j. Public procurement.

k. Internal control and internal audit.

l. European Union requirements for financial control.

m. External audit.

n. Organisation and capacity for reform.

a. Budget legislation

The legal framework for budgeting includes the constitution, the organic budget law, and in many countries other laws dealing with, for example, the treasury function, debt management, local government finance and external audit. Moreover, while the major principles should always be in statute law, many provisions can be placed in second- or third-level legislation, or in administrative policies, depending on local practice. For convenience, this questionnaire deals with these laws collectively; it is the responsibility of the user to determine whether specific questions should be related to the organic budget law (OBL), another law, or to a regulation or decree.

Do the constitution and laws:

1. Provide a clear and comprehensive definition of public money and

   • Determine that all of it is to be managed in accordance with the OBL?

   • Limit the creation of extra-budgetary funds to special cases, authorised by separate statute?

   • Authorise the government accounts, as defined in Section h) below, into which all public money must be paid and from which expenditures are made only by appropriation of the parliament?

2. Establish a relationship between parliament and the executive as described in Item b)?

3. Establish the following elements of intergovernmental fiscal relations?

   • The basic principles of supervision, intervention and audit responsibilities, and of revenue sharing arrangements, if any?

   • That subnational governments are allowed to borrow only from the central government?
   or
   that their borrowing is subject to approval by ministry of finance?

   • The budget accounting classifications are coherent and common to all levels of government?

4. Establish the scope of the budget as described in Item c)?

5. Establish the form and structure of the annual budget law (or finance bill) to be voted by parliament, including the definition of main headings or accounts which are controlled by parliament.

6. Establish a definition of the budget deficit and surplus which excludes borrowings from receipts, and excludes repayments of principal from expenditure?

7. Provide a legal basis for the management and control of financial flows to and from the EU budget, for the functioning of the National Fund and the distribution of responsibilities under the Memorandum of Understanding?

8. Provide a legal basis for the formulation and execution of the budget as described in Sections e, f, g and h including the role and authorities of ministry of finance?

9. Impose a duty on public officials to report suspected criminal behaviour, and establish a graduated set of administrative sanctions for infractions of budget legislation?

*10. Define the different classes of budgetary institutions, agencies and enterprises, the authority for creating and dissolving such entities, and the rules for financial management and control of the entities in each class?

*11. Provide a legal basis for management (internal) control and internal audit as described in Item k)?

*12. Define the authorities and responsibilities for issuing and reporting on government guarantees?

b. Parliament/executive relationships

The relationships between the executive and legislative branches of government are determined by the constitution, by the OBL and other laws, by the rules of procedure of the parliament, and by customary practice. Does one or more of these sources provide:

1. An explicit schedule for presentation of the budget by government and for its consideration and approval by the parliament?

2. Procedures and schedules for the presentation and approval of supplementary spending authorities during the year if needed?

3. Defined limits on the powers of the parliament to amend the draft budget bill (such as requiring a spending increase to be offset by reductions in other expenditures)?

4. For interim funding to continue normal government business when parliament has not approved the Budget in time for the start of the fiscal year (such as monthly release of 1/12 of prior year appropriations)?

5. Restrictive conditions on the government's use of reserve funds and emergency spending, such as requiring approval by the minister of finance and full reporting to parliament?

6. For the mandatory presentation by government of an essential minimum of budget documentation which specifies fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, comparison to EU convergence criteria, and major identifiable fiscal risks?

7. That new legislation with fiscal implications comes into force *only* after it has been included in an approved budget?

8. The timetable for reporting to the parliament during the year and in the final account, and arrangements for external audit of government accounts?

9. For an external auditor in the form of a supreme audit institution which is independent of the executive government and reports to the parliament?

10. A special parliamentary committee to study the final account and external audit reports?

11. A procedure by which the parliament votes to accept the final account and discharge the government's responsibility for it?

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*12. In the event of non-agreement on a budget in parliament, a remedial procedure which supports fiscal discipline?

*13. A special parliamentary committee (e.g. budget committee or finance committee) to review the budget and fiscal policy generally?

*14. Authority for the budget committee to overrule, or at least co-ordinate, the recommendations of sectoral committees?

*15. An opportunity for parliament to debate, or to approve, the fiscal framework targets in advance of the detailed budget estimates?

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c. Scope of the budget

1. Does the annual budget law include:

   a) Clearly defined appropriations for all spending authorities to be voted?

   b) All transactions of statutory extra-budgetary funds with the budget?

   c) All fiscal transfers to subnational governments for general and special purposes?

   d) All investments, transfers or other transactions between the budget and state-owned enterprises?

   e) Asset and liability transactions by type and with full details of major items?

   f) A borrowing clause to authorise the new ceiling on government debt for the fiscal year?

2. Does the budget documentation submitted to parliament include:

   a) Fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, comparison to EU convergence criteria, and major identifiable fiscal risks?

   b) Complete information on past and projected spending under any permanent appropriations which are not annually voted?

   c) Complete information on financial plans and operations of statutory extra-budgetary funds?

   d) All financing from aid donors, presented in a framework which meets the reporting standards for current and future EU financial flows?

   e) A statement of contingent liabilities resulting from state guarantees of third party debts, and an estimate of payments likely to be required under those guarantees during the budget year?

d. Measuring and monitoring the government deficit and government debt

In the context of membership of the European Community, the Treaty (Article 104, Protocol No. 5 on the excessive deficit procedure) and secondary legislation (Council Regulations No. 3605/93 and No. 475/2000) specify the definitions of the government deficit and public debt to be monitored by the European Commission. The concepts of general government net borrowing and net lending are defined in ESA95. In addition, Regulation No. 3605/93 lays down rules for the reporting of information on government deficits and public debt by Member States to the European Commission.

1. Are there any differences between the definition of revenue expenditure in the budget balance and the concept of the general government balance as defined in ESA95?

2. In addition to the budget balance, is the government balance published? What are the sector definitions of the fiscal balances (state sector, central government, local government, social security, general government)?

3. What time series are available for fiscal balances? Which accounting system is used (domestic public accounts, national accounts)?

4. Are there figures released for different fiscal balance definitions (balance of current operations, primary balance, net borrowing/net lending)?

5. Are the fiscal deficit figures presently available calculated on a cash or an accrual basis?

6. What definition(s) of government/public debt do the authorities rely upon? Which ministry/agency is responsible for monitoring and calculating debt figures? Are government debt figures published?

7. The European Commission monitors debt defined as gross debt of general government at nominal value outstanding at the end of the year. Is (are) the present measure(s) of the debt aggregates(s) close to this definition?

8. Do government debt data allow a clear distinction to be made between domestic and external debt?

9. Which ministry/agency is responsible for contracting and managing government debt? Is the same ministry/agency in charge of government guaranteed debt?

10. In the design of budgetary policy, what is the importance given to the level and evolution of government debt?

11. Is there a system of national accounts and public finance statistics that is consistent with the GFS and ESA95?

e. Medium-term fiscal and budget frameworks

1. Is there a medium-term fiscal framework (MTFF) and/or a medium-term budget framework (MTBF), which projects aggregate revenue and expenditure targets over a three- to five-year horizon, consistent with the macroeconomic targets?

2. Does the MTFF link macroeconomic and budget projections and include the financial plans of extra-budgetary funds?

3. Does the MTFF provide the following information required by the EU Stability and Growth Programme or Convergence Programme:

   - Medium-term budgetary objectives in terms of balance or surplus, and the path of adjustments in the deficit and debt ratio?

   - Main economic assumptions associated with the realisation of the objectives?

   - Budgetary and economic policy measures taken or proposed to achieve the objectives, including an assessment of their effect on the budget and on extra-budgetary funds?

- Sensitivity analysis of the effects of changes in main economic assumptions?

4. Are the economic forecasts and fiscal targets made public and widely disseminated?

5. Does the medium-term framework include expenditure projections by broad programming and/or prepared by line ministries?

6. Is the MTFF updated annually?

7. Is the policy and planning process tightly linked to the annual budget process to ensure affordability?

8. Are conflicts between resource needs and availability referred to the council of ministers for discussion with sufficient time for resolution?

f. Budget process

Setting the framework

1. Macroeconomic and expenditure forecasting

   a) Is this responsibility assigned to the ministry of finance?
   or
   if divided between ministries/agencies, are roles precisely defined?

   b) Are fiscal forecasts updated at specified intervals for the national budget, subnational governments, and all extra-budgetary funds?

   c) Are economic and budgetary forecasts produced that are relevant to the EU's stability and growth programme or convergence programme (e.g. fiscal deficits, public debt, public investment, real GDP growth, employment and inflation)?

   d) Do the expenditure forecasts include both annually voted funds and permanent/standing appropriations (if any)?

   e) Are the forecasts used to formulate revenue and expenditure assumptions for an MTFF/MTBF *or* an annual framework of fiscal targets?

   f) Are the same economic assumptions given to spending units to be used in their budget estimates?

   g) Are the fiscal targets sent for approval by council of ministers?

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   *h) Are internal forecasts validated by systematic comparison to economic forecasts from public and private sources?

   *i) Are the spending and deficit targets presented to parliament for debate?

   *j) Are systematic forecasts of expenditures mandatory with all new policy proposals?

*k) Are such estimates approved by the ministry of finance before policy proposals are submitted to the council of ministers?

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2. Ministry envelopes/ceilings

   a) Are budget ceilings for aggregate spending and for sector ministries recommended by the ministry of finance?

   b) Are the ceilings for sector ministries approved by the council of ministers?

   c) Do they cover both current and capital components of the budget?

   d) Are they communicated to spending units prior to the preparation of their estimate submissions?

   e) Are sector ministers able to re-allocate expenditures among their agencies within the sector ceiling (recognising that changes to specific programmes may be reserved to the council of ministers)?

Estimates process and documents

1. Is there a well-defined, and widely accepted, sequence of steps in the budget process?

2. Does the schedule allow practical intervals for the work at each stage?

3. Is there an annual budget circular or regulation issued by the ministry of finance and does it provide:

   • A clear set of rules for the budget process and the main forms to be used in estimates submissions?

   • The macroeconomic assumptions to be used in estimates?

   • Information on government priorities?

   • Spending ceilings or targets?

4. Are new policy proposals excluded from estimates submissions until they have been approved through the normal policy decision process?
   or
   Does the budget process include a well-defined procedure for obtaining decisions on new policy proposals?

5. Is there a clear role for the ministry of finance in analysing and assessing estimates submissions prior to inclusion in the draft budget?

6. Does the ministry of finance staff have the necessary information and skills in order to conduct microeconomic, financial, and policy analysis of estimates submissions?

7. Is there a clear role for the financial management staff of line ministries in analysing and assessing estimates submissions of subordinated agencies?

8. Does the financial management staff of line ministries have skills in accounting, microeconomic analysis and financial management?

9. Are there established rules or practices to guide the ministry of finance negotiations with line ministries?

10. Are there established rules to guide line ministry co-ordination and negotiation with subordinated agencies?

11. Are there clear arrangements for arbitration, by the prime minister or the council of ministers, of remaining differences between the ministry of finance and spending units (particularly desirable when there are binding top-down ceilings)? *or* are there clear authorities for the minister of finance and/or the prime minister to negotiate differences bilaterally with other ministers (preferable in the absence of such spending ceilings)?

12. Are estimates submissions required to clearly identify projects which are co-financed from external sources?

*13. Are estimates submissions required to include efficiency and effectiveness data and indicators?

Specialised expenditure categories — requirements

1. Personnel costs

a) Are cost estimates supported by a dependable system of controls on employee headcounts, either by the ministry of finance or by line ministries themselves?

b) Are forecast increases in salaries and benefits required to be consistent with the ministry of finance assumptions or regulations?

c) Are funds for all bonuses and special allowances identified separately within the personnel costs subhead of the estimates?

d) Are there controls to prevent unauthorised transfers of funds from salaries' budgets to increase bonuses and allowances?

*e) Is the efficiency of organisation structures determined by an appropriate supervisory agency or by an official standard?

*f) Are the classification levels of posts in the organisations required to be consistent with authorised standards?

2. Real property transactions

a) Is a register of real property assets maintained and regularly audited?

b) Do acquisitions and disposals of state property require approval by the ministry of finance/treasury, *or* are they required to conform to standards and regulations issued by the ministry of finance/treasury?

c) Are the proceeds from disposals of state property paid as general revenue into the budget *or* is their use subject to special ministry of finance/treasury regulation?

*d) Is there a law on public goods or similar legislation, which governs land-use, and construction on special categories of real property?

*e) Are ministries given incentives to privatise real property for which no future public use is expected?

3. Financial assets

a) Is there a central registry or inventory of major financial assets (shares in private-sector or public enterprises, loans to governments, international organisations or enterprises) maintained by the ministry of finance/treasury?

b) Does the budget include planned transactions, which add to or deplete the inventory of assets?

4. User charges

a) Is there parliamentary authority for all fees or charges imposed on users of government services?

b) Is there a law or policy requiring fee-based services to recover their full costs including cost of capital except where a subsidy in the form of lower fees has been transparently authorised?

c) Are fee reductions (subsidies) with social equity objectives (e.g. low incomes or remote areas) systematically compared with alternative programmes of direct benefits which could serve the same objective?

d) Is there a systematic decision-process to ensure that user fees are implemented *only* when there is a favourable ratio of revenues to recovery costs *or* for explicit policy reasons (e.g. to deter unrealistic demands)?

Presentation to parliament

1. Does the draft budget show the following information:

a) Documentation of fiscal policy objectives, the macroeconomic framework, the priorities for the budget, comparison to EU convergence criteria, and the major identifiable fiscal risks?

b) A clear and comprehensive plan for all public spending, including all levels of government and all extra-budgetary funds?

c) The linkage of appropriations to organisations and the hierarchy of accountability among persons and organisations to be entrusted with appropriated funds?

d) Clearly defined appropriations to be voted?

*e) The following technical information related to EU stability/convergence criteria:

- Methodology used to determine medium-term objectives?
- Implementation procedures for budget and economic measures?
- Revenue and expenditure composition of the budget?
- Institutional reforms in the budgeting process, already taken, or planned?

*f) The linkage of expenditures to specific organisations, objectives and activities?

*g) Identification of funding for new policy initiatives, clearly separated from the funding for continuation of existing programmes?

*h) A format and language that is accessible to citizens and media as well as to legislators?

g. Preparation and management of capital investment programmes

1. Are line ministries required to carry out ex ante technical and economic appraisals of capital investment projects?

2. Are current and capital investment budgets integrated into a single process?
   or
   Are the recurrent cost implications of investments calculated and the results incorporated in the annual budget and MTBF?

3. Is there a National Fund for handling EU pre-accession aid flows (ISPA/SAPARD, etc.)?

4. Is the National Fund incorporated within the national budget?

5. Does the budget identify the co-financing share of National Fund projects?

*6. Are investment appraisals based on a common methodology agreed with the ministry of finance or another central authority?

*7. Is there a unified process through which the government selects investment projects and approves both external financing sources and local currency provisions in the budget?

*8. Does this unified process co-ordinate the investment decisions at subnational levels of government?

h. Budget execution and monitoring

Cash management or treasury function

1. Are there laws, regulations and procedures which ensure that:

   a) All public revenues are deposited directly:
   – to the treasury single account under control of the ministry of finance or treasury?
   or
   – by spending units, to their separate subaccounts of a state treasury system?

or

– by geographically remote spending units, to separate bank accounts operated by means of imprest advances (meaning that a new advance is provided upon receipt of an accounting for the use of the previous advance)?

b) If separate bank accounts are permitted, the ministry of finance is responsible for opening, closing, and either directly operating them or monitoring their operation?

c) The above arrangements include one or more euro accounts in central or commercial banks capable of handling EU funds flows?

d) Payments are made:

– through the central treasury, which authorises and processes payment orders from spending units?

or

– by spending units, from their subaccounts within the financial limits authorised by the ministry of finance for the subaccounts?

e) Where separate subaccounts are permitted, budget credits are released to them only at rate required for payments obligations?

f) Information on actual expenditure is available to the ministry of finance/treasury in time for effective monitoring?

g) The ministry of finance/treasury controls cash balances daily relative to borrowings?

h) The ministry of finance/treasury makes daily/weekly/monthly forecasts of cash spending against which it monitors actual spending?

i) Spending units report to the ministry of finance/treasury on their commitments (obligations) to ensure that expenditures do not exceed budget?

j) There are procedures to report and correct overspending?

Legal and policy framework

1. Are there laws, regulations or policies which:

a) Limit and define the authorities at each level of the administration for transferring funds (virement) within the approved budget?

b) Prevent transfers, in either direction, between personnel costs and other subheads of the budget?

c) Specify how budget funds that are unspent at the end of the fiscal year should be treated?

d) Establish sanctions for overspending?

e) Define the permitted uses of the budget reserves and the decision-making authorities for approving allocations from the reserves?

*f) Bind all persons responsible for spending public money to implement management control practices?

*g) Bind all persons responsible for spending public money to observe the principles of efficiency and effectiveness?

*h) Provide clear criteria, and disclosure standards, for all tax and customs remissions and for the write-off of other debts due to the government?

*i) Establish clear rules on maximum proportions of unspent appropriations to be carried from one fiscal year to the next (if carryover is permitted at all)?

*j) If carryover is permitted, authorise the ministry of finance to limit the carryover privilege to fully justified cases, e.g. where there were unavoidable delays in investments or recruiting?

Distribution of responsibilities

1. Is the ministry of finance (and/or the council of ministers) empowered to:

a) Issue (normally through the treasury) the warrants, or equivalent , which authorise spending units to begin spending their budget appropriations?
or
Approve budget implementation plans of spending units, with discretion to impose delays or conditions on specific elements in the plans?

b) Reduce authorisations below the level of parliamentary appropriations if revenues fall below expectations?

c) Give prior approval for transfers of funds between chapters within the same budget heading, and to set rules for transfers among items within chapters?

d) Control the release of investment funds from official donors and obtain reports on execution?

e) Make regulations in all areas of budget preparation and execution, accounting and reporting, fees and charges, financial management, management control, internal audit, cash and debt management, public procurement etc.?

f) Regulate in similar fashion the financial management of statutory extra-budgetary funds?

g) Obtain reports from spending units on financial and task performance?

h) Obtain access to supporting documentation from spending units as required?

i) Report, through the council of ministers, to parliament on budget execution at least twice per year and whenever there are major changes in the forecast outturns?

j) Obtain reports and review breaches of budget legislation?

k) Take corrective and punitive actions which are within its authority?

l) Enforce EU standards of internal control of funds as they pass from the Commission through the national budget to ultimate beneficiaries?

2. Are the spending units required to:

a) Maintain accounting and control systems to ministry of finance standards?

b) Make forecasts of monthly cash flows for the budget year and submit for the ministry of finance/treasury approval?

c) Make regular reports to the ministry of finance/treasury on spending in comparison to budget and cash flows in comparison to forecast?

d) Review, approve, and monitor direct disbursement programmes by official donors in their sector?

e) Receive expenditure statements from aid agencies, and record the expenditures in the government accounts?

f) Supervise subordinate agencies and state-owned enterprises in accordance with government-wide rules?

g) Maintain accounts and report on EU funds in accordance with ministry of finance rules?

h) Ensure that staff of any Implementing Agencies are trained in EC procurement rules?

i) Maintain adequate staff with skills in accounting, information systems, financial management, performance management, and microeconomic analysis?

j) Conform to formal rules against overspending of budgeted appropriations (such as chief accountants, treasury offices or banks having authority to refuse payment orders)?

k) Report to the ministry of finance all breaches of budget legislation and correct and punish those which fall within their delegated authority?

*l) Maintain a budget planning and control framework which links spending to objectives and detailed functions (activities)?

*m) Develop and maintain systems of management (internal) control throughout their own and subordinate organisations?

*n) Maintain a programme of internal audit which meets ministry of finance and EC standards?

3. Is the council of ministers responsible for:

a) Reviewing periodic reports on economic and financial performance relative to the budget?

b) Revising targets and/or policies as required by the changed circumstances?

c) A priori approval of major investments?

d) Approving punitive and corrective action when breaches of budget legislation are beyond ministry of finance authority?

e) Temporarily blocking expenditures when required because of revenue decline or major changes in economic circumstances?

f) Defining national emergencies and approving spending changes to deal with them?

4. Is the parliament responsible for:

a) Reviewing periodic reports on economic and financial performance relative to the budget?

b) Approving permanent blocking of appropriations on the recommendation of government?

c) Approving supplementary budget bills, if required, including proposals to transfer funds between main headings of the approved budget?

Performance monitoring

1. Does the government foster an environment that supports and demands improved performance by organisations and individuals?

2. Is performance information on easily measured activities collected and used by spending units? By the ministry of finance?

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*3. Are managers who are responsible for government programmes and projects given clear short- and longer-term operational performance goals and targets?

*4. Does this practice include all the levels of management that have significant financial responsibilities?

*5. Are there mechanisms to feed back data on performance (such as systematic cost and output accounting, reports on selected indicators of workload, timeliness, quality etc.) to permit corrective action, and to benefit future policy-making?

*6. Is there a systematic decision-process to ensure that formal performance indicator systems are implemented *only* after full investigation and analysis of their potential effects?

Evaluation

1. Is there an evaluation capacity sufficient to respond to EU demands for monitoring and evaluation of Commission policies?

2. Are the results of evaluations published?

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*3. Are the results used in budget decision-making?

*4. Is there a legal or policy requirement that all programmes/projects be subjected to formal evaluation?

*5. Is there a mechanism to ensure that all programmes are periodically evaluated (e.g. requiring evaluation of a certain percentage of programmes/projects each year or every government operation to be evaluated every five years)?

*6. Are policies and standards for evaluation established by the ministry of finance or another appropriate authority?

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i. Accounting and reporting

1. Is there a unified accounting and budgeting classification system regulated by the ministry of finance/treasury?

2. Does the budget classification include an administrative category plus economic and functional categories that are consistent with the GFS and COFOG standards?

3. The chart of accounts should be comprehensive. Does it integrate accounts containing assets, liabilities, government equity, revenues and expenditures to facilitate the preparation of financial statements?

4. Does the accounting system define eligible expenditures, commitments, payments, etc. in accordance with EC reporting requirements?

5. Is the accounting system coherent and common to all levels of government so as to allow a consolidated presentation of the state of public finances?

6. Are there effective and up-to-date manuals setting out procedures and regulations for the accounting system?

7. Are expenditure statements produced during the fiscal year for the council of ministers and tabled in parliament?

8. Are the final accounts produced, audited and tabled in parliament shortly after the end of the fiscal year?

9. Does the system provide for recording commitments (obligations) as well as cash transactions?

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*10. Are liabilities (such as those for civil service pensions) determined in accordance with generally accepted actuarial principles?

*11. Is there a plan and schedule to implement a detailed programme classification (programme/activity/project categories)?

*12. Are physical assets inventoried and policies on valuation and accrual accounting (if any) established?

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j. Public procurement

Sound financial management, control and internal audit procedures are essential for effective procurement management. These aspects should be assessed using Section k of this Questionnaire.

1. Do the public procurement and related laws:

   a) Define the entities, and levels of government, covered by the law?

   b) Establish a central public procurement organisation with overall responsibility to design and implement procurement policy?

   c) Authorise secondary legislation and procedures to be issued for the effective operation of the system?

   d) Define decision-making powers at key levels of the administration?

   e) Identify permissible exemptions and the authority competent to approve them?

   f) Include adequate provisions for the review of complaints?

   g) Provide swift and certain penalties for fraud and abuse?

   h) Conform to both the EC Directives and good practice within Member States?

2. Do the public procurement procedures define:

   a) The different procedures which are appropriate for goods procurement, construction services procurement and for purchase of other services?

   b) Standard documentation for routine procurement transactions?

   c) Standard practices for bid deposit, bid opening, evaluation, publication and record-keeping?

   d) Time frames and advertising rules conforming to EC standards?

   e) Error-prevention mechanisms based on management control principles?

3. Is the public procurement organisation:

   a) An independent entity or located in an organisation at the centre of government (e.g. the ministry of finance, or the office of the prime minister or the council of ministers)?

   b) Empowered to collect, analyse, and report statistics on procurements by all the entities covered by the law?

   c) Responsible for developing and co-ordinating training programmes for procurement staff?

   d) Responsible for advising the government on exemptions and on proposals for policy change?

e) Issuing standards and manuals of procedure, and monitoring performance?

f) Adequately staffed with properly trained persons?

Implementation and training

1. Are there specialised recruitment and training programmes for procurement professionals?

2. Are staff of Implementing Agencies given special training in EC procurement requirements?

3. Are standardised procedures manuals, forms and documents available to contracting entities and training establishments?

4. Are there special programmes to disseminate information and training to potential bidders in the private sector?

Complaint review and dispute resolution

1. Is there a transparent and widely understood procedure for appeal of contract-award decisions and other complaints?

2. Is there a secondary, or final, level of appeal to an authority outside of the contracting entity itself?

k. Internal control and internal audit

Promotion and enforcement

1. Are there laws or regulations, which define coherent principles, systems and functioning of internal controls, including internal audit?

2. Do the accounting and reporting systems conform to the basic standards in Section i above?

3. Is there a system of ex ante controls of commitments and payments, preferably exercised within spending units?

4. Do the public procurement rules and systems meet the basic standards in Section j?

5. Are error-prevention features built into the design of government organisation structures (including all entities involved in the flow of EU funds through the National Fund and Paying Agencies), and into the definitions of competencies or authority delegation instruments?

6. Are there systems to prevent irregularities, and laws to permit recovery of losses due to irregularity or negligence?

7. Is the supreme audit institution empowered to audit the management (internal) control systems and permitted the discretion to use sampling in the audit of individual transactions?

8. Are there appropriate mechanisms for fighting fraud and corruption, either within the central office of control or in another central institution?

*9. Is there a central office of control in the ministry of finance or elsewhere that issues standards, provides technical advice and monitors performance?

*10. Are control systems integrated with line management reporting systems and with the budget planning?

*11. Are computerised information systems designed to management internal control standards and the designs verified by specialised audit staff?

Internal audit

Other models of internal audit, particularly that of an inspectorate general of finance, can be equally effective. For countries using such models the following questions should be re-interpreted accordingly.

1. Are internal audit units established in line ministries?

2. Do the internal audit units report directly to the chief executive to ensure their independence from their audit subjects?

3. Does the mandate for these units include:

   • Financial audit?

   • Systems audit?

   • Procurement process audit?

   • Review of management (internal) control arrangements (such as policies, organisation structures, procedures manuals, staff recruitment and promotion, disciplinary arrangements etc.)?

4. Are all spending units required to have an internal audit organisation if they are not served by that of a line ministry?

5. Are there written standards and procedures for internal audit which meet INTOSAI and EU specifications?

*6. Are the policies and standards for internal audit established and monitored by a central office of control and audit in the ministry of finance or elsewhere?

*7. Are the knowledge and skill qualifications for internal auditors established and monitored by the central office of control and audit?

*8. Are the internal audit reports made available to the external auditor?

*9. Are internal audit units expected to co-ordinate audit plans with those of the external auditor?

*10. Is a special code of conduct enforced for internal auditors?

l. European Union requirements for financial control

1. Is a coherent and comprehensive statutory base defining the systems, principles and functioning of financial control (management/internal control) systems, including mechanisms for internal audit/inspectorates, in place?

   a) Are the authorities responsible for reporting to the European Commission able to provide the Commission with relevant legal references and a list of the authorities and bodies designated to manage and control EU funds, as mentioned in Council Regulations 1257/1999, 1258/1999 and 1260/1999 to 1268/1999 and Commission Regulation 2064/97?

   b) Is there a legal base for the establishment of an internal audit/inspectorate of finance mechanism?

   c) Does the internal audit (IA)/inspectorate general of finance (IGF) have the legal mandate to audit all relevant funds?

   d) Does the IA or IGF have the legal mandate to do management, financial and performance audit?

   e) Does the statutory base provide clear-cut distinctions between the financial control responsibilities of different government authorities?

   f) Are the relevant legal provisions passed and approved at an appropriate constitutional level, e.g. as an act of parliament or a government decree?

2. Relevant internal (management) control systems and procedures have to be in place:

   a) Are there in place well-established and functioning accounting and reporting standards?

   b) Are the accounting and reporting standards laid down in written rules or guidelines?

   c) Is there in place a computerised accounting system?

   d) Does the accounting and reporting system define an audit trail, by which the movement of data can be traced forwards and backwards in the accounting system, enabling auditors and managers to cross-refer each bookkeeping entry to its source?

   e) Does the audit trail meet the indicative requirements of the Annex to Commission Regulation 2064/97?

   f) Are there in place ex ante control mechanisms for the control of commitments and payments?

   g) Do the ex ante controls meet the requirements of e.g. Council Regulation 1257/1999, 1258/1999 and 1260/1999 to 1267/1999 and Commission Regulation 2064/97?

   h) Are the requirements for ex ante regularity checks of procurements mentioned in the Financial Regulation and elsewhere, e.g. Council Regulations 1266/1999 and 1267/1999 met?

i) Are ex post controls of procurements done on a systematic basis?

j) Do the competent national authorities perform checks of the collection and management of EU own resources (customs, levies, VAT, GNP share) in accordance with the provisions of e.g. Regulations 1552/89, 1553/89, 88/376 and 94/728?

3. A functionally independent internal audit/inspectorate mechanism with relevant remit and scope has to be in place:

a) Are the IA units of EU funds implementing authorities able to exercise their duties independently of the spending units as required in e.g. Council Regulation 1267/1999, Annex III, 1266/1999, Annex and Commission Regulation 1663/1995, Annex?

b) Does the IA report to the highest-ranking civil servant or a high ranking politically appointed official of the ministry or government body in question?

c) Is the independence of the IA appropriately safeguarded as required in e.g. Council Regulation 1266/1999, Annex, Commission Regulation 1663/95, Annex?

d) Does the body designated to prepare a final certification of expenditure of EU programmes report to the highest level of government (e.g. the minister of finance) or parliament (e.g. the supreme audit institution)?

e) Does the IA/IGF audit all relevant funds on a systematic basis?

f) Does the IA/IGF perform financial and management audits as well as performance audits, including assessments of the soundness and/or effectiveness of the financial management system as such, as laid down in e.g. Regulation 1260/1999, Art. 38 and 1663/95, Annex?

g) Does the IA/IGF apply internationally accepted/recognised auditing standards as mentioned in e.g. Council Regulations 1266/1999, Annex, 1267/1999, Annex III and Commission Regulation 1663/95, Annex?

h) Does the IA/IGF have the technology and competence needed to perform and document appropriate audit sampling and risk analyses as referred to in e.g. Commission Regulation 2064/97, Art. 3?

i) Do audit standards or guidelines applicable for the government administration as such exist?

j) Does an authority responsible for the co-ordination, supervision and updating applied audit standards and methodologies exist?

4. Systems must be in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence

a) Are there in place mechanisms to take action against irregularities and to recover amounts lost as a result of irregularities or negligence as specified in e.g. Council Regulation 595/91, Commission Regulation 1681/94, Council Regulation 1260/1999 and 1258/1999?

b) Do the existing laws/regulations ensure that it is possible for the national authorities to recover amounts lost due to irregularities or negligence, as defined in Regulation 2988/95, Art. 4?

c) Is there in place a system to report regularly to the Commission on irregularities detected and the actions taken, as mentioned in e.g.1260/1999, Art. 38 and 1258/1999, Art. 8?

d) Has an authority responsible for the co-ordination and co-operation in the fight against fraud and corruption been designated?

e) Does this authority co-operate and co-ordinate its activities with the European Anti-Fraud Office (OLAF), as laid down in e.g. Interinstitutional Regulation 1073/1999 and Council Regulation 1074/1999.

m. External audit

These questions focus on policy, legislative and institutional issues concerning external audit. For a supreme audit institution (SAI) to assess the efficiency and effectiveness of its own operations and practices, a different and more detailed checklist should be developed by audit professionals.

1. Is there an external auditor (auditor general, audit court, national audit office), established by law with independence from the government and reporting to the parliament?

2. Does the SAI have clear authority to audit all public and statutory funds and resources, bodies and entities, including EU resources?

3. Does the SAI mandate include performance audit as well as financial and regularity audits as set out in INTOSAI Standards 38-40?

4. Does the SAI have the following practical characteristics of independence:

   • Freedom to decide what work it will do?

   • A mandate to review all matters affecting the management 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 parliamentary approval?

   • Freedom to recruit staff on the basis of professional merit alone?

5. Does the SAI enforce a special code of conduct for staff?

6. Does the parliament have a special committee and/or procedure for reviewing SAI reports?

7. Is the government required to follow up and respond publicly to SAI recommendations?

8. Does the SAI co-operate with the European Court of Auditors and the international associations of supreme audit institutions?

9. Has the SAI adopted internationally recognised auditing standards compatible with EU requirements?

10. Does the SAI make use of internal audit reports to avoid duplication of effort?

11. Does the SAI co-ordinate auditing plans with internal audit units?

n. Organisation and capacity for reform

1. Is there a coherent, written strategy for bringing the expenditure management system into line with western European counterparts and EC standards?

2. Does this strategy have the support of the minister of finance? Other ministers?

3. Is there a department or unit in the ministry of finance tasked with the specific responsibility of modernising the budget system?

4. Does this unit have adequate professional staff and are they dedicated full time to the reform task?

5. Does the strategic plan include a schedule for completing the various stages of work? Is progress on schedule?

6. Does the reform unit consult and collaborate closely with professional staff working in the forecasting, budget, accounting and treasury departments of the ministry of finance?

7. Have the "branch/financing/sectoral departments" of the ministry of finance been organised together with the budget department under a single head?

8. Have the staff of these departments been re-trained for their roles as budget examiners rather than advocates for their sectors?

9. Is there a systematic training and orientation programme for staff in the ministry of finance? For budget and financial management staff of line ministries and spending units?

10. Are the training programmes designed and scheduled to complement the reform programme?

11. Does the reform unit have access to technical assistance from EU, other international organisations, and/or bilateral programmes?

12. Is the reform strategy publicised to business and academic groups to ensure their support?

NOTES

1. This questionnaire, drawn together by Larry O'Toole, relies upon the work of many organisations and individuals, both academics and practitioners in many countries. Some questions are paraphrased, or directly borrowed, from questionnaires and checklists published for other purposes by the IMF, the OECD, the World Bank and the European Commission.

2. For purposes of clarity, all "advanced questions" are marked with an initial asterisk and separated from the other questions by dotted lines.

ANNEX II

ESTABLISHMENT OF A NATIONAL FUND SYSTEM

This Annex is intended as a guideline/checklist for the establishment of a National Fund system in the central and eastern European countries that are candidates for membership of the EU.

The National Fund system is a concept developed by the European Commission for the management of Community assistance/funds to the candidate countries until the time of accession. Upon accession it is expected that the candidate countries will have established a system for management of EU funds and the national budget (including all national resources) that fulfils the requirements of the European Union in terms of management, accountability and control.

Candidate countries are generally encouraged not to establish two separate systems for management of Community assistance and the national budget. A double or parallel system will require more resources than operating one system and may prove less efficient.

When designing a National Fund system a country should assess its existing administrative system and procedures and determine whether these are in compliance with EU requirements. Many structures and procedures may only need limited adaptation in order to satisfy EU requirements. Other structures and procedures may have to be restructured or newly established in order to fulfil the requirements.

The document is divided into eight sections, each addressing a group of issues that has to be considered when establishing a national fund system.

- System for managing EU funds (National Fund system).
- Budget execution, payment and accounting arrangements.
- Financial control and audit.
- Procurement under the Phare DIS Rules.
- Monitoring and evaluation.
- Management of SAPARD and ISPA funds.
- Budget process, programming of EU funds and co-financing.
- Irregularities, fraud and recovery of expenditures.

A. System for Managing EU Funds (National Fund system)

1. The National Fund

There is no unique "model" solution for the establishment of the National Fund system. Each country must chose its own approach and identify the appropriate institutional responsibilities. Many candidate countries, however, have chosen to make the National Fund the responsibility of the ministry of finance.

- Will the National Fund be a separate unit (section or department) in the ministry of finance?
- Or will the National Fund be integrated with the overall system of treasury management in the ministry of finance i.e. no separate function but identified officials responsible for EU funds?
- Have the mandate and the responsibilities of the National Fund been developed/established?
- How many staff are employed by the National Fund and what are their functions (job descriptions)?
- What is the status of National Fund staff (civil servants, state employees or contracted staff)? To whom are they accountable?

2. Implementing agencies

For the implementation of Community funds under the National Fund system, the Memorandum of Understanding and Financing Agreements prepared and signed jointly by the candidate country and the European Commission foresee the establishment of Implementing Agencies. As there is no Community standard for the Implementing Agencies, it is for each candidate country to choose how the agencies will be established and which institutional structure the agencies will have.

- What institutional structure do the Implementing Agencies have: e.g. units or departments in the relevant ministries, or separate institutions?
- What are the mandates and operating responsibilities of the Implementing Agencies?
- What is the number of staff and their role and responsibilities?
- What is the status of Implementing Agency staff (civil servants, state employees or contracted staff)? And to whom are they accountable?
- Who is ultimately responsible and accountable for the performance of the Implementing Agencies?
- What is the relationship between the Project Authorising Officers and the Implementing Agencies?

3. CFCU

All candidate countries have by now a Central Financing and Contracting Unit (CFCU).

- Will the CFCU be transformed into the National Fund? If yes, will another Implementing

Agency be established for institution building?

- Will the CFCU will continue as one of the Implementing Agencies (i.e. for institution building and/or as a support for line ministries, regional and local authorities which do not have the capacity for implementation of the DIS)?

4. Legislation

As the National Fund system includes new or different responsibilities and tasks for line ministries and government agencies, new legislation (primary or secondary) — or at least operating manuals and guidelines — may be needed in order to establish and clarify these new roles and responsibilities.

- Has any legislation (primary or secondary) or other official documentation been prepared setting out the respective responsibilities of the National Fund and the Implementing agencies?

- If not, how will the new responsibilities be shared between the different institutions?

5. Implementing manuals and guidelines

The establishment of the National Fund system will require that the institutions involved are able to operate the Phare DIS system and that the system has an audit trail. Each administration will have to develop its own procedures to fit the National Fund system of that country and its administrative system.

- Has a manual or other detailed instructions been developed that describe the functioning of the National Fund system and determine the activities and responsibilities of each of the institutions involved?

- Has standard documentation been developed for the National Fund system such as:

1. Forms

- Application for payment requests.

- Payment grid stamps.

- Payment orders.

- Form for the submission of tenders and contract and contractor information.

2. Reports

- Activity plans.

- Disbursement plans.

- Commitment and disbursement performance reports.

- Activity reports.

- Who is/will be responsible for the preparation of such documentation and what are the rules for signatures, submission, etc.?

B. Budget Execution, Payment and Accounting

1. Treasury function

Some candidate countries operate their financial management systems on the basis of a central treasury function which execute all payments for the line ministries and other government institutions.

- Will the EU funds be executed by the same treasury function? Classified under the budget classification system (administrative units, economic categories, functions)? Accounted for in the budget accounting system?

- If not, what is the system of budget execution i.e. who does actual payments to contractors etc.?

- Does the treasury function perform all *actual* payments for the spending government institutions?

- Will the treasury function perform all *actual* payments for the EU funds?

- Will local authorities be direct recipient of EU grants? How are the local authorities involved in the management process of the EU funds (what functions do they have, how are the funds channelled to them and are these transactions recorded in their budget?)?

2. Links with the budget

The way in which the EU funds are included in the budget will be important for budget execution, identification of co-financing, preparing budget accounts and reporting and monitoring the implementation of the funds.

- Is co-financing for EU funds earmarked as co-financing in the budget, i.e. can it be identified?

- In what way have the EU funds and co-financing been incorporated in the budget — e.g. as "lump sums" or under their respective programmes and ministries?

- Are EU funds included in the annual budget circular/instruction issued by the ministry of finance?

- How will EU funds be classified on the expenditure side and revenue side of the budget? How will they be identifiable as EU funds?

- How will the funds co-financed through the national budget be identified and linked to the matching EU funds?

3. Financial management systems

Depending on the design of the National Fund system, responsibility for the financial management of EU funds may be placed with different institutions (i.e. the ministry of finance, the treasury, the Implementing Agencies, the central bank, etc.).

- Who is responsible for the financial management of EU funds?
- Where will the bank accounts for the National Funds be held?
- Are these bank accounts consolidated with the other bank accounts to establish the global cash position? If so, how frequently is consolidated data made available (daily, weekly, etc.)?
- Are provisions made for the management of (potential) financial risks (e.g. interest charges, exchange rate fluctuations, etc.)? What techniques are used to manage these risks? Who is responsible?

4. Budget accounting systems

The budget accounting system operated in some candidate countries at present is able to operate with different currencies so that including accounts in euro should present no problem. However, it is important that the accounting system is able to meet the reporting requirements for monitoring reports and to provide a proper audit trail.

- Is the system able to record the movement of EU funds on an 8-digit code, link payments to contracts and link contracts to programmes, projects and subprojects?
- What kind of financial analysis and reporting can be made on the basis of the accounting system?
- Can the system be used as the basis for reporting to the Commission and requesting replenishment of funds?
- Are there provisions made in the accounts for exchange rate changes between Euros and national currency units? On what basis are charges made for currency depreciation and are gains from revaluation accounted for?
- How are physical assets (e.g. land, buildings, infrastructure, equipment) acquired by EU-funds accounted for? How are such assets valued? Are charges for depreciation made on a systematic basis?

5. Perseus

The European Commission requires that the reporting system Perseus is used for reporting to the European Commission on the implementation of the funds. As the system cannot be consolidated and has to be run by several institutions, a decision has to be made on which institution(s) is/are responsible for managing Perseus.

- Who will be responsible for managing and reporting on Perseus? The National Fund or the Implementing Agencies or both?
- How have the responsibilities for the Perseus system been distributed, i.e. who is responsible for which part of the system?
- How will the National Fund verify the data entered by the Implementing Agencies?

C. Financial Control and Audit

Most issues relating to internal control, internal audit and external audit apply generally to the management of public expenditures. (See Chapters 10 and 14 for further details.) The issues mentioned in this section are restricted to those that have special significance for the management of EU funds through the National Fund.

- Does the ministry of finance have a special role with regards to EU funds in relation to the internal audit departments/units in line ministries?
- What responsibilities do the units in the line ministries responsible for internal audit have in relation to the management of EU funds?
- What are the role and responsibilities of the supreme audit institution in respect of such funds?
- Do the laws relating to internal audit and external audit cover external funds?

D. Procurement under the Phare DIS Rules

It is important to ensure that the departments/units that are responsible for the enforcement and implementation of the existing national procurement rules, are not only aware of the Phare DIS system but also able to guide and monitor the institutions implementing the EU Phare DIS.

- Have staff of line ministries been trained in the DIS procurement rules?
- Are staff in EU funds Implementation Agencies able to implement the DIS procurement system?
- Is there any experience with works procurement according to EU Phare DIS (FIDIC) in the line ministries?
- Have the internal and external audit functions been trained in the EU Phare DIS and FIDIC procedures?

E. Monitoring and Evaluation

With the introduction of the National Fund system, the requirement for candidate countries to monitor Community funds has increased. A system of monitoring committees headed by a Joint Monitoring Committee is to be established in each country. The monitoring committees will monitor the programmes on the basis of reports and evaluations (which can be commissioned by the Committee). Each country will have to develop procedures for implementing these requirements.

In general, the functions of implementation on the one hand and programme monitoring on the other hand have to be separated with regard to functional responsibility.

- Which institution(s) is responsible for programming of EU funds?
- Which institutions(s) is responsible for overall programming of SAPARD and ISPA?

- Which institution(s) is responsible for monitoring the implementation of the EU funds programmes?
- Who is responsible for establishing the monitoring system?
- Which institution(s) is responsible for the preparation of monitoring reports?
- Which institution is responsible for developing the standard monitoring reports?
- Have the required monitoring committees been established?
- Do there exist internal guidelines for the elaboration of a monitoring system that ensures that monitoring gives an accurate view of reality?
- What is done with the results of this monitoring? Are they used for evaluating the effectiveness of policy execution and the spending of public funds? Who makes this evaluation? What are the consequences of this evaluation at the political level?

F. Management of the Phare, SAPARD and ISPA Funds

- Are national budget support and SAPARD implemented through the same system?
- Who is responsible for implementation of SAPARD?
- What is the role of the SAPARD agency?
- Has proper separation of the programming and implementation functions been developed for SAPARD?
- Have the ex ante control and internal audit functions been developed for SAPARD?
- Does the treasury make actual payments for SAPARD? Or has the payment function been delegated to other institutions?
- Which authority is responsible for accreditation of the Paying Agent for SAPARD?
- Which authority is responsible for certification of payments under SAPARD? Who carries out the certification (an auditing company, a national financial control organisation, or other)?
- What is the current system for implementation of infrastructure investment (especially transport and environment)? Which institutions are involved? Are these institutions also responsible for Phare financial transport and environment programmes? Are the same institutions be responsible for ISPA?
- Are local authorities involved in implementing ISPA-funded programmes? What is their role?
- Who are the beneficiaries of ISPA projects? What is their role in project implementation?

G. The Budget Process, Programming of EU Funds and Co-Financing

With the introduction of the Accession Partnerships and the National Development Plans the programming of EU funds has shifted towards a closer link with the national budget and a multi-annual budgeting approach. Although the programming of Community funds is a separate procedure from the budget process as such, a close co-ordination between the two procedures needs to be established.

- Which institution is responsible for programming of EU funds?
- Who is responsible for the National Development Plan and the motoring of the National Development Plan?
- Who is responsible for the Accession Partnership and the National Programme for Adoption of the Acquis?
- How is the programming of EU Phare funds co-ordinated with the budgeting process and the public investment programme?
- Is there any legal relationship between the National Aid Co-ordinator and the National Authorising Officer?

H. Irregularities, Fraud and the Recovery of Unjustified Expenditures

Systems must be in place to prevent irregularities, or detect them and take remedial action, in particular to recover any amounts lost as a result of the irregularity or negligent behaviour. It is important to review the requirements dealing with the prevention, detection and correction of irregularities for each relevant EC regulation (e.g. Customs, Phare, ISPA and SAPARD).

The main criteria for judging the effectiveness of the system are the extent to which: 1) it includes preventive a priori controls, as required by the relevant EC regulations; 2) existing laws and secondary legislation enable the recovery of amounts lost (including damages and/or penalties incurred) resulting from irregularities, negligence or errors; 3) structures are in place to fight fraud and/or corruption (either by means of existing national institutions or separate entities) in accordance with EC requirements and regulations.

- What systems and procedures are in place to detect and take action against financial irregularities and fraud, including measures for the recovery of unjustified expenditure?
- What provisions exist in national law, including administrative law, to enable funds lost as a result of irregularities and fraud to be recovered?
- Is it possible to impose administrative fines and penalties without recourse to the civil or criminal courts?
- Is it possible, without recourse to the courts, to recover from a contractor or beneficiary an amount unused, or used incorrectly, provided that the conditions for use, including the possibility of recovery, have been notified to the contractor or beneficiary in advance and accepted by them in writing?

- Is there legislation providing for action to be taken by the courts for misuse of public funds, including non-conformity with the regulations governing the grant of such funds, whether or not the person or organisation concerned has not benefited from the misuse?

- Do the technical services and the Implementing Agencies have a clear understanding of the definition of an irregularity, as defined in Regulations 595/81 and 1681/94?

- Do the technical services and the Implementing Agencies have standard forms to report about a possible irregularity?

- Do the technical services and the Paying Agencies have a procedure to let any possible irregularity be reviewed by a legal department within the technical services and/or the Implementing Agencies?

- Do the technical services have a procedure to ensure that all possible irregularities are notified to the relevant Implementing Agencies?

- Do the Implementing Agencies have a register that maintains an up-to-date record of irregularities reported, legal advice, claims and legal remedies, information provided to the Commission on progress in collecting claims, and payments made to the Commission?

ANNEX III

EUROPEAN COMMUNITY REGULATIONS CONCERNING FISCAL SURVEILLANCE, BUDGET, FINANCIAL CONTROL AND AUDIT[1]

PRIMARY LAW

Number	*Subject*
TEC, Article 10	Establishing general obligations of the Member States
TEC, Article 211	Obligations and responsibilities of the European Commission
TEC, Article 104	Excessive deficit procedure
TEC, Article 246-248	Provisions for the European Court of Auditors
TEC, Articles 268-279	Financial provisions
TEC, Article 280	Fight against fraud

New classification following the Amsterdam Treaty amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts.

SECONDARY LAW

Fiscal Surveillance

Number	*Subject*
3605/93	Council Regulation of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.
97/C 236/01	Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997.
1466/97	Council Regulation of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies.

1467/97	Council Regulation of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.
475/2000	Council Regulation of 28 February 2000 amending Regulation (EC) No. 3605/93.

Budgeting

Number	*Subject*
1231/77	Financial Regulation of 21 December 1977 applicable to the general budget of the European Communities.
3418/93	Commission Regulation (Euratom, ECSC, EC) No. 3418/93 of 9 December 1993 laying down detailed rules for the implementation of certain provisions of the Financial Regulation of 21 December 1977.
94/729	Council Decision (EC, Euratom) of 31 October 1994 on budgetary discipline.
Interinstitutional agreement	Budgetary discipline and improvement of the budgetary procedure.

Own resources

Number	*Subject*
88/376	Council Decision (EEC, Euratom) of 24 June 1988 on the system of the Communities' own resources (Implemented by 1552/89).
89/130	Council Directive (EEC, Euratom) of 13 February 1989 on the harmonisation of the compilation of gross national product at market prices.
1552/89	Council Regulation (EEC, Euratom) No. 1552/89 of 29 May 1989 implementing Decision 88/376/EEC, Euratom on the system of the Communities' own resources.
1553/89	Council Regulation (EEC, Euratom) No. 1553/89 on the definitive uniform arrangements for the collection of own resources accruing from value added tax.
94/728	Council Decision (EC, Euratom) of 31 October 1994 on the system of the European Communities' own resources.
210/97	Decision No. 210/97/EC of the European Parliament and of the Council of 19 December 1996 adopting an action programme for customs in the Community (Customs 2000).

General regulations concerning financial control and audit

Number	*Subject*
2988/95	Council Regulation (EC, Euratom) No. 2988/95 of 18 December 1995 on the protection of the European Communities' financial interests.
2185/96	Council Regulation (Euratom, EC) No. 2185/96 of 11 November 1996 concerning on-the-spot checks and inspections carried out by the Commission in order to protect the European Communities' financial interests against fraud and other irregularities.

Agriculture and fishery

Number	*Subject*
4045/89	Council Regulation (EEC) No. 4045/89 of 21 December 1989 on scrutiny by Member States of transactions forming part of the system of financing by the Guarantee Section of the European Agricultural Guidance and Guarantee Fund.
386/90	Council Regulation (EEC) No. 386/90 of 12 February 1990 on the monitoring carried out at the time of export of agricultural products receiving refunds or other amounts.
307/91	Council Regulation (EEC) No. 307/91 of 4 February 1991 on reinforcing the monitoring of certain expenditure chargeable to the Guarantee Section of the European Agricultural Guidance and Guarantee Fund.
3508/92	Council Regulation (EEC) No. 3508/92 of 27 November 1992 establishing an integrated administration and control system (IACS) for certain Community aid schemes (Implemented by 3887/92).
3887/92	Commission Regulation (EEC) No. 3887/92 of 23 December 1992 laying down detailed rules for applying the integrated administration and control system for certain Community aid schemes.
1663/95	Commission Regulation (EC) No. 1663/95 of 7 July 1995 laying down detailed rules for the application of Council Regulation (EEC) No. 729/70 regarding the procedure for the clearance of the accounts of the EAGGF Guarantee Section.
515/97	Council Regulation (EC) No. 515/97 of 13 March 1997 on mutual assistance between the administrative authorities of the Member States and co-operation between the latter and the Commission to ensure the correct application of the law on customs and agricultural matters.
723/97	Council Regulation (EC) No. 723/97 of 22 April 1997 on the implementation of Member States' action programmes on control of EAGGF Guarantee Section expenditure.

1257/1999	Council Regulation (EC) No. 1257/1999 of 17 May 1999 on support for rural development from the European Agricultural Guidance and Guarantee Fund (EAGGF) and amending and repealing certain Regulations.
1258/1999	Council Regulation (EC) No. 1258/1999 of 17 May 1999 on the financing of the common agricultural policy.
1263/1999	Council Regulation (EC) No. 1263/1999 of 21 June 1999 on the Financial Instrument for Fisheries Guidance.

Structural funds

Number	*Subject*
2052/88	Council Regulation (EEC) No. 2052/88 of 24 June 1988 on the tasks of the Structural Funds and their effectiveness and on co-ordination of their activities between themselves and with the operations of the European Investment Bank and the other existing financial instruments (Implemented by 4253/88).
4253/88	Council Regulation (EEC) No. 4253/88 of 19 December 1988 laying down provisions for implementing Regulation (EEC) No. 2052/88 as regards co-ordination of the activities of the different Structural Funds between themselves and with the operations of the European Investment Bank and the other existing financial instruments.
2064/97	Commission Regulation (EC) No. 2064/97 of 15 October 1997 establishing detailed arrangements for the implementation of Council Regulation (EEC) No. 4253/88 as regards the financial control by Member States of operations co-financed by the Structural Funds.
1260/1999	Council Regulation (EC) No. 1260/1999 of 21 June 1999 laying down general provisions on the Structural Funds.
1261/1999	Regulation (EC) No. 1261/1999 of the European Parliament and of the Council of 21 June 1999 on the European Regional Development Fund.
1262/1999	Regulation (EC) No. 1262/1999 of the European Parliament and of the Council of 21 June 1999 on the European Social Fund.

Cohesion funds

Number	*Subject*
1164/1994	Council Regulation (EC) No. 1164/94 of 16 May 1994 establishing a Cohesion Fund.
1264/1999	Council Regulation (EC) No. 1264/1999 of 21 June 1999 amending Regulation (EC) No. 1164/94 establishing a Cohesion Fund.

1265/1999	Council Regulation (EC) No. 1265/1999 of 21 June 1999 amending Annex II to Regulation (EC) No. 1164/94 establishing a Cohesion Fund.

Pre-accession funds

Number	*Subject*
3906/89	Council Regulation (EEC) No. 3906/89 of 18 December 1989 on economic aid to the Republic of Hungary and the Polish People's Republic — with amendments (Phare).
1266/1999	Council Regulation (EC) No. 1266/1999 of 21 June 1999 on co-ordinating aid to the applicant countries in the framework of the pre-accession strategy and amending Regulation (EEC) No. 3906/89.
1267/1999	Council Regulation (EC) No. 1267/1999 of 21 June 1999 establishing an Instrument for Structural Policies for Pre-Accession.
1268/1999	Council Regulation (EC) No. 1268/1999 of 21 June 1999 on Community support for pre-accession measures for agriculture and rural development in the applicant countries of central and eastern Europe in the pre-accession period.

Reclaiming of amounts and sanctions

Number	*Subject*
595/91	Council Regulation (EEC) No. 595/91 of 4 March 1991 concerning irregularities and the recovery of sums wrongly paid in connection with the financing of the common agricultural policy and the organisation of an information system in this field.
1681/94	Commission Regulation (EC) No. 1681/94 of 11 July 1994 concerning irregularities and the recovery of sums wrongly paid in connection with the financing of the structural policies and the organisation of an information system in this field.
1469/95	Council Regulation (EC) No. 1469/95 of 22 June 1995 on measures to be taken with regard to certain beneficiaries of operations financed by the Guarantee Section of the EAGGF.
745/96	Commission Regulation (EC) No. 745/96 of 24 April 1996 laying down detailed rules for the application of Council Regulation (EC) No. 1469/95 on measures to be taken with regard to certain beneficiaries of operations financed by the Guarantee Section of the EAGGF.

Anti-fraud and anti-corruption regulations

Number	*Subject*
Decision	Commission Decision of 28 April 1999 establishing the European Anti-Fraud Office (OLAF) (notified under document number SEC(1999) 802) (1999/352/EC, ECSC, Euratom).
Agreement	Interinstitutional Agreement of 25 May 1999 between the European Parliament, the Council of the European Union and the Commission of the European Communities concerning internal investigations by the European Anti-Fraud Office (OLAF).
1073/1999	Regulation (EC) No. 1073/1999 of the European Parliament and of the Council of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF).
1074/1999	Council Regulation (EURATOM) No. 1074/1999 of 25 May 1999 concerning investigations conducted by the European Anti-Fraud Office (OLAF).

NOTES

1. For more detailed information, see the legal texts themselves on the European Commission "Eurlex" web site at http://europa.eu.int/eur-lex/en.

ANNEX IV

IMF CODE OF GOOD PRACTICES ON FISCAL TRANSPARENCY[1]

A. Clarity of Roles and Responsibilities

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

   - The boundary between the government sector and the rest of the economy should be clearly defined and widely understood. The government sector should correspond to the general government, which comprises the central government and lower levels of government, including extra-budgetary operations.

   - Government involvement in the rest of the economy (e.g. through regulation and equity ownership) should be conducted in an open and public manner on the basis of clear rules and procedures, which are applied in a non-discriminatory way.

   - The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.

   - Clear mechanisms for the co-ordination and management of budgetary and extra-budgetary activities should be established, and well-defined arrangements vis-à-vis other government entities (e.g. the central bank, and state-controlled financial and non-financial enterprises) should be specified.

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

   - Fiscal management should be governed by comprehensive laws and administrative rules applying to budgetary and extra-budgetary activities. Any commitment or expenditure of government funds should have a legal authority.

   - Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.

   - Ethical standards of behaviour for public servants should be clear and well publicised.

B. Public Availability of Information

1. The public should be provided with full information on the past, current, and projected fiscal activity of government.

   - The annual budget should cover all central government operations in detail and should also provide information on central government extra-budgetary operations. In addition, sufficient information should be provided on the revenue and expenditure of lower levels of government to allow a consolidated financial position for the general government should be presented.

   - Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.

   - Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditures, and quasi-fiscal activities.

   - The central government should regularly publish information on the level and composition of its debt and financial assets.

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

   - Specific commitments should be made to the publication of fiscal information (e.g. in a budget law).

   - Advance release date calendars for fiscal reporting to the public should be announced.

C. Open Budget Preparation, Execution and Reporting

1. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

   - A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.

   - Any fiscal rules that have been adopted (e.g. a balanced budget requirement and borrowing limits for lower levels of government) should be clearly specified.

   - The annual budget should be presented within a comprehensive and consistent quantitative macroeconomic framework, and the economic assumptions and key parameters (e.g. effective tax rates) underlying budget estimates should be provided.

   - Existing commitments should be distinguished from new policies included in the annual budget.

   - Major risks to the annual budget should be identified and quantified where possible, including variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g. financial restructuring).

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

   - Government transactions should be on a gross basis, distinguishing revenue, expenditure, and financing, and classifying expenditures on an economic and functional basis. In addition, expenditure should be classified by administrative category. Data on extra-budgetary operations should be similarly classified. Budget data should be presented in a way that allows international comparisons.

   - A statement of objectives to be achieved by major budget programmes (e.g. improvement in relevant social indicators) should be provided.

   - The overall balance of the general government should be a standard summary indicator of the government's financial position. It should be supplemented by other fiscal indicators (e.g. operational balance, structural balance, and primary balance) when economic circumstances make it inappropriate to base judgements about fiscal policy stance on the overall deficit alone.

   - The annual budget and final accounts should include a statement of the accounting basis (i.e., cash or accrual) and standards used in the preparation and presentation of budget data.

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

   - A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.

   - Procedures for procurement and employment should be standardised and accessible to all interested parties.

   - Budget execution should be internally audited, and audit procedures should be open to review.

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

   - During the year, there should be regular, timely reporting of budget and extra-budgetary outturns, which should be compared with original estimates. In the absence of detailed information on lower levels of government, available indicators of their financial position (e.g. bank borrowing and bond issues) should be provided.

   - Timely, comprehensive, and audited final accounts of budget operations, together with full information on extra-budgetary accounts, should be presented to the legislature.

   - Results achieved relative to the objectives of major budget programmes should be reported to the legislature.

D. Independent Assurances of Integrity

The integrity of fiscal information should be subject to public and independent scrutiny.

- A national audit body, or equivalent organisation, should be appointed by the legislature, with the responsibility to provide timely reports to the legislature and public on the financial integrity of government accounts.

- Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.

- The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.

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1. The *Code of Good Practices on Fiscal Transparency — Declaration on Principles* was adopted on 16 April 1998 by the Interim Committee of the Board of Governors of the IMF in Washington, DC. See http://www.imf.org/external/np/fad/trans/code.htm.

GLOSSARY[1]

accountability

A government policy or management concept that means (i) politicians and public officials have to respond periodically to questions concerning their activities (answerability) and (ii) must be held responsible for the exercise of the authority provided to them. For effective accountability, clear lines of responsibility must be firmly established and consistently maintained. Accountability measures should address three questions: accountability by whom; accountability for what; and accountability to whom. To ensure that accountability is properly enforced, there is a need for predictable and meaningful consequences related to performance. In the public sector, accountability of individual officials, within their organisation and to external controlling bodies, is applied most often to how money has been spent and what results have been achieved. Crucial too in democratic systems is the general accountability of ministers to parliament and to the public at large.

accounting

The theory and systems of organising and summarising information about financial and economic activities. Good accounting systems are essential for budget management, financial accountability and efficient decision-making. *See also accounting basis and accounting system*.

accounting basis

Defined in IFAC (2000) as "the body of accounting principles that determine when the effects of transactions or events should be recognised for financial reporting purposes. It relates to the timing of the measurements made, regardless of the nature of the measurement." There are many variations of the basis of accounting. IFAC identifies two basic reference points (cash and accrual) and two variations (modified cash and modified accrual) in the spectrum of accounting bases. Cash-based accounting systems recognise transactions and events when cash is received or paid. Accrual-based systems recognise transactions or events at the time economic value is created, transformed, exchanged, transferred, or extinguished and when all economic flows (not just cash) are recorded. Certain modifications of the cash basis recognise receipts and disbursements committed in the budget year and allow a specified period after year-end for payments of these to be recorded and reported (the so-called "complementary period"). Under certain modifications of the accrual-based methods, physical assets are expensed at the time of purchase.

accounting controls

Procedures and documentation concerned with safeguarding of assets, the conduct and recording of financial transactions and the reliability of financial records. They are frequently based on standards

issued by the ministry of finance or the supreme audit institution to ensure comparability of accounting practices across all ministries and conformity with national and/or international conventions.

accounting system

The set of accounting procedures, internal mechanisms of control, books of account, and plan and chart of accounts that are used for administering, recording, and reporting on financial transactions. Systems should embody double entry bookkeeping, record all stages of the payments and receipts process needed to recognise accounting transactions, integrate asset and liability accounts with operating accounts, and maintain records in a form that can be audited.

accounts payable/receivable

Money owed to/by suppliers/customers.

accrual accounting

See accounting basis.

accrual-based budget (accrual budgeting)

This term can be interpreted in two ways: (i) budgetary documents that include in addition to cash-based appropriations accrual accounting information; or (ii) budgetary appropriations based on accrual accounting information, e.g. including provision for depreciation. In the United Kingdom, accrual accounting/budgeting is referred to as resource accounting/budgeting.

acquis communautaire

Comprises the entire body of European Community legislation that has accumulated, and been revised, over the last 40 years. It includes the founding Treaty of Rome as revised by the Single Act and the Treaty of Maastricht and Treaty of Amsterdam; all the regulations and directives passed by the Council of Ministers; and the judgements of the European Court of Justice.

activity

In terms of expenditure classification, an activity is a subdivision of a programme with specific objectives and outputs, thus facilitating the measurement and management of performance.

activity-based costing (ABC)

A costing approach that specifically addresses the problem of overhead cost allocation. ABC differs from traditional cost allocation by seeking to identify the cost driver for a particular category of overhead, rather than simply applying an arbitrary allocation basis.

administrative controls

Non-financial procedures and records of ministries which ensure compliance with rules on:

- appointment, promotion, pay, and disciplining of personnel;
- public procurement (bids, tenders, contract management, etc.);
- equal opportunities for minority groups;

- the handling of information flows;
- travel and entertainment allowances, etc.

Agenda 2000

Single framework in which the European Commission outlines the broad perspective for the development of the EU and its policies beyond the turn of the century; the impact of enlargement on the EU as a whole; the Opinions on membership applications from the candidate countries; and the future financial framework for 2000-2006.

aid-in-kind

Flows of goods and services with no payment in money or debt instruments in exchange. In some cases, so-called "commodity aid" goods (such as grain) are sold and the receipts transferred to the budget. More commonly, the receipts are transferred through a special fund.

allocative efficiency

Refers to the capacity of the government to allocate resources and select programmes and projects in conformity with its objectives. In economic theory, allocative efficiency, also called "Pareto efficiency", occurs when resources are allocated in such a way that any change in the amounts or type of outputs currently produced would make someone worse off.

allotment

Either synonymous with apportionment or a particular stage in the procedure for distributing budget funds among spending units. *See also apportionment*.

apportionment

Authorisations or distributions of funds generally made by the ministry of finance to line ministries and other spending units permitting them to either commit or pay out funds, or both, within a specified time period and within the amounts appropriated and authorised. *See also warrant*.

appraisal

Examination of the details of a policy proposal or capital investment project on the basis of an analysis of its economic, financial and other effects. Policy/project appraisal is sometimes called ex ante evaluation.

appropriation

Refers to an authority granted under a law by the legislature to the executive to spend public funds, up to a set limit, for a specified purpose. Annual appropriations are made through annual budget laws or, in some countries, separate appropriation acts consistent with the budget. Supplementary budgets/appropriations are sometimes granted subsequent to the annual law if the annual appropriation is insufficient to meet the specified purpose. The term "standing appropriation" is sometimes used to define an authority extending beyond a single budget year under separate legislation (such as social

security legislation). In most countries, agencies and departments require specific executive authorisation ("apportionment, allotment, or warrant") to actually incur an obligation against an appropriation.

arrears

Amounts that have not been paid or received by the date specified in a contract or within a normal commercial period. Payment arrears may arise from non-payment by government ministries/agencies in areas such as bills due from suppliers, salaries due, transfers, or debt repayment costs. Tax arrears are taxes due to government but not paid.

assets

Property functioning as a store of value over which ownership rights are enforced by institutional units, individually or collectively, and from which economic benefits may be derived by holding them or using them over a period of time. "Tangible" assets may either be financial (e.g. cash or government securities) or physical (e.g. buildings, roads, national parks, etc.). Assets may also be "intangible" such as copyright or mineral exploitation rights.

attestation audit

See audit.

attribution

Deciding how much of the outcome is truly attributable to a policy measure or government expenditure programme, rather than to other influences. It is one of the most challenging tasks in an evaluation study.

audit

Expert examination of legal and financial compliance or performance, carried out to satisfy the requirements of management (internal audit), or an external audit entity, or any other independent auditor, to meet statutory obligations (external audit). A particular task of internal audit is to monitor management control systems and report to senior management on weaknesses and recommend improvements. The scope of audits varies widely, as does the terminology in this area, and includes (according to the auditing standards prepared by the International Organisation of Supreme Audit Institutions (INTOSAI):

1) Financial audit (regularity audit) comprising:

- Attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions of financial statements.
- Attestation of financial accountability of the government administration as a whole.
- Audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations.
- Audit of internal control and internal audit functions.

- Audit of the probity and propriety of administrative decisions taken within the audited entity.

- Reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed.

Note that the first two items above are commonly known as attestation audit. The third and fifth items are commonly known as compliance audit.

2) Performance audit (value for money audit) comprising:

- Audit of the economy of administrative activities in accordance with sound administrative principles and practices, and management policies.

- Audit of the efficiency of utilisation of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements, and procedures followed by audited entities for remedying identified deficiencies.

- Audit of the effectiveness of performance in relation to the achievement of the objectives of the audited entity, and audit of the actual impact of activities compared with the intended impact.

audit finding

Pertinent statements of fact. Audit findings emerge by a process of comparing "what should be" with "what is".

audit risk

The risk that the procedures carried out by the auditor will not detect matters which, if known, would require the auditor's report to be altered.

audit sampling

Audit procedures carried out on a sample of an underlying population relevant to the audit work being carried out, rather than the whole of that population.

balance sheet

A financial statement showing the values of the stocks of assets and liabilities held by an entity at a particular point in time. A balance sheet is typically compiled at the beginning and end of an accounting period. Balance sheets summarising starting balances, incomes and outflows, and ending balances are generally required for each distinct fund within a government's accounting structure. However, in practice, very few governments prepare statements of their financial position that can genuinely be described as comprehensive balance sheets covering all assets and liabilities. See also net worth

baseline budget

The amount of funding for current programmes or existing policies — often adjusted for inflation, one-time expenditures, legally mandated requirements under changed demographic conditions — from which increases and decreases in expenditures are negotiated during budget preparation. In

a narrow and cautious definition, this baseline budget includes the costs of the current level of activity, that is the costs of ongoing programmes adjusted for inflation services, legally mandated requirements, one-time expenditures, and the impact on a full year basis of decisions made the current year. In addition, account can be taken of the current level of services and, therefore, the baseline budget can also include changes in clients served in various programmes (e.g. school children, etc.).

below-the-line-items

Items that are not actual revenues and expenditures but may be used to finance the government's deficit.

benchmarking

Methods and procedures for comparing one organisation with another as a means of improving performance. Process benchmarking is the study and comparisons of the processes and activities that turn inputs into outputs. Results benchmarking compares actual performance of organisations using performance indicators or measures.

budget

Document(s) that include the plan of the future financial activities of the government or a governmental organisation. The budget is generally prepared annually, and comprises a statement of the government's proposed expenditures, revenues, borrowing and other financial transactions in the following year and, in many countries, for two or three further years. The budget is prepared on a cash basis in most countries. It is submitted to parliament, which authorises expenditure by approving either a budget act or an appropriation act that is consistent with the budget proposals.

budget examination

The process of reviewing budget requests from ministries and agencies by a staff member of a central budget department in the ministry of finance, in which the budget request is analysed, alternatives are developed, conclusions are reached, and recommendations are made.

budget formulation

The steps and processes for preparing a government's budget, from preliminary analyses and forecasts, through submission of budget requests by ministries and other government bodies and the review and decision of the executive, to its official presentation to the legislature.

budget request

See estimates submission.

budget year

The period of time for which parliament authorises expenditures and other budget transactions. In a number of budget systems, actual allocations, commitments, deliveries, and payments relating to government expenditure programmes may extend beyond the year for which they were originally appropriated.

budgetary documents

The set of documents presented to the parliament with the budget. In addition to proposals relating to government spending, revenues and borrowing, the budget documents may include a statement of the economic and financial context for the budget proposals, the government's economic policy objectives, and medium-term macroeconomic projections, and some explanation of the government programmes and activities to be funded under the budget.

budgeting

The process by which the government, or a governmental organisation, plans for its future expenditures, revenues, borrowing and other financial activities.

capital (capital assets)

A stock of physical or financial assets. *See also gross fixed capital formation and non-financial assets*.

capital account

See capital expenditure.

capital budget

See capital expenditure.

capital charge

In a very limited number of countries (e.g. New Zealand), a capital charge is applied to the assets of government ministries/agencies. Introducing a capital charge is aimed at giving incentives to spending agencies to use their capital more efficiently. It requires a proper system for accounting for, and valuing capital assets.

capital expenditure

Expenditure incurred for the acquisition of land and other physical assets, intangible assets, government stocks, and non-military, non-financial assets, of more than a minimum value, with an expected lifetime of more than one year. Capital expenditures are often recorded in a separate section (or capital account) of the budget, or into an entirely separate budget for capital expenditures. *See also gross fixed capital formation*.

capital transfer

A transfer of ownership of an asset (other than inventories and cash) or the cancellation of a liability by a creditor, without any payment being received in return. Such a transaction consists of the transfer of cash that is linked to, or conditional on the acquisition of the asset concerned. A transfer that is not a capital transfer is a current transfer. Capital transfers made by the government are classified as expenses in GFS 2000.

cash accounting

See accounting basis.

cash-based budget

A budget in which appropriations are authorisations for cash payments.

cash management

The process of developing agency and central cash flow forecasts, the release of funds to spending agencies, the monitoring of cash flows and expected cash requirements, the issue and redemption of government securities for financing government programmes.

central agencies

Those organisations in the executive branch that co-ordinate the activities of, and provide policy direction and operational guidance to the line ministries and agencies. Practice varies widely from country to country, but "central agencies" generally include: the ministry of finance; the office that reports directly to the prime minister or the council of ministers in the development and co-ordination of policy; the ministry or agency responsible for developing and co-ordinating policies in relation to human resource management within the public sector; the ministry of foreign affairs, in certain areas of work such as international co-operation; and the ministry of justice, in relation to work on legal norms and law drafting.

central bank

A public institution responsible for performing monetary policy functions such as issuing currency, managing international reserves, and accepting deposit liabilities to other banks. The central bank also acts as the lender of last resort, and, frequently, provides fiscal agent services to the central government (e.g. managing the government's treasury single account).

central government

All units of government that exercise authority over the entire economic territory of a country. In general, the central government is responsible for those functions that affect the country as a whole: for example, national defence, conduct of relations with other countries and international organisations, establishment of legislative, executive and judicial functions that cover the entire country, and delivery of public services such as healthcare and education. Non-market, non-profit institutions controlled and mainly financed by the central government are included in the central government. *See also general government, local government, state government and subnational government.*

centre of government

The centre of government encompasses the body or group of bodies that provide direct support and advice to the head of government and the council of ministers, or cabinet.

certification

See verification.

chart of accounts

The classification of transactions and events (payments, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature. It defines the organisation of the ledgers kept by government accountants.

cheques issued

A stage in the expenditure process at which payment instruments are issued by the treasury or by ministries' payment officers and are sent to suppliers of goods and services as payment for goods and services received. In some countries, where the banking system is not highly developed, separate checks or warrants may not be issued and the payment orders certifying delivery may serve as an instrument calling for direct cash payment by the treasury. Government accounts often records expenditure on the basis of checks or warrants issued.

cheques paid

A stage in the expenditure process represented by the presentation and payment of government cheques at banks and the corresponding debit to the accounts of the treasury or ministries/agencies. Government expenditure is reflected in the monetary accounts through cheques paid and the resulting debits to the government's accounts.

closed accounts

The principal statement on the final budgetary outcome produced by the supreme audit institution, or another accounting or auditing agency, after the closing of the budgetary period. Closed accounts may be cash accounts, recording annual receipts and payments (with or without a complementary period), or accrual accounts, recording also obligations for future expenditure, or obligations of future tax collections, as well as the carry-overs of revenues and expenditures from preceding budgets.

commitment

In accounting terms, a commitment refers to a stage in the expenditure process at which a contract or other form of legally binding agreement is entered into, generally for future delivery of goods or services. A liability will not be recognised until delivery of the item, but the government is contractually committed to meeting the obligation once delivery is made. In some budget systems, the term commitment refers to a stage in the expenditure cycle different from the commitment stage in its accounting sense (e.g. reservation of appropriations or the verification stage). The term commitment is also used in a more general, non-contractual sense to mean a firm promise of the government made in policy statements.

complementary period

A period after the close of the regular fiscal year during which uncompleted collections and payments or commitments may be carried out and assigned to the previous budgetary period. It may be several months in duration. In some countries, the accounting period includes a "complementary period" for payments (e.g. 30 or 60 days) after the close of the fiscal year. Payments over the complementary period that are related to transactions (commitments and deliveries) incurred during the previous fiscal year

closed are reported as expenditure during that year. In some countries, both paid and unpaid payments orders are recognised as expenditure during the complementary period.

compliance audit

See audit.

comprehensiveness

Comprehensiveness of the budget means that the budget must encompass all the expenditures, revenues, borrowing and other financial activities of the government. This creates a framework that promotes sound appraisal of competing policy options, and efficient budget planning and execution.

concession

A concession is a form of public-private partnership. Concession contracts may have different legal names and scopes under different national laws. In most concession contracts, the contractor bears the risk involved in operating the service, generally obtaining a significant part of revenue from the user, usually by charging fees in one form or another. The European Commission defines concessions as contracts in which public authorities authorise a third party to run infrastructure projects or other public services on its behalf and in which the third party assumes the operating risks. *See also contracting-out*.

consolidated accounts

See consolidation.

consolidated fund

The main fund into which all receipts are deposited and from which all payments are made, unless otherwise legislated; equivalent to a treasury single account. Term used in many British Commonwealth countries. *See also general fund*.

consolidation

The process of eliminating transactions between different ministries/agencies/units of government and combining in a common set of categories the sum of their "external" transactions to and from the rest of the economy.

consumption of fixed capital

The reduction in the value of fixed assets used during the accounting period that results from physical deterioration, normal obsolescence or accidental damage. *See also depreciation*.

contestability

Ensures that existing policies are subject to review and evaluation.

contingency fund or reserve

A separate fund or a budget provision set aside within the annual budget total, to be allocated later, and to meet unforeseen changes in external circumstances. In medium-term budgeting, contingency and policy reserves are used to provide flexibility and to avoid premature expenditure commitments, with progressively bigger reserves in the totals set aside for later years.

contingent liability

Obligations that have been entered into, but the timing and amount of which are contingent on the occurrence of some uncertain future event. They are therefore not yet actual liabilities, and may never be if the specific contingency does not materialise.

contracting out

An arrangement whereby a department or agency enters into a commercial contract with an external supplier that provides public services. Concerning the construction of large infrastructure assets, governments may enter into arrangements with private sector firms to build such assets, often with an agreement that the private sector firm may be guaranteed the right to revenues for a number of years following construction. Such arrangements may be referred to Build Operate and Transfer (BOT), Build Lease Transfer (BLT), Build Own and Operate (BOO), concessions or Design Build Finance and Operate (DBFO).

control

See financial control, internal (management) control.

Copenhagen criteria

Agreed upon in 1993 by the European Council, the Copenhagen criteria must be fulfilled by candidate countries if they are to become members. Candidate countries must achieve stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union; and the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

corporate governance

The rules and procedures to ensure that a company is properly and efficiently managed, including that directors and staff behave appropriately and in accordance with law and best practice.

corruption

There are many different definitions of this concept. The simplest, and broadest, is “the misuse of public or private position for direct or indirect personal gain”.

cost driver

Any factor that causes a change in the cost of an activity or output.

cost-benefit analysis

A type of analysis that includes measures in pecuniary units of costs and/or benefits (such as leisure time or environmental impacts) which do necessarily not have a market value. Cost-benefit analysis involves the application of three logical steps: (i) defining objectives and alternatives for accomplishing those objectives; (ii) analysing incremental changes with each alternative intervention versus without the respective alternative; and (iii) comparing costs and benefits of the various alternatives.

cost-effectiveness analysis

A type of analysis that compares projects or programmes having broadly common outcomes or outputs. Used to compare alternatives for which major outputs can be identified but not valued. Cost-effectiveness indicators include the cost per unit of output, or units of output per unit of costs, and is aimed at identifying the least costly method of achieving a particular good or objective. *See also least-cost analysis*.

cost recovery

See user charges.

council of ministers

The principal policy-making body of the government, chaired by the prime minister, and consisting of senior ministers (in many countries, all ministers). The council of ministers usually meets at least once a week. Detailed business is often carried out in subcommittees. In some countries, the council of ministers is called the "cabinet", in others the "cabinet of ministers" or simply the "government".

current account

Receipts (including grants) and payments (including interest) that are not capital transactions.

current expenditure

Expenditure other than for capital expenditure or capital transfers. See also capital expenditure and capital transfer.

current transfer

See capital transfer.

debt management

Managing the public sector debt portfolio in as efficient manner as possible in order to minimise the costs to the government. Debt management functions are sometimes carried out by a department of the ministry of finance, sometimes by the state treasury, sometimes by an agency reporting to the minister of finance.

decentralisation

The transfer of responsibility to democratically independent lower levels of government, thereby giving them more managerial discretion, but not necessarily more financial independence.

deconcentration

The transfer of responsibility from central ministries to field offices or more autonomous agencies, thereby becoming closer to citizens while remaining part of central government.

deficit/surplus

There are different definitions of the deficit:

- The deficit (or surplus) as defined in the European Council regulations within the context of the Treaty of Maastricht and the Treaty of Amsterdam is the net borrowing (or lending) of the general government as defined in ESA95.

- The deficit *on a cash basis*, as defined in the GFS 2000, is equal to expenditure payments plus "lending minus repayments" less revenues on a cash basis less grants received. By contrast to the deficit defined within the context of the Treaty of Maastricht and the Treaty of Amsterdam, this measure of the deficit comprises only cash transactions and includes "above the line" some transactions classified as financing transactions in the SNA93 and ESA95 (such as the sale of shares and equity related to privatisation programmes).

- The deficit *on a commitment basis* is defined as the cash deficit plus the net increase in arrears, or expenditure at the verification stage plus "lending minus repayments" minus revenues (on a cash basis). This measure of the deficit should not include commitments related to undelivered orders and multi-year commitments.

departmental enterprise

An unincorporated industrial or commercial unit that: (i) is closely integrated with a government ministry/agency; (ii) is likely to hold a small working balance; (iii) is either mainly engaged in supplying goods and services to government units or the general public; but (iv) operates on a small scale.

depreciation

The reduction in the value of an asset over time that is brought about through physical use or obsolescence. Under accrual accounting, depreciation estimated over the useful life of an asset is progressively deducted (written off) from the value of the asset each year. Depreciation as recorded in business accounting, or as allowed for taxation purposes, may deviate from the value of consumption of fixed capital estimated for the national accounts, especially during periods of inflation. *See also consumption of fixed capital*.

discounting

A method of comparing costs or benefits that will occur (or have occurred) at different times. 1 euro in year n is given a "present value" of $1/(1+r)n$ euro in year 0, where r is the "discount rate". *See also net present value and internal rate of return*.

discretionary spending

This refers to the part of the budget which the government and the legislature must each year decide to spend for the next fiscal year, such as for housing, education or foreign aid. It is to be contrasted with "mandatory spending" on those items where there exists a legal requirement for the government to provide funds and a permanent appropriation authorising such expenditures. Interest on the debt and entitlement programmes are examples. The "mandatory" part of the budget is often much larger than the discretionary portion.

double-entry accounting/bookkeeping

In a double-entry system each flow gives rise to two equal-valued entries, a credit and a debit entry. By convention, increases in asset accounts and decreases in liability and net worth accounts are debits. Conversely, decreases in asset accounts and increases in liabilities and net worth accounts are credits. Use of the double entry system facilitates consistency checks of recorded flows and stocks.

earmarking

Tax earmarking is the practice of assigning revenue from specific taxes or group of taxes to specific government activities or areas of activity.

economic classification

The classification of expenditures (or expenses) and the acquisition/disposal of assets into economic categories, which emphasise the economic nature of the transaction (salaries, interest, transfers, etc.) *See also object/line-item classification. For the international standard on economic classification, see also GFS.*

economy

The acquisition of the appropriate quality and quantity of financial, human and physical resources at appropriate times and at the lowest cost.

effectiveness

The extent to which programmes achieve their expected objectives, or "outcomes". Effectiveness is the most important element of value for money in the public sector. Goods or services may be provided economically and efficiently but, if they do not achieve their intended objectives, the resources used will be largely wasted.

efficiency

The relationship between the goods and services produced by a programme or an activity (outputs) and the resources used to produce them (inputs). Efficiency is measured by the cost per unit of output.

end outcomes

See outcomes.

entitlement programme (demand-led programme)

Any spending programme where expenditure is open-ended (usually transfer/grant payments) and where beneficiaries must be paid or given transfers/grants if they meet certain criteria, as defined in legislation or government regulations. Some common examples are found in social security programmes, unemployment programmes, and poverty-reduction programmes.

estimates submission

Refers to the set of documents that a spending unit sends to the ministry of finance to define and support its requests for additional funding through the budget.

European Union (EU) Member States

The European Union is the result of a process of co-operation and integration which began in 1951 between six countries (Belgium, Germany, France, Italy, Luxembourg and the Netherlands). After nearly fifty years, with four waves of accessions (1973: Denmark, Ireland and the United Kingdom; 1981: Greece; 1986: Spain and Portugal; 1995: Austria, Finland and Sweden), the EU today has fifteen Member States and is preparing for its fifth enlargement, this time towards Eastern and Southern Europe.

Poland, Hungary, the Czech Republic, Estonia, Slovenia and Cyprus have been holding membership talks since 1998. Bulgaria, Romania, Slovakia, Lithuania, Latvia and Malta began similar talks in 1999. Turkey is also a candidate.

evaluation

Programme evaluation is an in-depth examination of the economic, financial, social, etc. effects of a programme or policy initiative. Summative evaluations are carried out when the programme has been in place for some time (ex post evaluation) to study its effectiveness and judge its overall value. Formative evaluations are usually undertaken during the implementation of the programme (intermediate evaluation) in order to improve its effectiveness.

evaluation design

The logic model used to arrive at conclusions about outcomes in an evaluation study. In selecting the evaluation design, the evaluator must determine simultaneously the type of information to be retrieved and the type of analysis this information will be subjected to.

ex ante control (a priori audit)

Prior authorisation of a specific expenditure. Payment orders and supporting documentation received are checked to verify that the transaction is properly authorised, is legal and regular, and that there are sufficient provisions in the budget. Such inspections may be carried out by central authority of the ministry of finance or by line ministries/agencies.

ex post control (a posteriori audit)

See audit.

expenditures

The term "expenditures" is sometimes loosely used to refer to cash payments. However, a strict definition is the cost of goods and services acquired, regardless of the timing of related payments. Expenditures on goods and services occur at the times when buyers incur liabilities to sellers, i.e. when either (a) the ownership of the goods and services concerned is transferred from the seller to the new owner; or (b) when delivery of the goods and services is completed to the satisfaction of the consumer.

expenses

In GFS 2000, the term "expense" defines the set of transaction flows that reduce net worth over the accounting period. Expense transactions include compensation of employees, use of goods and services transactions, consumption of fixed capital, property expenses (interest and rent), social benefits, subsidies, grants and miscellaneous transactions, such as transfers to non-profit organisations and compensation of damage or injury. Acquisitions of non-financial assets and financing transactions are not expense transactions.

external audit

Refers to audit carried out by a body that is external to, and independent of, the organisation being audited, the purpose being to give an opinion and report on the organisation's accounts and financial statements, the legality and regularity of its operations, and its financial management procedures and financial performance. Organisations responsible for external audit of government activities most often report directly to parliament, and are often referred to as supreme audit institutions (SAI).

external debt

Debt owed to non-residents of the country concerned.

extra-budgetary funds/accounts (EBF)

The term generally refers to government activities that are not included in the annual budget presentation. Moreover, EBFs may be subject to different systems of cash management, control and reporting than the budget itself. A wide variety of extra-budgetary arrangements are used, including funds (such as social security funds) set up under separate legislation, commodity funds that use proceeds of commodity aid, and earmarking certain revenues for specific purposes. *See also off-budget expenditures*.

financial audit (regularity audit)

See audit.

financial control

Aspects of internal (or management) control that relate to financial issues and performance. *See also internal (management) control*

financial instrument

Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

financial ledger system

See general ledger system.

financial management

The legal and administrative systems and procedures put in place to permit government ministries and agencies to conduct their activities so as to ensure correct usage of public funds that meets defined standards of probity, regularity, efficiency and effectiveness. Financial management includes the raising of revenue; the management and control of public expenditure; financial accounting and reporting; cash management; and, in some cases, asset management.

financial reporting

The communication of financial information by an entity (e.g. the government, a line ministry) to interested parties (e.g. parliament, the ministry of finance). It encompasses all reports that contain financial information based on data generally found in the financial accounting and reporting system.

financial statements

The accounting statements prepared by a reporting entity to communicate information about its financial performance and position. An accrual accounting system commonly entails the preparation of a Financial Position Statement, or Balance Sheet, which shows the total assets, liabilities and the net worth; a Financial Performance Statement, or Operating Statement, which shows the revenues and expenses of the period; and a Statement of Changes of Net Worth, which explains movements in the opening and closing balances. These accrual-based statements are supplemented with a Statement of Cash Flows. They include those notes and schedules that are needed in order to clarify or further explain items in the statements. Similarly, the analytical framework in GFS 2000 includes the following tables: Government Operations, which is a summary of the transactions of the general government in a given accounting period; Statement of Other Economic Flows, which tabulates influences, other than transactions, on the government's financial position; and a Balance Sheet and Statement of Sources and Uses of Cash.

financing

All transactions in financial assets and liabilities that balance the fiscal deficit or surplus. Broadly speaking, the means by which a government obtains financial resources to implement its policies, programmes and projects.

fiscal deficit

See deficit.

fiscal policy rules

Permanent constraints on fiscal policy, typically defined in terms of an indicator(s) of overall fiscal performance such as the deficit/GDP ratio, the debt/GDP ratio. In the EU context, these rules are defined in the Treaty of Maastricht and the Treaty of Amsterdam.

fiscal transparency

A policy of providing information to the public about the functions and organisation of the government, its economic and fiscal policy goals and objectives, its financial forecasts and public sector accounts. It involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities—including those activities undertaken outside the government sector—so that the electorate, legislature and financial markets can accurately assess the government's present and future financial position.

fiscal year

The regular annual budget and accounting period for which provision of revenue and expenditure is made, and for which accounts are presented, excluding any complementary period during which the books may be kept open after the beginning of the following fiscal year.

fixed assets

Durable goods except land, mineral deposits, timber tracts and similar non-reproducible tangible assets, employed in production by resident industries, producers of government services for civilian purposes, and producers of private non-profit services to households, including owner-occupied dwellings, permanent family dwellings for military personnel, breeding stock, draught animals and dairy cattle.

float

Cheques issued but not yet paid. The amount of float is reflected in the difference between the total of cheques issued by the treasury and the total of cheques paid as shown in the books of the treasury's bank account. If float can be identified, it should be shown as an adjustment to total expenditure. It is also known as "items in transit". The term "float" is also sometimes used to mean the payables that are not immediately due for payment (e.g. invoices recorded before the latest time they can be paid without incurring additional charges or penalties).

floating debt

The amount of obligations, other than fixed-term contractual obligations, incurred by a government for goods and services received that have not yet been paid for, that is, an accumulated backlog of unpaid bills. (In some countries, the term refers to the unconsolidated portion of outstanding government short-term debt).

foreign debt

See external debt.

forward commitments (multi-year commitments)

Commitments that cover a period of more than one year (e.g. contracts for an infrastructure project). Effective monitoring of forward commitments is essential, for good budgeting and expenditure control. A number of countries include authorisations for forward commitments in the budget.

fraud

The severest form of an irregularity. In respect of expenditure, it includes any intentional act or omission relating to:

- The use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds.
- Non-disclosure of information in violation of a specific obligation, with the same effect.
- The application of funds for purposes other than those for which they were originally granted, with the same effect.

In respect of revenue, fraud includes any intentional act or omission relating to:

- The use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the illegal diminution of the resources of the budget.
- Non-disclosure of information in violation of a specific obligation, with the same effect.
- Misapplication of a legally obtained benefit, with the same effect.

full costs

The sum of all the costs of a programme or activity, including consumption of fixed capital, overheads and the costs of activities related to the programme but performed by entities other than the entity responsible for the programme.

functional classification

The classification of expenditure (as well as expense) transactions and acquisitions/disposals of financial assets for policy purposes, according to the purpose for which transactions are undertaken. A functional classification is independent of the administrative organisations or units that carry out the activities or transactions concerned. The standard Classification of Functions of the Government (COFOG) system, established by the United Nations, is aimed at facilitating international comparisons and preparing income accounts consistent with the System of National Accounts (SNA) methodology.

general fund

This refers to the account in which the majority of tax revenues are deposited, and from which the majority of the operating expenses of government activities are paid. It is to be contrasted with earmarked funds, proprietary funds, trust or enterprise funds and extra-budgetary funds. In the British Commonwealth context, the general fund is called the consolidated fund.

general government

According to the System of National Accounts, "general government" is the grouping of government units at different levels: central, state (in federalist countries), local authorities and social security funds. Government units are units that, in addition to fulfilling their political responsibilities and their role in economic regulation, produce principally public services for individual or collective consumption and redistribute income and wealth. A defining characteristic of government units is the ability to impose, directly or indirectly, taxes and other compulsory levies for which there is no direct quid pro quo on other sectors of the economy. *See also central government, local government, state government, subnational government*.

general ledger system

Core system(s) for budget execution, accounting and financial reporting. This system(s) maintain data on approved appropriations and supplementary appropriations; virements; fund release (apportionment/allotment, warrants, cash plans, etc.); commitments, accrued expenditures and payments against budgeted allocations and fund release. The general ledger system maintain the ledgers, and registers also data on revenues, debt and other liabilities, financial assets (and physical assets under full accrual accounting), and other financial transactions (such as transactions between government agencies). *See also government financial management information systems*.

general purpose financial reports

Financial reports intended to meet the information needs of general users.

Generally Accepted Accounting Principles (GAAP)

The GAAP (termed "Practice" in the United Kingdom) are the accounting concepts or principles which represent the consensus of experts and bodies of the accounting profession. In a number of countries these accounting concepts and principles are prescribed by the government, after consulting experts and the private accounting professional bodies. In some EU Member States (e.g. France), a "general accounting plan" defines the core structure of the chart of accounts and its associated accounting principles.

generational accounting

An accounting system used to assess the distributional implications of fiscal policy for different cohort groups. This is accomplished by estimating the present value of net tax payments (taxes paid less benefits received) over the lifetime of different generations under current tax and spending policies. A generation is defined as including all males and females (separately accounted for, because of differing tax and benefits profiles) born in the same year. The technique has heavy data requirements and the results depend on a large number of simplifying assumptions. It is generally regarded as a supplementary technique for analysis of the sustainability of fiscal policy and intergenerational distribution questions.

goals and objectives

Both terms are used to describe the desired, measurable results to be achieved from government programmes or activities. "Goals" (or "general objectives") typically refer to broad results which may take a number of years to achieve and often involved many people, activities, processes, and intermediate

achievements. "Objectives" (or "specific objectives") tend to refer to more specific results, often precisely measured (time, cost, number, quality), which can usually be accomplished in a shorter time period, and are often an intermediate step in achieving a broader goal.

governance

Governance is the exercise of political powers to manage a nation's affairs. Sound governance invokes as essential elements political accountability; freedom of association and participation; reliable and equitable legal frameworks; transparency; and effective and efficient public sector management.

government financial management information systems

The information systems that assist ministries/agencies manage their programmes efficiently and effectively, and in accordance with the law. At the core of these systems are the procedures for accounting and reporting that keep the ledger into which all inflows and outflows of funds are recorded. Under an integrated approach, other information systems must be seen as supportive of these core accounting systems by adhering to their data exchange standards. Management information systems form a key element of management controls, and must themselves be efficient and cost-effective. *See also general ledger system.*

Government Finance Statistics (GFS)

GFS is published by the International Monetary Fund (IMF). The 2000 version substantially revises the earlier version published in 1986, e.g. in relation to information on accrual-based accounting. GFS 2000 should be published in late 2000 or in 2001.

grants

In GFS, a grant is a voluntary current or capital transfer between government units, or between a multi-national organisation and a national government (e.g. a Phare grant). In addition, a voluntary transfer to a private organisation or person is also often called a grant.

gross fixed capital formation

The value of new or existing durable non-military goods, property, plant and equipment acquired by government or produced for own account, less sales of such goods. It encompasses only goods that have a normal life of more than one year and a value above a specified minimum level. Changes in government stocks or inventories are included in capital formation but not in fixed capital formation. Consumption of fixed capital (depreciation) is subtracted from gross fixed capital formation to measure net fixed capital formation.

impact

The term "impact" is often used synonymously with the term "outcomes". The "net impact" of a programme describes the outcomes that are truly attributable to the programme. It does not include the effects of factors external to the programme, and is estimated through evaluation methods. "Impact analysis" refers to the assessment of the effects of a programme or policy initiative on its surroundings (e.g. an environmental impact study), or shows the extent to which a programme actually produced the desired effects on the beneficiaries concerned.

imprest fund

A fixed-cash or petty-cash fund in the form of currency, government cheques or bank accounts, which has been advanced as "funds held outside of treasury" and charged to a specific appropriation account to an authorised cashier for payment. The fund may be a revolving type, replenished to the fixed amount as spent or used, or may be of a stationary nature.

inputs

The resources used to produce outputs. Inputs are usually expressed as amounts of expenditure or of resources themselves (e.g. the number of employee/days). An input to one activity may be the output of an earlier activity.

institution

Sometimes used synonymously with the term "organisation" or "body", e.g. a ministry or government office. However, the term is also increasingly used in a different sense, to describe the formal and informal rules that determine behaviour, and the enforcement of these rules.

institutional sector

An institutional sector is a group of institutional units with similar behavioural characteristics (e.g. the general government sector).

institutional unit

In the SNA and GFS 2000, an institutional unit is an entity that can own assets, incur liabilities and act on its own behalf in economic and financial matters. Three types of government units are distinguished:

- Administrative units of the central, state or local governments, including extra-budgetary funds.
- Social security funds.
- Non-market, non-profit organisations that are controlled and mainly financed by the government.

internal audit

Refers to audit carried out by a department or unit within a ministry or another government organisation, entrusted by its management with carrying out checks and assessing the organisation's systems and procedures in order to minimise the likelihood of errors, fraud and inefficient practices. Internal audit units must be functionally independent within the organisation they audit and report directly to the organisation's management.

internal (management) control

Defined as "the organisation, policies and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned; that programmes

are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making" (INTOSAI). In practice, internal control systems embrace a wide range of specific procedures, including, for example, controls on accounting, processes, procurement, separation of duties and financial reporting. Internal control systems require effective communications within an organisation and need to be supported by sound internal audit procedures. It is the responsibility of an organisation's management to establish and monitor internal control systems, not that of the external auditor. However, an external auditor should comment on the absence or adequacy of such systems since a consequence of good internal controls is that less detailed auditing of individual documents and transactions will be necessary. *See also accounting controls, administrative controls and financial control.*

internal rate of return (IRR)

The discount rate which would give a zero net present value (NPV) for the investment. See also discounting and net present value.

inventory

Goods, other property and services that are:

- Held for use in the ordinary course of operations.
- In the process of production for sale.
- Or to be used up in the production of goods, other property or services including consumable stores and supplies, but not including depreciable assets.

least-cost analysis

A type of analysis that compares projects or programmes having a common outcome or common outputs. Least cost analysis is used to compare alternatives for which major outputs and outcomes are identified, but not quantified. *See also cost-effectiveness analysis.*

legitimacy

Legitimacy means that decision-makers who can change policies during implementation must take part in and agree to the original policy decision, whether it is made during the process of formulating the budget or at some other time.

lending minus repayments

See transactions in financial assets for policy purposes.

liability

Loss of service potential or future economic benefits that an entity is presently obliged to make to other entities as a result of past transactions or other past events. A liability must be recognised in the statement of assets and liabilities only when it is probable that the future loss of service potential or future economic benefits will be required; and the amount of the liability can be measured reliably.

line-item classification

See object classification.

local government (or local authorities)

Local government is a collection of public bodies with authority over a subdivision of a significant area of a country's territory. It is either the third tier in federal countries or the second and third tiers in unitary countries (regions, counties, municipalities, etc.) To exist as a separate entity, a local government body must have the authority to exercise powers independently from other levels of general government. *See also central government, general government, state government and subnational government.*

macroeconomic framework

A medium-term macroeconomic framework typically includes projections of the balance of payments, the real sector (or production sector), the fiscal accounts and the monetary sector. It is a tool to check the consistency of assumptions or projections concerning economic growth, the fiscal surplus or deficit, the balance of payments, the exchange rate, inflation, credit growth and its share between the private sector and the public sector, policies on external borrowing, etc.

market testing

A process by which government ministries/agencies assess whether the services for which they are responsible can be delivered by private sector companies rather than remaining in the public sector. The "market testing" approach was popularised in the United Kingdom during the 1980s and 1990s to evaluate whether government activities should be contracted out or privatised.

medium-term budget framework (MTBF)

A framework that includes projections of government expenditures and revenues over the medium-term (generally 3-5 years). Different degrees of detail for expenditure projections are conceivable, depending on the country context. Some countries have established a disciplined multi-year budgeting process. In these countries, the multi-year estimates focus on existing policies and become the basis of budget negotiations in the years following the budget. In other countries, they only provide background information to budgeting. Generally, the multi-year estimates are rolled forward by one year, so that another year is added at the end of the period.

medium-term expenditure framework (MTEF)

The public expenditure component of a medium-term budget framework. *See also medium-term budget framework.*

medium-term fiscal (or financial) framework (MTFF)

Aggregate projections of revenue, expenditure and financing over the medium-term. *See also medium-term budget framework.*

mission

A broad statement of the high level goals and objectives of an organisation or programme.

modified accrual accounting

See accrual accounting.

modified cash accounting

See cash accounting.

monetary financial assets and liabilities

Assets and liabilities to be received or paid in fixed or determinable amounts of money.

multi-year budget, multi-year estimates

See medium-term budget framework.

net fixed capital formation

See gross fixed capital formation.

net lending/borrowing

Net borrowing/lending as defined in the GFS 2000 and ESA95 as the net increase in financial assets less the net increase in liabilities incurred. It can be calculated also as the net operating balance plus the net acquisition of capital assets. *See also lending minus repayments*.

net operating balance

One of the key balances of the government operation table prepared under the GFS 2000 methodology. It is defined as revenue less expenses, or the change in net worth resulting from transactions.

net present value (NPV)

The net value of a set of costs and benefits after they have been discounted to a specific time. It is most often applied to the costs and benefits of constructing and using a proposed capital investment over its lifetime, discounted to the year in which construction would start. *See also discounting*.

net worth

Net worth is the difference between the value of all assets and all liabilities at a particular moment in time. It is the balancing item in a balance sheet.

non-financial assets

Assets that include:

- Those that come into existence in the form of outputs from a process of production. They include fixed assets and inventories. In the government sector, assets are classified as buildings and structures, machinery and equipment, cultivated assets and intangible fixed assets.

- "Non-produced assets" that come into existence in ways other than through a production process. They may occur naturally (e.g. water resources) or they may be created by legal or accounting actions (e.g. ownership rights to the electromagnetic spectrum).

non-financial public sector

The general government sector plus non-financial public enterprises. The non-financial public sector excludes public enterprises in the financial sector because consolidation with public financial institutions would eliminate statistics on the financing requirements of general government and of non-financial public enterprises met by the central bank and other government-owned and/or controlled banks.

object classification

A group of expenditures that identifies the specific types of goods or services acquired or transfer payments made within a particular programme or activity. This concept is often called a "line-item" classification.

obligation

Generally refers to commitments and liabilities, actual and contingent. Sometimes used more narrowly, to mean only commitments.

obligation-based budget

A budget that includes obligation-based appropriations. Such appropriations give rights to enter commitments with third parties and make cash payments according to these commitments, without a predetermined time limit. Such appropriations have their own life cycle and are not limited to one year. This system is no longer used for all expenditures, but may be used for special programmes (e.g. in the US).

off-budget transaction (activity)

The term "off-budget" is often used differently from "extra-budgetary". An "off-budget" transaction is one conducted by a spending agency or line ministry whose transactions should be within the budget (e.g. by means of a "special fund" set up to appropriate revenues generated by the ministry that are not paid over to the treasury or ministry of finance and are used for bonus payments to staff or other purposes). An extra-budgetary fund (typically set up by law and executed to rules) conducts transactions that are, by definition, outside the budget. *See also extra-budgetary funds/accounts*.

operating activities

Activities that relate to the provision of goods and services.

operating statement

A financial statement that shows, for the fiscal year or some other financial period, the full cost of resources consumed by a ministry/agency in achieving its objectives; the extent of any cost recoveries (e.g. through user charges); and any other operating revenues from independent sources and revenues from the government. It is in effect an income and expenses statement.

organic budget law (OBL)

A law specifying the time schedule and procedures by which the budget should be prepared, approved, executed, accounted for, and final accounts submitted for approval. In some countries, the OBL takes precedence over other financial laws, e.g. on accounting, treasury, debt management, internal control, local government finance, etc. The law provides for both authorities and responsibilities for the preparation, management, and execution of the annual budget. It may also be referred to as the "budget system law".

Organisation for Economic Co-operation and Development (OECD)

The OECD brings together 30 countries sharing the principles of the market economy, pluralist democracy and respect for human rights. The original 20 Members of the OECD are the Western countries of Europe and North America (Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States). Next came Japan, Finland, Australia and New Zealand. More recently, Mexico, the Czech Republic, Hungary, Poland and Korea joined. In September 2000, the OECD invited the Republic Slovak to become its 30th Member.

outcomes

Economic or social changes brought about by a policy measure, programme or activity. Outcomes are distinct from outputs, which measure the immediate effects of a programme or activity. For example, the outcome of a random breath-testing campaign conducted by the police may be a decline in drunk driving, while one of the outputs could be the number of drivers charged with exceeding the legal alcohol limit. Programmes usually have two types of outcomes: (i) End outcomes that reflect the desired end or ultimate results that the programme or activity aims to achieve; (ii) Intermediate outcomes that are expected to lead to the ends desired, but are not themselves ends. *See also impact, outputs, performance indicators and performance measurement*.

outlay

Refers to government expenditures.

outputs

The products and services produced directly by a programme or activity. Outputs are important e.g. in setting targets for staff to achieve and measuring performance, but do not in themselves indicate the extent

to which progress has occurred toward achieving a programme's ultimate purpose. Depending on their nature, outputs may or may not be easy to measure, e.g. the number of hospital cases is easier to measure than the quality of advice on a policy issue submitted by a health official to the minister concerned.

output budgeting

A budget system that links appropriations to specific outputs. In the purest form of output budgeting, appropriations are measured on an accrual basis, instead of a cash basis as usually, and managers are engaged to deliver outputs through "contracts" negotiated with ministers. Until recently, such a budget system was implemented in only one OECD country (New Zealand), though some countries such as the United Kingdom are moving towards implementation of accrual-based budgeting systems that would present a number of similar features. *See also accrual budgeting*.

outturn

Actual revenues and outlays.

payment order

Authorisation for payment against a bill or invoice made by officials of line ministries, other spending units or the ministry of finance.

pension funds (funded type)

Organisations established for the purpose of providing benefits on retirement to specific groups of employees. They have their own assets and liabilities and engage in financial transactions in the market on their own account. Such pension funds are included in the financial sector.

performance audit

See audit.

performance budgeting

Performance budgeting consists of classifying government transactions into functions and programmes in relation to the government's policy goals and objectives; establishing performance indicators for each programme or activity; and measuring the costs of these activities and the outputs delivered. The terms "performance budgeting" and "programme budgeting" are often used interchangeably, but programme budgeting can also be defined as a form of performance budgeting giving greater emphasis to the classification of programmes according to the government's policy objectives and the needs of efficient resource allocation. A full system of performance budgeting is difficult to realise, in large part because of the high information requirements and complex management systems that are needed. See also planning programming budgeting system (PPBS).

performance indicators

Performance can be monitored and assessed through measures or indicators. Measures correspond to direct records of inputs, outputs and outcomes (e.g. the number of police patrols carried out in a given period is an output measure). Indicators are used as a proxy when direct measures are difficult

or costly to obtain (e.g. the "street" price of illegal drugs is an indicator of the outcome of an anti-drug programme). In practice, however, the terms "measures" and "indicators" are often used interchangeably. "Performance indicators" may be used to evaluate inputs, processes, outputs and outcomes. *See also performance measurement*.

performance measurement

Assessment of the efficiency and effectiveness of a programme or the activities of an organisation by measuring the relevant inputs, processes, outputs and outcomes. "Performance measures" or "performance indicators" may be used for this purpose.

planning programming budgeting system (PPBS)

A systemic programme budgeting approach that was developed in the US in 1965, and later in many other countries. The PPBS processes consist essentially of three phases: 1) In the planning phase, systems analysis is used to establish the objectives of the programme and identify related solutions. 2) At the programming stage, means are reviewed and compared to the solutions identified at the planning stage. Sets of activities are grouped into multi-year programmes, which are appraised and compared. Cost-benefit and cost-effectiveness analyses are used to compare the various programmes and activities as competing means of achieving a given objective. 3) In the budgeting phase, these programmes are translated into the annual budget. After years of efforts and discouraging results, the PPBS was largely abandoned by the countries that have experimented with it, though elements of the system can still be found (e.g. in performance budgeting systems). *See also performance budgeting*.

planning reserve

A small portion of total planned budget expenditure that is (notionally) set aside by the ministry of finance before the budget is formulated, and then allocated to programmes by the government according to perceived policy priorities on individual sectors, programmes, etc.

policy

A set of activities, which may differ in type and may have different beneficiaries, which are directed towards common general objectives or goals. In contrast to a programme, a policy does not have necessarily a delimited budget.

policy balance

In GFS 2000, the "policy balance" is defined as net lending/borrowing less the net acquisition of financial assets for policy purposes, or as revenue less expenses less net acquisition of capital assets less net acquisition of financial assets on a non-market basis. The negative value of the policy balance is referred to as financing for liquidity management purpose. This balance is the accrual equivalent of the overall deficit/surplus as defined in the 1986 version of GFS. *See also deficit/surplus (on a cash basis)*.

predictability

Predictability in budget management means that managers should know in advance the amount of resources allocated to their programmes. Lack of predictability creates difficulties for public

officials in planning for the provision of services. However, predictability requires a significant level of macroeconomic stability. Predictability of government expenditure in the aggregate, and of the government's overall fiscal position, gives assurance to the private sector that it has a secure economic and financial basis on which to make its own production, marketing and investment decisions.

programme

A group of activities intended to contribute to an identifiable set of government objectives (e.g. crop development). A programme should have an identifiable target population; a defined budget, staffing and other necessary resources; and clearly defined objectives and outputs.

programme budgeting

See performance budgeting.

programme classification

The classification of the country's budget and expenditures according to the overall programme structure for government activities. The programme's classification is the primary classification for budget formulation and execution in countries using programme budgeting. However, it is normally used in conjunction with other classifications (organisation, economic), and some systems generally provide for analysis and reporting according to internal functional categories.

project

A single, non-divisible activity with a fixed time schedule, a dedicated budget and clearly defined objectives and outputs.

provincial government

See state government.

public corporation

A company or enterprise controlled by the government. The government can be said to exercise a controlling interest on a corporation if it has the ability to determine general corporate policy e.g. by appointing appropriate directors, if required. Control is usually established through government ownership of more than half of the voting shares of the corporation. In addition, it may be possible to exercise control through special legislation, ownership of a significant minority of the voting shares, or indirectly through ownership of a second public corporation.

public expenditure management

The term can be broken down into its parts. Public expenditure is generally understood to mean expenditure by: general government, central government through the national budget and other budgetary instruments, and local government. Public expenditure in this book does not include the activities of public enterprises, which are essentially commercial enterprises, and financial institutions owned by the state. The management of public expenditure covers: the preparation,

management, and execution of the budget. Budget execution includes ex ante control, ex post control, internal and external audit, and evaluation, with various types of reporting at each stage.

public investment programme (PIP)

A rolling investment programme, generally covering a period of 3-5 years, prepared in a number of transition and developing countries, and often using loan or grant finance from multi-national organisations such as the World Bank and EBRD and bilateral donor assistance. PIPs should be regarded as a component of the beneficiary country's medium-term budget framework, or at least should be consistent with the country's medium-term fiscal projections. PIPs financed by the International Financial Institutions often include a significant element of current expenditures. *See also medium-term budget framework*.

public quasi-corporation

Unincorporated enterprises owned by the government that are engaged in market production and which operate in a similar way to publicly owned corporations.

public sector

General government, plus all public corporations and quasi-corporations. *See general government*.

quasi-fiscal operations

Activities of the central bank (or, possibly, other state-owned financial or non-financial enterprises) that are in character similar to fiscal actions pursued by the government. Although undertaken at the direction of the government, they are usually financed by the central banks and are not included in the national budget. Examples include the provision of credit to commodity boards (or other entities) at below-market interest rates, and expenditures by the central bank to bailout failing commercial banks.

reconciliation

Usually, the process of checking payment orders issued by a government agency against actual payments according to bank statements. Reconciliation can also apply to other stages of the expenditure process, such as commitments made and payment orders issued.

reliability

As relating to the quality of financial information: when such information can be depended upon to represent faithfully, and without bias or undue error, the transaction or events that it either purports to represent or could reasonably be expected to represent.

reporting entity

The government organisation or entity required by law or regulation to make financial reports during implementation of the budget and/or at the end of the budget year ("closing of account" reports). Such reports may be delivered to the ministry of finance, parliament or the supreme audit institution.

reporting model

The configuration and presentation of financial statements — in particular, what tables and statements are to be included, how they are interrelated, and how key measures are to be displayed in the various statements.

revaluation

The act of placing a market value on a capital asset at a particular date.

revenue estimate

An estimate of the revenues available to the budget for the next year or next several years. Preparing an estimate of revenues is essential at the beginning of budget formulation. This estimate usually needs to be updated several times during the budget cycle.

risk analysis/assessment

A systematic process for assessing and integrating judgements about possible adverse conditions and/or events, as a basis for the appropriate budgetary treatment of those conditions or events. Examples include the risk of war, bank failures, floods and other natural disasters, epidemics of virulent disease, etc. *See also contingent liability.*

service quality

In its broader sense, "quality of service" refers to effectiveness. However, it is generally used in a narrower sense, in terms of satisfying the more immediate needs of users, such as the timeliness, accessibility, accuracy and continuity of services. As such, it relates to the quality of service delivery rather than of service outcomes. Development of a responsive client/consumer-oriented culture in public service delivery is on the reform agenda of most EU Member States (e.g. the "Citizen's Charter" in the United Kingdom).

social security funds

Funds that provide social benefits to the community through a social insurance scheme which generally involves compulsory contributions by participants. In most countries, such funds are separately organised from the other government activities, have their own budget, and hold their assets and liabilities separately. Social security systems which do not hold their assets and liabilities separately are not called social security funds. In the GFS, the preferred treatment of social security funds is to classify them as a part of the level of government at which they operate. An alternative treatment is to group all social security funds into a separate subsector. Funded government/employee pension plans are not social security funds. They are financial corporations and are excluded from the general government sector.

special accounts

Accounts recording transactions of an "exceptional" character that are made outside the normal procedures for expenditure approval and recording. Examples of such arrangements are "temporary accounts" (such as advances), or transactions whose authority is questionable, or the accounts of extra-budgetary funds, or "below-the-line" accounts.

special funds

Usually refers to extra-budgetary funds, but sometimes refers to funds financed by earmarked revenues or user charges that are within the government's budget.

special purpose financial reports

Financial reports other than "general purpose financial reports" that includes management reports.

spending unit

Any government entity that is responsible for its own budgetary operations. In many countries, these units are denominated in terms of several hierarchical levels (first level spending unit, second level spending unit, etc.) with the first level corresponding to a ministry or other organisation headed by a person of ministerial rank. In addition to ministries, such units may include subordinated and autonomous agencies, extra-budgetary funds, or administrative units within entities that (exceptionally) deal directly with the ministry of finance on budget matters.

standing appropriations

Moneys appropriated by a specific act of parliament for a specific purpose (e.g. payments of social welfare benefits). Standing Appropriations may or may not be for a specific amount of money or a particular period of time. However, they do not require annual spending authorisation by the parliament since they do not lapse at the end of each fiscal year. Also referred to as "permanent appropriations".

state government

State government has independent authority for certain functions in a significant part of a country's territory. This intermediate level of government exists in all countries with a federal constitution (provinces, Länder). Regional government authorities have similar characteristics in terms of territorial jurisdiction but are generally found in countries that do not have federal constitutions. *See also central government, general government, local government and subnational government*.

statement of assets and liabilities

A financial statement that gives information on the assets and liabilities of an entity at the end of each reporting period. *See also balance sheet*.

strategic plan

A plan which sets forth an organisation's mission, goals, objectives, courses of action, and expected results for a specific time frame, usually five to ten years. Strategic planning is the process by which such plans are developed. A council of ministers, or cabinet, may have a strategic planning process to establish goals and priorities for the government, but generally will not produce a "strategic plan" (document) as would a ministry or agency. Sometimes called "business plans", these documents are often used a major justification for an organisation's budget request.

subnational government

All government below the first (central or national) level. *See also central government, general government, local government and state government*.

subsidiarity

The subsidiarity principle requires that decisions be taken at the lowest practicable level of government. It implies that central government should not take action unless doing so is more effective than action taken at regional or local government level. The term is commonly used in the European Union to define the areas where Member States have an independent right of action, i.e. where the *acquis communautaire* does not apply (e.g. the timetable for preparing the annual budget and submitting it to parliament is a matter of subsidiarity).

subsidy

According to the GFS and the SNA, the term "subsidy" is narrowly defined as current, unrequited transfers that the government makes to enterprises either on the basis of the levels of their production activities or on the basis of the quantities or values of the goods and services that they produce. More broadly, the term "subsidy is also often used to in the sense of payments or tax credits to individuals on the basis of their personal circumstances, according to criteria laid down in law or regulations (e.g. if they are unemployed or disabled).

supplementary appropriation

Legislation passed during the budget year to provide for expenditures additional to the original budget.

supreme audit institution (SAI)

A public organisation, normally independent of government and accountable to the legislature, that is responsible for auditing the government's financial operations. The SAI may carry out different types of audit activity: financial, compliance and regularity, and performance audits. *See also audit*.

surplus

See deficit.

suspense account

A type of special temporary account used to record balances, or correct mistakes in amounts, that have not yet been "posted" to the relevant line-item. Such transactions often include payments of adjustable advances, until the final amount chargeable is known.

tangible/intangible assets

These assets may be grouped in several categories. Tangible fixed assets consist of dwellings, other buildings and structures, machinery and equipment, and cultivated land. Intangible fixed assets include mineral exploration rights, computer software and works of art. Tangible non-produced assets are assets that occur

in nature and over which ownership rights may be enforced (e.g. land on which dwellings are constructed). Intangible non-produced assets include examples such as the granting of a patent.

tax expenditures

Concessions or exemptions from a "normal" tax structure that reduce government revenue collection and, because the government's policy objectives could be achieved in other ways such as through a subsidy or other direct outlays, the concession is regarded as equivalent to a budget expenditure. Precise definition and estimation of tax expenditures thus requires definition of the "normal" tax base as well as determination of the most appropriate way of assessing costs (i.e. by revenue forgone or the expenditure required to achieve the policy objective). Several countries (e.g. France and the US) include information on tax expenditures in their annual budget.

transaction

A transaction in the SNA and GFS 2000 is defined "an interaction between two institutional units by mutual agreement or an action within a unit that is analytically useful to treat as a transaction". A transaction can be in cash or in kind. *See also transfer.*

transactions in financial assets for policy purposes

GFS 1986 defines "lending minus repayment" as government transactions in debt and equity claims taken for public policy purposes, rather than for management of government liquidity. In GFS 2000, "lending minus repayment" is called "financial transactions in assets for policy purposes (or by non-market means)". Such transactions are made for purposes such as assisting ailing enterprises or fostering new industries. They can take a variety of forms such as granting loans with an interest subsidy component, and the acquisition or sale of equities. According to the GFS, privatisation programmes and acquisitions of liabilities as a result of government guarantees are always policy related. Identifying other transactions in financial assets for policy purposes is not always easy. Although it is termed "lending minus repayment" in GFS 1986, this concept should not be confused with the term "net lending/borrowing" as defined in the System of National Accounts and GFS 2000. *See also deficit/surplus and policy balance*.

transfer

A transaction in which one individual or institutional unit provides a good, service or asset to another individual or unit without receiving from the latter any good, service or asset in return as a counterpart. Transfers may be made in cash or in kind.

unfunded public pension liabilities

This term refers to future liabilities of government under unfunded, or partially funded public pension schemes. Liabilities for such schemes are generally not recognised in accounting terms until the obligation to pay arises, though this will depend on institutional arrangements in particular countries. Such future liabilities need to be taken into account in assessing fiscal sustainability over the long-term.

user charges

Payments made directly by the consumer for goods and services provided by public sector entities to the private sector (whether for partial or total recovery of costs of provision) as well as the internal

pricing of goods and services (i.e. user charges between one government agency and another). In many countries, rules governing the scope and application of user charges, and the methodology for calculating them, are issued by the ministry of finance.

valuables

Capital assets that are not used primarily for the purpose of production or consumption but are held as store of values over time.

value for money audit

See performance audit.

verification (certification)

Once a bill for goods or services has been received, the relevant line ministry/agency must confirm that the bill is correct and that the goods or services have in fact been received. At this point, the bill becomes a liability of the public sector. In accrual accounting terms, an expenditure is recognised even though the bill has not yet been paid.

virement

The process of transferring expenditure provision from one line-item to another during the budget year. To prevent misuse of funds, spending agencies must normally go through approved administrative procedures to obtain permission to make such a transfer.

vote

See appropriation.

warrant

A release of all, or more commonly a part, of the total annual appropriation on a quarterly or monthly basis that allows a line ministry or spending agency to make commitments. *See apportionment*.

zero-base budgeting (ZBB)

A system of programme budgeting attempted in the US in the late 1990s. Literally interpreted, ZBB consists of evaluating all programmes each year and preparing the budget from scratch. In practice, however, the ZBB system did not go so far. Agencies were asked to rank the programmes within predetermined funding limits. The main features of the system consisted of: (i) formulating objectives for each agency; (ii) identifying alternative approaches to achieving the agency objectives; (iii) identifying alternative funding levels, including a "minimum" level normally below current funding; (iv) preparing "decision packages", including budget and performance information; and (v) ranking the decision packages against each other. Nevertheless, ZBB was excessively time-consuming and proved to be short-lived. However, similar approaches have been tried in other countries (e.g. the United Kingdom's programme of "Fundamental Expenditure Reviews" started in 1993). *See also performance budgeting*.

NOTES

1. Main sources for this glossary are: Everard, Patrick and Diane Wolter (1989), *Glossary: Selection of Terms and Expressions Used in the External Audit of the Public Sector*. Luxembourg: Court of Auditors of the European Communities; IFAC (2000), *Governmental Financial Reporting. Accounting Issues and Practices*. Study 11. New York; IMF (2000), *A Manual on Government Finance Statistics*. Washington DC; SIGMA (1997), *SIGMA Paper No. 19: Effects of European Union Accession: Part 1. Budgeting and Financial Control*, OECD/GD(97)163, Paris: OECD; EC, IMF, OECD, UN, and the World Bank (1993), *System of National Accounts*, Brussels, Luxembourg, Paris, New York, Washington DC; World Bank (1998), *Public Expenditure Management Handbook*, Washington DC.

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SELECTED WORLDWIDE WEB SITES[1]

http://www.adb.org The web site of the Asian Development Bank.

http://www.eca.eu.int The web site of the European Court of Auditors.

http://europa.eu.int/scad The European Commission's bibliographic database with access to hundreds of thousands of documents, divided into Community legislation, official publications, articles from periodicals, and opinions from the two sides of industry.

http://www.eurosai.org The European branch of INTOSAI, see below.

http://www.ifac.org The web site of the International Federation of Accountants. The Public Sector Committee of IFAC is developing a set of International Public Sector Accounting Standards.

http://www.iia.org.uk The web site of the Institute of Internal Auditors which issues standards in the field of internal audit.

http://www.imf.org The International Monetary Fund.

http://www.imf.org/external/np/fad/trans/code.htm The web site of the IMF's fiscal transparency code.

http://www.internationalbudget.org/index.htm The International Budget Project of the Center on Budget and Policy Priorities helps non-governmental organisations and researchers to analyse and improve budget policies and decision-making processes.

http://www.intosai.org The web site of the International Organisation of Supreme Audit Institutions.

http://magnet.undp.org The web site of the United Nations Development Programme which includes activities in the governance area.

http://www.oecd.org/puma/budget/index.htm The budgeting pages of the OECD's Public Management Directorate.

http://www.oecd.org/puma/sigmaweb The web site of the SIGMA Programme. See in particular the audit and financial control web pages.

http://simap.eu.int Système d'information pour les marchés publics (SIMAP) is a European Commission project to develop the information systems infrastructure needed to support the delivery of an effective public procurement policy in Europe.

http://www1.worldbank.org/publicsector/pe/index.htm The World Bank's "Public Expenditure Online" web site. Includes links to hundreds of other sites.

NOTES

1. These are provided for the readers' information. Additional sites are listed in footnotes and in the bibliography.

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Note: For terms listed in the index by abbreviation only, please refer to the List of Abbreviations at the beginning of the book for guidance.

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