

CHAPTER 6

BUDGETING ISSUES

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Reform of the budget system needs to be an integral part of any decentralization strategy. However, the budget process typically is not explicitly addressed in the discussion of design issues in intergovernmental relations. The implicit assumption is that behind the proper expenditure and revenue assignments, there is an autonomous and well-functioning budgetary framework at each level of government capable of supporting decentralized policies. This is an assumption that cannot be taken for granted in most countries in transition, including in Kazakstan.

The budgeting system inherited from the Soviet Union had particular strengths in the areas of internal control and audit. This element was emphasized because, to a large extent, it was all that mattered. Other aspects of modern budgeting were either weak or nonexistent. Most important from the perspective of a decentralized system of government is that the Soviet budgeting system granted little or no autonomy to subnational units of government. Subnational budgets were progressively nested into each other from the smallest settlement or *rayon* up to the Union budget. Ultimately all significant budget decisions were made in Moscow. But the budget of the Soviet Union itself was more an accounting document than an instrument of economic policy. All policy decisions were made separately in the economic plan by Gosplan.

As a consequence of centralized planning, the process of budget preparation was and has remained weak in many former Soviet republics, including Kazakstan. Important aspects of the budget formulation process, such as an appropriate budget classification and sound revenue and expenditure forecasting, were determined by the plan or not needed at all. Budget execution and the treasury function were carried out in the Soviet system with the help of the central bank. But this system has been disintegrating, as the central banks of the newly independent republics of the FSU have concentrated on implementing monetary and financial policies, and increasingly have refused to serve as agencies of the budget office.

Even the strong, internal control practices of the past have weakened, as the roles of the party and the police state have dissolved, and the information and controls provided by the banking system have waned. Other important elements of a modern budgeting system, external ex post audit and budget evaluation, are incipient or nonexistent.

The current budgeting system in Kazakhstan is not compatible with a modern decentralized structure of government. This chapter reviews the current budgeting process in Kazakhstan, the principles and best practices for budgeting, and the changes that need to be introduced to get a budgeting system that is compatible with decentralized government.¹ The chapter first examines the importance of budgetary autonomy. Next, it reviews current budgetary institutions in Kazakhstan to determine the existing level of budgetary autonomy. The last three sections of the chapter review the current practices in budget preparation, execution, and audit, and recommend directions for reform. Because of the considerable overlap of central and subnational budgeting processes, many of the issues discussed and the recommendations proposed apply to both the central and subnational levels of government in Kazakhstan.

RELEVANCE OF BUDGETARY DISCRETION TO DECENTRALIZATION POLICY

The realization of benefits from decentralization is not possible without budgetary discretion. The design of a decentralized system of intergovernmental relations has the single and fundamental objective of increasing the efficiency of public expenditures by making government more responsive and accountable to the needs and preferences of the public. These increases in efficiency are important, especially in economically pressed countries in transition, because they can increase the welfare of the average citizen significantly without imposing any additional demands on national resources. Decentralization simply allows a higher level of welfare with the available level of national resources. Institutions of decentralization policies are also politically significant because they consolidate and reinforce democratic government institutions.

¹ It has been extremely difficult to prepare this chapter. The tax system, which was reformed in 1995, just before the Mission visited Kazakhstan in August of that year, has been kept essentially unchanged as a matter of government policy. However, budget policy and practice have been in constant flux. In some cases, reforms identified by the Mission in earlier drafts have since been introduced or proposed. Until there has been a reform of the budget law and the law on local self government similar to that for the tax law, it is virtually inevitable that a study such as this will contain some errors and omissions.

Success for Kazakhstan's decentralization policies eventually will be judged, as everywhere else, by the efficiency gains in the provision of local public services. The gains provided by greater responsiveness and political accountability of government to the needs and preferences of voters will be difficult to quantify. However, it is important to remember that they are the main goal and justification for decentralization policy.

However, none of the gains in efficiency that go along with a decentralized system, or the reinforcement of democracy at the local level, is possible without granting subnational governments budgetary autonomy. The concept of budgetary autonomy involves many different aspects and as such is not precise. However, there are some minimum conditions that must be met for budgetary autonomy to exist. First, subnational governments must be able to formulate their budgets separately from the budget of the central government. This means that subnational governments must be able to vote on and approve their budgets, even when the central government's budget has not been approved. This is inherently difficult in a unitary system, especially one with substantial reliance on subventions. But it can be achieved by moving from the "gap-filling" model described below, to one in which subnational governments are assigned specific sources of revenue and transfers are determined on objective grounds. This requires minimum levels of stability and certainty in expenditure responsibilities and funding sources of subnational governments.

If subnational budgets are to be independent, budget officials and those in charge of implementing the subnational budget in all different fields must be exclusively responsible to the elected subnational authorities; that is, the budget officials must be exclusively subnational government officials. While the tradition of dual subordination of civil servants inherited from the Soviet system exhibits features of systems of dual subordination used successfully in other countries to economize on scarce administrative resources and ensure coordination between levels of government, it can be inimical to budgetary autonomy of decentralized governments.

Second, subnational governments must have the means at their disposal to increase their budgets, at least at the margin, through autonomous sources of revenues. Even if revenue sharing and transfers from the central government represent the bulk of subnational government revenues, subnational governments must have access to significant sources of marginal revenues over which

they have absolute discretion.² How much discretion at the margin is needed to provide adequate autonomy is not easily determined, but obviously the larger the discretionary amount, the more significant the effect will be. And third, subnational governments must have the freedom to allocate most resources among budget programs as they see fit, and should be able to produce and deliver public services using the techniques and input combinations they consider most appropriate. Central government mandates, limitations on the use of cost-recovery measures, and wage and price controls limit the ability of decentralized governments to realize efficiency gains.

When budgetary discretion is absent, revenue assignments and transfer systems are irrelevant. As will be discussed at greater length in the rest of this chapter, the essence of the current budgetary system for subnational governments in Kazakhstan is to determine a “minimum required” budget for each government.³ The part of the minimum required budget which subnational governments cannot finance with their own revenues from local taxes and user fees must be funded with tax sharing and subventions. In most cases, own-revenues represent only a small fraction of the minimum required budget. However, the larger the share of the minimum required budget that can be covered by subnational governments’ own-revenues, the smaller the allocation of central government funds through revenue sharing and subventions. Although considerable discussion and effort goes into selection of the form revenue sharing and subventions should take, it is clear that without budgetary discretion at the subnational level, the particular form central government funding takes is largely irrelevant, because in this gap-filling model the central government will always adjust revenue sharing or subventions to meet the shortfall of the predetermined “minimum required” budget (also see Chapter 7).

A well-functioning budgetary process needs to complement budgetary discretion. Budgetary autonomy at the subnational level will produce the efficiency gains associated with decentralization only when this autonomy is accompanied by a well-functioning budget process at all the stages of preparation, execution and control, audit, and evaluation. That is, the promotion of efficiency and accountability at the local government level requires not only that subnational government officials have a high degree of discretion, but also that this discretion can be used effectively. In the last analysis, a decentralized system with a budget process that is ineffective or out of control will not represent any advantage over a centralized system of finance.

² Chapter 8 argues that the most important area of subnational discretion is in the setting of tax rates. Subnational choice of taxes to impose, definition of tax bases, and tax administration are less important and can actually be counterproductive.

³ In theory, this is based on norms and prior expenditure levels; in fact, in recent years it has been based on inflation adjustment of approved budgets of earlier years.

BUDGET PROCESS, EXTENT OF BUDGETARY AUTONOMY, AND ROLE OF THE BUDGET

Kazakstan is a unitary state; thus, all the budgetary authority of subnational governments is delegated by the central government. At the first tier of subnational governments, there are 19 *oblasts*. In addition, two cities, Almaty and Leninsk, have *oblast* status. At the second tier, there are 217 *rayons* and 84 municipalities or cities. At each *oblast*, *rayon*, and city there is an elected assembly, the *maslikhat*, with authority to vote and ultimately decide the composition of local budgets. However, the head of the *oblast* government, the *akim* or governor, is appointed by the President, and the heads of *rayons* and cities are appointed by the head of the *oblast* government. This provides substantial vertical control from the central government to lower levels of government. Further curtailing subnational government autonomy is the fact that most members of the subnational administrations, as in the rest of the FSU, are under dual subordination. Although civil servants report to the subnational governments and ultimately to the *maslikhats*, they are also vertically integrated in the hierarchical structures that run all the way up to the central government, as under the Soviet Union.⁴

The current nominal degree of subnational budgetary autonomy is defined in the Law on the Budgetary System of 1991. This law states (Clause 1) that the subnational budgets are independent of the republican budget. In addition, the law prohibits (Clause 13) interference with the budget formulation process by higher government, declares illegal (Clause 23) the capture of any surplus funds of subnational governments by the central government, and leaves it to subnational governments (Clause 15) to decide independently the use of funds, regardless of the origin of these funds. The newly adopted constitution also provides that local government budgets are to be formulated and executed without interference from central government authorities. Despite these guarantees provided in the constitution and in the budget law, budgeted local government expenditure levels are determined centrally by MOF. A major reason for this is the limit on local government ability to raise own-revenues. This issue is discussed in greater detail in Chapter 7.

However, in practice, subnational government budgetary autonomy in Kazakstan remains limited. There are multiple obstacles to the exercise of budgetary discretion by subnational

⁴ Here Kazakstan seems to have evolved at a slower pace than other parts of the FSU from the institutions of the previous regime. In Russia, Ukraine, and the Baltic states, only budget officers have been under dual subordination. In Kazakstan, formal dual subordination has been abolished only for STC.

officials, in addition to the overwhelming presence and power of the appointed heads of the subnational governments who seem to have both de facto veto power over subnational budgets and the willingness to use it to implement the policies of the central government, even where subnational determination of policy might be more appropriate. These include (i) the lack of measures complementary to those in the Law on the Budgetary System truly enabling decentralized budgeting; (ii) restrictive regulations and practices of the central government toward subnational governments; and (iii) practical limitations born out of traditional attitudes of officials in the local public sector, an element not unrelated to the fact that most employees are still under dual subordination.

The most serious limitation to budgetary autonomy in Kazakhstan is the lack of a permanent and stable method of financing subnational governments. *Oblast* governments get most of their funds from revenue sharing and subventions from the central government. These are changed every year, and, more often than not, their amounts are not known until late in the year. The ability to raise own revenues at the subnational levels is, as discussed in Chapter 7, very limited. Similarly, *rayon* and city governments see their funding changed every year and do not know their revenues until the *oblast* government decides how to share its revenues, including those received from the central government. *Oblast* governments have total discretion over how to share revenues with lower-level governments. The uncertainty associated with this system of financing reduces the budgetary autonomy of local governments by practically eliminating their ability to plan and ultimately to act independently of the central budget. Subnational governments cannot initiate their budget preparation in earnest until the higher level of government adopts its own budget.

An additional source of revenue uncertainty has been MOF's arrears with *oblast* budgets and cuts in budgeted subventions. In 1994, subnational governments eventually received only 80 percent of the budgeted subventions. While perhaps unusual (1995 was more normal) and inevitable (revenues of the central government fell by a far greater amount), this clearly compromises the fiscal autonomy of *oblasts*. The central government's control over funding of subnational governments also undermines important aspects of budgetary autonomy declared in the Law on the Budgetary System. For example, subnational governments' right to keep any budget surplus realized at the end of the fiscal year does not mean much when any surplus can be easily taken back by MOF through reductions in tax sharing or subventions in the next fiscal period.

This possibility undermines subnational governments' incentives to operate efficiently and to increase own-revenue mobilization.

Another factor reducing budgetary discretion of subnational governments is the central government's use of unfunded (or partially funded) "mandates." Examples of this are subnational governments' obligation to pay nationally determined salary scales and to provide services free of charge⁵ or at fees controlled by the central government.⁶ Given the labor intensive nature of most public services, nationally determined wage scales significantly reduce the expenditure items that subnational governments can actually control. While this problem may have relatively little practical significance at present, given the low level of public salaries, it illustrates a potentially important problem. Even more problematic is the requirement that local governments provide services (for example, housing and communal services) to employees of the central government.

BUDGET PREPARATION: ISSUES AND NEEDED REFORMS

Process: Interdependency of Budgets and the Role of Negotiation

The government has been in the process of rewriting the current budget law; drafts of the new law were circulated in late 1995 and the first few months of 1996. It is expected that many of the issues and problems discussed in this section will be addressed in the new budget law.

Despite the declaration of subnational budget independence in the current Law on the Budgetary System, the budgets of all levels of government are hierarchically interlinked. Final budgets are the result of a complex iterative process linking the central budget with *oblast* budgets and *oblast* budgets with the *rayon* and city budgets. This approach not only creates considerable uncertainty, as noted above, but contributes little to adequate budget planning. Negotiations are important at the execution stage of the budget, as well as in budget planning. Subnational government officials go to Almaty on a routine basis in attempts to receive priority for disbursement of funds, as well as initial budget allocations. The

⁵ For example, there is a constitutional mandate to deliver health care free of charge.

⁶ For example, a recent Presidential Decree limits cost recovery for meals served in kindergartens to 30 percent of costs.

lack of a structured and transparent framework for negotiations is also pervasive in the relationship between *oblast* governments and local governments.

The budget process starts with a resolution from the Cabinet of Ministers (now called the Government) identifying spending priorities. On the basis of these priorities, MOF issues guidelines to *oblasts*, line ministries, and other spending units on the basic assumptions for the formulation of their respective budgets, including basic macroeconomic variables. Because of the high rate of inflation in the past years, quarterly or semiannual (almost monthly in 1994) budget revisions have often been prepared in recent years.

Oblasts, line ministries, and other spending units submit budget forecasts (requests) through the budget department of MOF. Budget estimates submitted by *oblasts* are consolidated for the entire *oblast*, including all *rayon* and city budgets. There is hardly ever any direct contact between federal government institutions and *rayon* governments; the level of funding for *rayon* and city governments is negotiated with the *oblast* government alone. The budget department of MOF examines the estimates with the assistance of sectoral departments within MOF with expertise in education, health, and other areas. The specialized departments make recommendations to the budget department on the levels of expenditures by the *oblasts* and other agencies that need to be funded. Officials from the specialized departments frequently meet with *oblast* and agency representatives to resolve discrepancies in these estimates. Discussions between MOF and the *oblasts* can be complex and may require multiple meetings. Officials of the *oblast* and central governments may also disagree over the levels of revenues expected to be collected in a given *oblast*. This can affect the tax-sharing rates or subventions used to finance *oblast* budgets. Once these are approved, *oblast* governments retain (part of) any collections in excess of those budgeted. Particular periods of time are set aside for negotiations between MOF and the subnational authorities.

The budget, prepared by MOF, is approved by the Council of Ministers and eventually by the President. The draft budget is sent to the Parliament where the Committee on Reforms, Budget, and Finance plays the major role in the legislative review process.⁷ The budget contains rules for the funding of *oblasts*, including (if not specified in the individual tax laws) *oblast* shares in the regulating taxes and the subventions of “subvention *oblasts*,” those

⁷ This discussion reflects practices followed before the Parliament was dissolved in 1995.

for which even 100 percent retention of all the revenues collected from the regulating taxes is not enough to fund the minimum required budget determined by MOF. All but nine *oblasts* are subvention *oblasts*⁸ (see also Chapter 7).

It is clear from this process that the eventual level of funding for an *oblast* (*oblast* government and consolidated *rayon* and city budgets) to some degree depends on the skills and connections of *oblast* budget officials. However, it is not possible to quantify its impact. In this regard, it needs to be remembered that *oblast* budget officials are employees of MOF with dual subordination. This makes it unlikely that they would take a hard bargaining stand with their superiors.

In the process of budget determination, each *oblast* level government must basically accept MOF revenue estimates and expenditure projections, or else convince MOF authorities of its viewpoints. In discussions of revenue estimates, both sides appear to take the expected positions on the accuracy of the forecasts. *Oblast* officials have an incentive to underestimate revenues so the sharing rates for the regulating taxes can be higher and the subvention, if any, larger; MOF, on the other hand, has an incentive to overestimate *oblast* revenues.

On the expenditure side of the budget, the *oblasts* also negotiate with MOF about the minimum level of expenditures in the social sector and all other services for which they are responsible. MOF uses norms and coefficients, together with estimates of cost increases resulting from inflation, to establish expenditure levels. This approach puts emphasis on the fulfillment of needs, as derived from existing capacity, rather than using the budget as an instrument to carry out policy programs. Norms perpetuated existing modes of expenditure without asking the hard questions of whether some expenditures should be continued or whether there is a more efficient way to achieve the same desired results, or a preferable result. *Oblast* expenditure estimates, and the demands for services on which they are based, tend to be higher than the estimates of MOF. As with revenue estimates, it is in the interest of both parties to take significantly different positions on expenditure needs.

⁸ The fact that a minority of the regional governments subsidizes the majority of regional governments is not atypical of the rest of the FSU. This reality may affect the political economy or the actual shape that a decentralized system of government will take in Kazakhstan. Subvention *oblasts* are more likely to favor a centralized system, while nonsubvention *oblasts* are more likely to favor decentralization, especially if it allows them more control of their own fiscal resources. As discussed further in Chapter 8, a more rational tax assignment system can be expected to cause some redesignation of *oblasts* (subvention versus nonsubvention).

The current practice of using past year budget figures, adjusted for inflation, as the basis of budget formation has not been, from this perspective, an improvement. Approved budget figures for the previous year are adjusted for inflation using a set of coefficients or multipliers. The coefficients are not specified for budget categories, but instead by budget categories such as wages, food, heating, capital repair, and so on. In a sense, the use of norms based on capacity has been preserved because the information used for budget preparation comes from the approved rather than executed budgets for the previous year. Of course, the historical chain of approved budgets takes us back to the time when capacity norms were used.⁹ MOF officials favor using approved rather than executed budgets because this approach encourages more responsibility and efficiency among subnational governments; subnational governments can attempt to expand their budgets by raising their own revenues or seeking additional resources from the central government. This approach may also keep expenditures down. In general, executed budget figures are higher than those of planned budgets because subnational governments are able to muster additional moneys, for example from extrabudgetary funds, or simply run arrears.

Because of the extremely high rates of inflation of the past two years, most of the “bargaining” and negotiation have been focused on the appropriate inflation adjustment. The process has been complicated by the differential rates of inflation across regions due to the different levels of policy controls and by the lack of accurate survey-based data.

The budgetary process between the *oblast* and *rayon* budgets is similar to that between the central and regional budgets. Once the revenue estimates for the entire *oblast* are “approved” by MOF, the *oblasts* start reviewing revenue forecasts by *rayons* and cities to initiate the budget process for these jurisdictions. The budget department of each *rayon* also negotiates with the *oblast’s* budget department the size of the minimum required budget for social services and all other services for which *rayons* and cities are responsible. Typically, *oblast* and *rayon* finance officials meet until some agreement is reached.

As in the case of the negotiation between MOF and regions, *rayons* have an incentive to understate their revenue forecasts and overstate their expenditure needs, while *oblasts* have the incentive to do the reverse. The *oblast* budget department recommends to the *oblast maslikhat* the specific sharing rates in the “regulating” taxes for each *rayon* and, if the *rayon* is poor, the size of the subvention.

⁹ The further out in time the budget gets, the lesser will be the influence of norms when the inflation rates for the different components of the budget diverge over time.

Other Problems and Issues in Budget Preparation

Budget Calendar

The budget timetable has not been respected. There have been many delays in approving the budget. The initial 1994 budget was not approved by the Parliament until December 1993, making it difficult for subnational governments to plan their own budgets. The 1995 budget was approved in April 1995, but the 1996 budget was approved in December 1995. Also, high levels of inflation have forced the government to go through repeated rounds of budget revisions—nine times in 1994. Of course, these practices have added a considerable amount of uncertainty, making it virtually impossible for subnational governments to plan expenditures. Until the budget is approved, generally speaking, expenditures are authorized at the levels in the previous budget, and generally much lower in real terms, because of inflation. The annual budget cycle and calendar should be set as explicitly as possible, allowing for reasonable leads and lags, and then followed strictly¹⁰ (see Box 6.1).

Poor Forecasts

Revenue forecasting at the budget preparation stage needs better data, improved techniques, and greater ability to simulate trends. MOF and *oblast* government budget departments lack the trained staff needed to assess the impact of alternative options for taxation and revenue sharing. The large arrears of subnational governments in 1994 resulted in large part from poor forecasts of revenues; in some cases actual revenues were only 60 percent of those forecasts. Of course, under the circumstances of the past few years, with high inflation and radical economic restructuring, forecasting would have been a challenge for the best trained and equipped staff. The forecasting of cash flows remains a weak link in the budgetary system. A team of international experts financed by USAID have been working on the development of revenue forecasting models. Forecasting problems and needs are discussed in Chapter 4.

¹⁰ International experience suggests that it is not a good idea to adjust initial budget figures for inflation. Unless revenues rise as fast as inflation, which ordinarily is not to be expected, this will cause a (larger) budget deficit.

**Box 6.1. Formulation of the Budget—The Japanese
Experience**
Calendar of Main Points of Decision Making and Activities

Months before start of FY ^a (t)	Main Events and Activities
(Year t-1):	
12-11 (April/May)	Ministries (and agencies) start preparation of reports on next year's budget.
10-09 (June/July)	Cabinet discusses and agrees policy guidelines on budget requests, prepared by MOF.
08 (August)	Ministries submit revenues, expenditure estimates and budget requests to MOF. Ministries submit request of Fiscal Investment and Loan Program (FILP) funds.
07-04 (September/December)	MOF holds budget hearings with ministries and agencies about budget requests (including FILP funds). MOF negotiations with ministries take place hierarchically, from lower official levels to ministerial level (if necessary).
04 (December)	Cabinet decides on budget estimates (including FILP program), taking also into account the macroeconomic results for the new fiscal year.
(Year t):	
03 (Late January)	Cabinet submits budget documents to the Diet. MOF delivers two budget speeches to the two Houses.
01-0 (March/April)	Diet debates and approves the budget.
0 (1 April)	Start of fiscal year (t)

^aThe fiscal year (FY) begins on 1 April (year t) and ends on the following 31 March (Year t+1).

Annual Budget Cycle

- Each ministry and agency begins estimating its revenue and expenditure for the following fiscal year budget around April or May of each year. They must prepare reports on expected revenue, required expenditures, and other necessary matters under their jurisdiction and send them to MOF no later than 31 August.
- In June or July, the guideline for the budget request proposed by MOF is discussed and decided by the Cabinet. It contains instructions which each ministry and agency has to follow as calculations are made.
- According to the Cabinet agreement on the guideline for the estimate budget request for FY 1986, this guideline included a

10 percent reduction for current expenditure and a 5 percent reduction on capital expenditure, measured against the nominal expenditure level according to the previous budget. Excluding national debt service costs and Local Allocation Tax Grants, the guideline only applies to about 33 percent of total general account expenditures, also taking into account the obligatory character of several programs.

- In preparing the budget, each ministry decides the requests after hearing the opinion of the Policy Affairs Research Council consisting of members of the Diet of the ruling Liberal Democratic Party in late August.
- The MOF's Draft Budget for departmental budgets includes unallotted financial resources for the so-called revival negotiations—meaning the new negotiations take place at a higher level of hierarchy— amounting to 0.3 percent of total expenditure in FY 1986. (The guideline for estimate budget requests does not contain unallotted financial resources for the revival negotiations).
- After the process of examinations which includes hearings and reviews by MOF from September to early December, MOF prepares the Draft Budget and submits it to ministries and agencies in late December. After the notification of the Draft Budget of MOF to ministries and agencies, the “revival negotiations” between MOF and each ministry and agency take place. For nearly a week, financial decision making takes place through negotiations at three official levels ending up at the ministerial level.
- MOF's Draft Budget includes unallotted financial resources, which are distributed to specific programs in the course of the revival negotiations so that the total amount of the expenditure in the Draft does not change after the revival negotiations.
- When they do not come to a settlement, negotiations are to be run by the three major executives of the ruling Liberal Democratic Party: Secretary-General, Chairman of the Policy Affairs Research Council, and Chairman of the Executive Council. The final decision is to be made by the Prime Minister, if necessary.
- At the end of December, the Economic Planning Agency prepares the “Outlook and Basic Policy on the National Economy” for the following fiscal year through consultation with relevant ministries including MOF, and it is to be agreed by the Cabinet. At nearly the same time, “General Principles of Budget Compilation” are decided by the Cabinet as well. Finally, the government approves the Budget for submission to the Diet.

Usually the deliberation process of both Houses ends in early April.

Extrabudgetary Funds

Extrabudgetary funds are legal (Clause 23 of the Law on the Budgetary System) and they represent an important part of the finances of the public sector. In 1994, extrabudgetary funds represented one third of the public sector consolidated budget. However, most of this money corresponded to social policy funds at the central government level including the Pension Fund, Social Insurance Fund, and Unemployment Fund, all of which were separated from the budget in 1991. The Pension Fund is the largest of the three with around 90 percent of all disbursements. In 1993, the family allowance was transferred from the Social Insurance Fund to the general central government budget. Legislation to create a medical insurance (health) fund was enacted in 1995, to go into effect in 1996. Subnational governments share in the Road Fund and the Environmental Fund. Many extrabudgetary funds were neutralized in July 1995, when the reform of the tax system eliminated a long list of earmarked revenues.

The size and number of subnational extrabudgetary funds are not known, and at present there are no reporting requirements on these funds. Their relative importance is said to differ by *oblast*. The attraction of extrabudgetary funds for subnational governments lies in the fact that MOF does not take them into account in determining revenue sharing and subventions needed to fund the minimum required budget of the *oblast*. Historically, under the Soviet Union, extrabudgetary funds had the attraction of constituting the only moneys that the authorities in Moscow could not claw back at the end of the year. All other moneys, whether from more efficient operation or higher tax effort, could be recaptured by the central authorities. In theory, this practice does not exist in Kazakhstan. It is illegal for upper-level governments to capture any surpluses generated by lower-level governments. However, because of the interdependence of the budgets, in practice, surpluses can be recaptured, for example by changing tax-sharing rates or the level of subventions. The only exception may still be extrabudgetary funds and revenues from commercial activities, for which upper-level governments do not have any information.

However, the undesirability of extrabudgetary funds is well known. Breaking the principle of universality and integrality of the budget, these funds are not subject to the same level of scrutiny as regular budget funds, which means they generally lack accountability. The use of multiple extrabudgetary funds decreases

the careful consideration of priorities in the allocation of public resources. With the exception of social insurance and pension funds, which can be justified as being outside the budget at the central level, all other extrabudgetary funds should be fully integrated into the regular budgets. Complementary budget reforms giving subnational governments true budgetary discretion would make it unnecessary for them to keep extrabudgetary accounts as a protection from the abuse of higher-level governments. The undesirability of extrabudgetary funds in general extends to earmarked revenues of any kind in the budget. All types of expenditures ideally must compete with other expenditures for scarce budgetary funds on a regular basis. The only exception to this principle are fees or user charges intended to finance a particular investment project such as a road or bridge, which may be used to pay back revenue bonds associated with the project.

Budget Classification

Until 1996, the classification of budget expenditures was based on the “branch department” approach inherited from the planning environment. All levels of government employed the old Soviet classification based on large “complexes,” which was neither an economic or functional classification by programs, nor an operational classification by type of spending agency. The critical items, in order of generality, were the branch of economic activity to which the expenditure was being applied, the department carrying out the spending, and the object of expenditure. The classification by object of expenditure was the closest to an economic classification of expenditures, but also includes items of a functional nature. This classification system is not sufficiently detailed to be useful in economic analysis or decision making by legislators and budget officials. Budgetary control, audit, and evaluation are also made more difficult.

During 1995, the government adopted a budget classification system based on IMF’s Manual on Government Finance Statistics for both budget formulation and execution. It was the hope that the new budget classification system could be introduced with the 1996 budget. However, the 1996 budget was initially approved using the old classification system. A Presidential Decree mandated that the central government budget for 1996 be recast using the new classification system. In the future, the new classification system will be extended to all subnational budgets.

Confusion about the Roles Played by Line Ministries in the Context of a Decentralized Budget Process

The transition from a centrally planned system toward a more decentralized approach to budgeting has brought significant confusion about the role of line ministries in both the budget process and policy formulation for those expenditure activities that are the responsibility of subnational governments. One important role of line ministries in the previous regime was the definition of national policies which informed the economic plan and ultimately were translated into the budget framework through the elaboration of detailed budgetary norms. Because these norms have largely come into disuse, there is no concrete linkage between line ministries and actual budgetary allocation.

Inadequate Capital Budgeting

At present, investment policies are defined for some sectors, but there is not an overall investment strategy for the government that allows the comparison of competing demands across ministries, levels of governments, and programs. Budget preparation for capital investments at present consists mostly of lists of proposed projects gathered from ministries and subnational governments. These “wish lists” are trimmed down by the Ministry of Economy and further by MOF. The process by which capital investment requests get into the budget is to a large extent uncoordinated, and the quality of the project analysis appears to vary considerably. Good project preparation practices do not appear at all to be common. Moreover, investment projects, especially those cofinanced by foreign loans, are not totally reflected in the expenditure side of the budget.

In the final budget, the projects have never been systematically reviewed or compared. The current budget structure does not allow for a separate capital budget document. Once capital projects are approved, little systematic information is available on the status of implementation. The fiscal austerity of recent years has resulted in delays of already initiated projects or in the complete abandonment of projects. The budget process lacks tools such as commitment accounting or the implementation of projects by self-contained *tranches* that could help avoid or minimize the waste of resources implied by the discontinuation or suspension of projects. After projects are finished, there is no formal evaluation process.

Recommendations on Budget Formulation

This section presents recommendations for improving the process of budget formulation¹¹ based on the Mission to Kazakstan in August 1995. As mentioned above, the government is in the process of rewriting the budget law. The new budget law will render some recommendations contained in this section obsolete. Where possible, these are noted.

Restructuring Budget Relationships. The present system of budget determination, which is characterized by negotiation and extensive use of extrabudgetary funds, has obvious disadvantages:

- lack of transparency of the budget process;
- susceptibility to being manipulated for ad hoc political convenience;
- slowdown and delay in budgetary decisions; and
- lack of cohesiveness.

The most desirable avenue for reform would be to provide for the independence of the budgets at different levels of government. This will require a rational and lasting assignment of revenues and expenditure responsibilities, complemented by a transfer system based on objective criteria, such as a formula. This should be achieved by introducing a subnational government budget law along the lines being proposed by the US Treasury Department/USAID team of advisers. At the end of these reforms, budgetary autonomy will be achieved if upper-level governments can only affect the budgets of lower-level governments by changing standard and transparent revenue sharing and transfer formulas.

Approach to Budget Preparation. There seems to be a consensus that the budget preparation process should not go back to an exhaustive system of detailed physical norms.¹² The intentions are to develop more general and more flexible norms based on population (capitation basis) and other more general parameters, similar to those now being used in the Russian Federation. Real progress in budget preparation should come about through the more systematic utilization, from the administrative stage onward, of the “revolving budget,” the approach that high inflation rates

¹¹ For a general discussion of these issues see Allan (1994) and Premchand (1990).

¹² Although the norms have been abandoned by MOF as a tool of budget formulation, they are still used by line ministries, often with perverse results. Because most norms are based on capacity rather than actual use, there are reported instances in which facility managers have seen their budgets reduced after attempting to downsize and streamline their services.

has forced upon Kazakhstan authorities. In the revolving budget approach, the starting point for preparation of a budget is the appropriation level for the preceding year, adjusted to comply with new laws and regulations and any amendments to the regulations (see Box 6.2). This method constitutes the approach most commonly

used in other countries for budget preparation and submission.

Box 6.2. The Revolving Budget Approach

Most budgetary systems involve preparation and submission of the budget for a given year based on the preceding year's budget. This method highlights new projects and supplemental efforts or areas of saving that reflect the guidelines adopted for each administrative program and subprogram. Efforts made, particularly in the US, to formulate a method of appropriation with no reference at all to previous years (zero-base budgeting) have proved useful as a means of complementing this differential approach. They cannot replace it, however, because comparison with measures taken previously is quicker and more transparent and immediately highlight the new priorities on which the discussion of the budget will focus.

This method is also used in Australia, Canada, and France. In the case of France, the procedure is formally structured in the budget law. For operating expenditures, which by their very nature are recurrent from one year to the next, the method starts out by calculating the level of appropriations that will allow operating expenditures to match those of the preceding year, with adjustment for inflation. Then adjustments are made to accommodate decisions taken during the year, the impact of which has to be evaluated for a full year (for example, a wage increase that took place in December of the preceding year). All of these appropriations (in general, supplemental, but sometimes negative, for example, if an agency is closed down during the year) are termed "acquired measures." The level of appropriations allocated is compared to this base level, indicating whether the item represents a supplemental effort (+) or a saving (-).

Source: World Bank (1995a).

Extrabudgetary Activities. As mentioned earlier, ideally all extrabudgetary operations should be included in the budget with the exception of the pension fund and the social insurance fund. In particular, all foreign exchange operations should be incorporated into the budget. If some extrabudgetary funds must exist, then the budget accounting system should permit the aggregation of their transactions with those covered by the budget and accompanied

by full disclosure of relevant information by subnational governments. The draft now on the budget system would ban all use of extrabudgetary funds, except the Pension Fund, the Medical Care Fund, the Road Fund, and the Employment Fund. Also, it would incorporate these funds into budget totals, except as provided by law.

Fiscal Privileges. Fiscal expenditure arising from tax advantages granted in the tax laws should be accurately measured and incorporated into an annex to the draft budget, as is done in many other countries, in the form of a tax expenditure budget.

Role of Line Ministries. The role of line ministries should still be the elaboration of national sectoral policies that the central government will implement directly through its budget or indirectly through matching grants and similar programs with subnational governments. A decentralized form of government, however, will call for the devolution of policy-making powers in many areas now nominally controlled by the line ministries to the subnational governments.

More Priority to Deficit Containment. Containment of the budget deficit is crucial to macroeconomic stability; it is the primary focus of negotiations with IMF. Widespread international experience indicates that no permanent and effective deficit containment takes place without an explicit targeting of the permissible deficit (see Box 6.3). Yet, the deficit has not been given the importance and consideration it deserves at the budget preparation stage. One reason for this lack of precision in targeting the budget deficit has been the inadequate economic forecasting capabilities in MOF. Forecasting has also been made more difficult than usual because of the unstable economy and the shifting institutional environment. The available evidence in Kazakhstan is that the budget process is not sufficiently focused on deficit containment at any level of government. Although subnational governments are supposed to operate with balanced budgets, in reality they have been running significant deficits. For these measures to be effective, the budget law needs to define carefully (and the draft budget law does define) what the budget deficit for the central and subnational governments is. The reform of the budget process should also seek to curb Parliament's power to amend the budget at both the preparation

¹³ Many countries around the world have sought ways to control budgetary deficits over the past decade (von Hagen 1992; World Bank 1995a). Measures which seem to have been most effective include giving preeminence to MOF over all other government agencies in the budget preparation process and limiting the powers of legislative representatives to amend the budget proposal or affect its execution. Overall expenditure ceilings or debt limits appear to have been much less effective because eventually they are changed or lifted.

and execution stages.¹³

Need for Accurate Forecasting. Budgeting must be based on realistic and professionally established forecasts of revenues, expenditures, and general economic conditions. The basic technical components of projected revenue levels and actual program costs must be free of partisan manipulation. They should be based on technically sound procedures. See also Chapter 4.

Budget Classification. MOF and all subnational governments should complete implementation of the new budget classification system following the functional and economic classifications in IMF's *A Manual on Government Finance Statistics*. This will provide the right framework and information for making policy decisions and facilitate the compilation of accounts and therefore accountability in the use of public funds. The new classification will help improve budget execution and evaluation.

Improve the Budget Format by Providing Separate Operating and Capital Budgets. Budgets in most countries provide for separate estimates of capital and operating costs. The operating budget provides for normal recurring expenditures while the capital budget provides for construction and other expenditures that will provide benefits over several years. The advantage of a capital budget is that it can include information on the sources of financing for proposed projects, a description of the benefits from each project, and the expected operating cost impact for each proposal. The draft budget law envisions differentiation between current and capital expenditures (and thus could accommodate a capital budget), but does not explicitly introduce a separate capital budget document.

Adopt a Multiyear Planning Framework for Capital Investments. As noted in the previous chapter, all capital investments are the responsibility of the central government. Certain capital investment responsibilities should be shifted to subnational governments. But regardless of the level of government responsible for capital investment, there is a need to improve the planning framework of these expenditures. Investment selection presents a particular difficulty because many capital projects extend beyond one fiscal year, while the government budget is for one fiscal year. The large number of programs remaining incomplete is a clear reflection that investment allocations often have been deferred in a fiscal crunch. However, the large number of investment projects that remain incomplete are also likely the result of the lack of proper budgeting techniques, most importantly the insufficient rigor of investment programming, especially recognition of spending beyond the current

Box 6.3. International Approaches to Deficit Containment

Besides an overall limit to total spending, another frequently used tool for deficit containment is the setting a priori of financial limits to the request and proposals of individual ministries and departments, practicing what is known as “top-down” budgeting. Virtually, all countries in the Organisation for Economic Co-operation and Development, for example, use specific quantitative targets for total expenditures and the overall deficit, rather than general qualitative statements of intent about these objectives. These targets are typically expressed as a ratio or percent of GDP, an absolute value of target variable, or a rate of change over the levels in the previous period. Most of these countries have pursued policies of deficit containment and reduction over the past 15 years. These policies have taken different forms and shapes. What follows is a sample of individual approaches.

In Canada, since the issuance of the White Paper “Attack on Inflation” in 1975, the government has stuck consistently to the policy that the total of the entire public sector should not grow faster than the trend of GDP. Since the introduction of the Policy and Expenditure Management System in 1979, budget targeting has been incorporated in a multiyear fiscal plan presented annually to Parliament.

In France, deficit containment policies in the 1980s took the form of explicit fiscal constraints which were rolled over from year to year limiting the size of the deficit vis-a-vis GDP.

In Germany, the deficit reduction strategy in recent years has consisted in maintaining the growth of federal spending below the rate of growth in GNP, and by capping the maximum rate of growth of expenditures. Complementary policies consisted in increasing the share of investment in public expenditures and reducing the tax burden.

In Spain, the approach for a deficit reduction policy in the 1980s consisted in the adoption of tripartite agreements between the government, worker unions, and the confederations of business organizations. One key element of the Social Economic Pacts was deficit reduction to specific shares of GDP.

In the US, several presidential campaigns were run with the theme of deficit reduction, and budgets have routinely set targets of the federal deficit as percent of GDP. In 1985, Congress passed a Balanced Budget and Deficit Reduction Act (also known as the Gramm-Rudman-Hollings Act) which set specific targets for deficit reduction for several years until its complete elimination in 1991. The innovative part of this Act was that if the President and the Congress failed to meet the deficit reduction targets established in the Act for any year, the automatic prespecified procedures for expenditure reduction included in the Act would take effect so as to insure that the deficit reduction goals were met.

Source: OECD (1987).

year. Beyond the separation of operating and capital budgets, as recommended above, both the central and subnational governments will need to develop a rolling multiyear Public Investment Program (PIP) of viable and well appraised projects (see Box 6.4). PIP should provide the basis for the preparation of the capital investment budget in the current fiscal year. To facilitate adjustments in capital spending during the year, a helpful tool will be to establish a commitment accounting system. Whenever possible, implementing agencies should plan investment projects in tranches that are self-contained so that, if there is a need to discontinue funding, the previously spent funds are not wasted. The government needs to allocate considerable resources for training budget officials at the central and subnational government levels in capital budgeting, project evaluation, and other modern budgeting techniques. The draft budget law envisages

specification of expenditure requirements three years in advance.

Box 6.4. Public Investment Program

Nature of PIP. PIP explicitly documents the investment needs of the government and matches these investment needs with available resources by establishing a prioritized list of investment projects. PIP is the key instrument for government to define clear strategic priorities for investment in the public sector. Well-defined sectoral policies are fundamental to an efficient use of scarce resources for investment and for deciding what sectoral programs to include in PIP. A key feature of PIP is its long-term perspective. Investment activities typically involve decisions and financial commitments beyond a single budget period. PIP collects into a single document all demands for future capital investment resources. It also allows a quantification of the requirements imposed on future current budget resources for operation and maintenance purposes. Each future capital investment project will represent some recurrent expenditure for maintenance and operation. PIP is a key element of the government's long-term fiscal planning in several other ways: it helps coordinate sometimes conflicting government policy objectives; it helps prioritize the use of scarce financial resources for investment; it becomes a key element in the formulation of the capital expenditure budget for the current year; it becomes a ready standby instrument to channel international investments and financing which may become available in an unanticipated manner; and it allows exploration of different cost-efficiency implications of rehabilitation of existing capital infrastructure vis-a-vis new construction.

Development of PIP. The development of PIP starts with a list

of proposed projects from all interested spending agencies. At this first stage, the requests are evaluated for their inclusion in or exclusion from PIP. The main criterion for selection into PIP is overall consistency of the proposed projects with the policy objectives of the government sectoral policies.

At the second stage, once projects are initially incorporated into PIP, the sponsoring agency spends considerable time and effort in defining the project objectives, in determining the approach to implementation, and conducting a thorough evaluation based on internal rate of return or least-cost analyses. If the desired conditions are met under this more thorough analysis, the specific project is included in PIP.

Format of PIP. PIP should have several components. First, it should have a summary of the government's overall investment policy objectives, a summary of the long-term strategies for the main sectors of the economy, and a discussion of how the investment objectives fit into the government's macroeconomic policy objectives.

Second, PIP contains summaries of planned capital expenditures by sector and within sectors, planned disbursements for each of the next three years and remaining outlays for the life of the projects. The summary tables also must specify sources of financing including direct budget transfers, direct government lending or on-lending from international loans, other domestic or foreign loans with government guarantee, and domestic or foreign financing without government guarantees. The tables should also contain information on secured sources of funds for the current year and the likely (or secured) sources of funds for subsequent years. Another set of tables must describe and quantify the recurrent budget incremental costs in operation and maintenance implied by each project and by how much they will impact the central government budget.

Third, PIP should contain summary profiles of each of the projects in PIP. These briefs should contain information not only on the particular project and the sources of financing, but also on how the project fits into established government sectoral policies.

Content of PIP. The question of what kind of projects should be included in PIP is an unresolved one. The most practical approach is to include only those projects that have a direct impact on the central government budget. This assumes that there is a separate PIP for central government and for subnational governments.³ These latter are often called regional and municipal investment programs. At the central government level, the rule for inclusion of a project in PIP is whether the project has a direct claim on central government resources. Whether central government loan guarantees represent a direct claim on these resources is debatable. The practice of different countries varies in this respect. PIP should include public

enterprise projects as long as these enterprises have a claim on the budget.^b

The selection of projects for inclusion in PIP needs foremost to be compatible with the privatization objectives of government. That is to say that there is no room in PIP for otherwise economically viable projects that can and should be developed by the private sector. To arrive at the right content of PIP, it is necessary to maintain clear criteria on the roles to be played by the private and public sectors in the economy. In the current period of transition, it may be justified to make some exceptions to preserve the value of assets to be privatized over a long period. A list of sectors within the public domain would include defense, environmental policy, education, highways, and culture. Other sectors where there may be a substantial government interest, although in competition with the private sectors, are health, public utilities, and transport infrastructure, including airports and railway facilities.

How large should PIP be? The overall envelope of the resources available for public investment determines the size of PIP. The forecast should include three different sources of financing:^c (i) direct transfers from the budget, (ii) resources to be raised through domestic borrowing, and (iii) foreign loans and grants.^d These forecasts of total available resources are to be made by the PIP unit in close collaboration with the macroforecasting unit of MOF. Based on this forecast and the government's overall investment strategy, the PIP unit should inform ministries and autonomous spending units with overall envelopes of available financing to keep project submittals proportionate to what can be financed.

To be a useful planning and budgeting tool, PIP needs to incorporate only those projects that can be realistically financed in every one of the years covered by PIP. A wish list of projects that is a multiple of what can actually be financed reduces or practically destroys the usefulness of PIP. Two defensible, but also contradictory, positions are taken with respect to the size of PIP vis-a-vis the expected level of available funding. One position is that the size of PIP should be larger than the expected level of funding because unavoidably some project will be delayed and others entirely dropped. The other position argues that invariably there are cost overruns, that costs tend to increase as more information is available, and that there is also the possibility of funding shortfalls.^e All these reasons argue for a PIP that is smaller than expected available resources if implementation is to be carried out without exerting pressures for additional borrowing. A commonly accepted solution to this dilemma is to develop a "core" PIP side by side with a noncore PIP. The core PIP matches investment projects with the best available estimate of the resources that will be available. The noncore projects can be

added as more funds are made available or core projects are delayed or become discontinued.

Selection of Investment Programs in PIP. This is the most difficult task in the formulation of PIP. In an ideal world with perfect information, program selection would be relatively simple. All proposed projects would be in a descending order according to given investment criteria, such as the internal rate of return. Fund availability would dictate the line above which projects would get incorporated into PIP and eventually implemented. However, in reality, the computation of internal rates of return or carrying out cost-benefit analyses is not always feasible because of lack of data. For example, often there is no information on the willingness by taxpayers to pay for government services. Other times the necessary data may become available only after actual project implementation is well advanced. Another particular difficulty in the real world is that the lack of market prices for some resources makes it necessary to use “shadow prices” or estimated opportunity costs for these resources. But because the shadow prices used in the computation of rates of return tend to differ by sectors, this makes internal rates of return computed across sectors noncomparable. All these reasons make it hard or impossible to rank all projects using “objective” investment criteria.

The only practical way to allocate available resources across sectors is to use as a guide the objectives for national priorities defined in an overall investment government strategy. Once the allocation of resources across different sectors has been accomplished, it is desirable to use objective investment criteria whenever possible to decide on the allocation of resources within each sector.^f The preselection of projects within each sector should be according to the objectives contained in well-defined sectoral policies. The objective investment criteria should be interpreted as revealing the most cost-effective way to attain the sectoral objectives.

Quality of the Project Portfolio. The overall quality of the PIP portfolio will depend on the ability of ministries and autonomous spending agencies to develop and submit relevant projects for inclusion in PIP. The role of the PIP unit will be to select the best projects among those submitted by the spending units and to coordinate the financial demands for all investments projects. Once the projects have been selected and included in the annual capital budget, the implementation and execution of the project is exclusively the responsibility of the spending unit. The PIP unit, however, should play a role in the evaluation of the project together with the spending unit. The lessons extracted from both successful and also less successful projects should be incorporated by the PIP unit in the selection of future projects.

Carrying out the necessary project preparation will demand considerable training efforts of PIP personnel as well as those of the ministries and spending units in charge of the projects. This will require the production of manuals and standardized guidelines for project identification, preparation, evaluation, and presentation. Preparing for the first PIP will be especially demanding because of the lack of trained personnel and because it will require the largest review of projects at any particular time, for a time horizon of at least three years. Ongoing projects will need to be reviewed for their incorporation into PIP. Although the government has well-defined sectoral policies in some areas, such as in reconstruction, there are many other sectors lacking a clear sectoral policy.

Capital Budget: There is an important distinction between PIP and the capital budget. Although the capital budget is based on the information and planning contained in PIP, it is very different from PIP. The capital budget commits resources and appropriates funds to spending agencies to carry out investment programs. PIP, on the other hand, is just a planning tool. The annual capital budget is in every respect similar to the annual recurrent budget, but it commits public funds over a multiyear framework. As in the case of the annual recurrent budget, the government prepares an annual capital budget every year. The most common approach to the preparation of the annual capital budget is to roll the previous year's capital budget into this year's budget. Capital expenditures committed in previous years have an implicit approval for inclusion in this year's capital budget. This approach has the advantage of focusing on the evaluation and performance of ongoing projects and it allows the implementation of any necessary changes. As ongoing projects are completed, the current availability of financial resources dictates the incorporation of new projects taken from the three-year rolling PIP into the annual capital budget.

^a The investment needs of subnational governments are included in PIP when there is no separation between the central government budget and the subnational government budgets.

^b A project in which government participates only with a guarantee generally would be excluded from PIP.

^c Investment funds may also arise from privatization proceeds, but, of course, this will not be a sustainable, long-term source of financing.

^d The ability to borrow will depend on the share of investment projects that can be self-financing through realistic costing and price-recovery policies.

^e All of these are different from intentional underestimates of project costs. Proper screening of projects should avoid the overloading of PIP with these practices.

^f There are additional technical complications in the use of shadow prices to compute internal rates of return within a sector. In particular, internal rates of return are unreliable when the total demand for resources exceeds the available amount of resources because in this situation shadow prices of resources such as foreign exchange become endogenous to the computation. With demand exceeding the supply of the resource, the shadow price of the resource may increase to levels at which hardly any individual project would qualify.

Source: Martinez-Vazquez et al. (1995).

BUDGET EXECUTION: ISSUES AND NEEDED REFORMS

Process of Budget Execution

Until very recently, Kazakstan used the cash execution method inherited from the Soviet Union. The government is now in the midst of reforming the process of budget execution through the introduction of a modern treasury function with assistance from IMF. Because this is a period of transition, many of the observations made in this section may be obsolete when this book is published. The intent is to identify issues with the current system, and, when the information is available, to identify the direction of intended government reforms.

MOF and *oblast* and *rayon* budget departments would ideally distribute expenditure authorizations among main departments in accordance with the approved budgets. The latter would, in turn, distribute expenditure authorizations among smaller spending units. The distribution of expenditure authorizations would be in line with a spending plan (Smeta), to spend a given amount for specified goods and services during a quarter. Payments would be processed from the central account of the Treasury kept at the regional offices of NBK. To finance expenditures at the central level, quarterly allocations of funds would be placed in a bank account at the disposal of the budgetary spending unit. In fact, this was not done by MOF before 1996.

In the recent past, the payment process was initiated by a payment order from the budgetary unit, identifying purpose and nature of expenditure by the appropriate codes of the budgetary classification. NBK checked the payment order for conformity with the spending plan, and payment was implemented either in cash, or by a transfer to another accounting system. NBK operated de facto as the Treasury for the government and kept an accounting

system parallel to that kept by the spending agencies.

One important development in budget execution procedures in the recent past was the attempt to link expenditure payments to actual cash collections. Before, as in the former Soviet system, government spending was fully separated from revenue collection. Periodic allotment of funds depended on the progress made in tax collections. In practice, often only fractions of the quarterly or monthly appropriations were advanced and the rest of the funds were transferred, depending on revenue availability.

Once the spending unit had been credited with the funds, it could write checks up to the maximum authorized in the budget. Spending units could not overdraft their bank accounts. The unit was supposed to report monthly the actual balances drawn from the account. However, this could differ from the expenditures the spending unit had accrued during the period. This is how substantial arrears can occur within the budget system.

The current government plans are to control expenditures through the use of obligation accounting based on issuance of warrants and subwarrants, as part of the deployment of the treasury system. Warrants are to be issued only for expenditures approved in the budget, by institution, program, subprogram, and economic classification of expenditure. The goal is to prevent the recurrence of budgetary arrears by monitoring the issuance of subwarrants. This system should be effective in preventing accumulation of arrears, perhaps with the exception of budgetary arrears for wages and salaries at the subnational level, which may not be brought under control until the enactment of civil service reform. The government plans are to switch spending authority currently allocated on a five-day basis to a system that commits funds budgeted for periods of two weeks or even a month. At present, subwarrants are being used to monitor line items only at the central government level.

The government needs a Consolidated Revenue Fund, into which all revenues are deposited and from which all disbursements are made. In fact, budget execution has taken the form of enterprises paying taxes into the government's revenue accounts at the NBK branches throughout the entire country. Payment periods differ depending on the type of taxpayer. In the past, the lack of a treasury with a single account caused significant cash management problems. There were often situations when accounts in some regions had surplus funds, while funds in other regions were rationed for the lack of liquidity. NBK has established a single government account, as recommended by IMF.

Main Problems in Budget Execution

Effective Expenditure Control and the Treasury Function. The most serious flaw in Kazakhstan's budget execution process has been the lack of an efficient control of expenditures. In most Western countries, the execution of the budget is based on a four-stage procedure which facilitates ex ante control of government expenditures. These four stages are as follows: (i) the commitment of expenditures, meaning that budget appropriations are authorized, contracts are signed, and procurement is initiated; (ii) the contracting stage, only meaningful for investment and subsidy programs; (iii) the verification stage in which work is completed, bills received, and the obligation to pay is verified by each spending unit; and (iv) the payment stage. In Kazakhstan as in the rest of the FSU, both at the central and subnational levels, control of expenditures has been done at the payment stage rather than at the commitment stage (Ter-Minassian et al. 1992). Actually, the effective constraint on expenditures has been exercised by limiting the amount of fund transfers to the spending units. This means that there had been no information on spending until the payment obligation had actually been generated. This practice has led to difficulties in the control of expenditures and the accumulation of undesired arrears.

Responding to the lack of a mechanism for the control and monitoring of spending before the payment stage, MOF, with technical assistance from IMF, and with financing from a World Bank loan, established a treasury department within the Ministry in 1994. The World Bank approved a loan to implement the treasury function and the new treasury is being tested with a pilot project in Almaty City during 1997. The current plan is to have the system replicated throughout the national territory during 1998/99. The treasury department has been working on the deployment of a treasury system which will require all spending units to report their operations at the commitment, verification, and payment stages. The new approach should allow the government to exercise effective spending controls and have updated information on government commitments and expenditures. Current plans are for interim use of a system of Budget Banks to take over from NBK, to extend to subnational governments many of the budget execution functions of the new treasury (especially the cashier function), including cash settlements and management, intergovernmental splitting of shared revenues, and daily reporting of cash balances.

Lack of Financial Management. The lack of proper financial practices had been pervasive at all levels of government. There

was no attempt at cash management to take advantage of the pooling of funds into a centrally managed general fund. The single treasury account is designed to take care of this problem. Central management of cash funds minimizes idle excess balances, while maximizing interest received on cash balances. Just as important, active cash management would also permit regulating the flow of cash so that disbursement requirements are met in a way that minimizes interest paid on borrowing. Creation of a Consolidated Revenue Fund, as provided in the draft budget law, will provide a framework for improved cash management.

Insufficient Degree of Disaggregation in Budgets for Execution Purposes. Until recently, central and subnational budgets have appropriated funds at a level that is too aggregate by western standards. A *rayon* or city budget, for example, might run only a few pages. Execution and control of the budgets could thus be improved by appropriating the budget at a paragraph/item level. This is one purpose and effect of the new budget classification that was introduced in 1996. It provides details by function, institution, program, and economic category.

There is a clear tradeoff between the degree of execution flexibility allowed in the budget and the effective control of budget execution. At present, a large portion of budgetary allocations is decided administratively, because administrators control the number of people hired as well as their job titles and pay. On the other hand, leaving more discretion to the implementing units about what inputs to hire for the delivery of services has clearly increased the efficiency of expenditures. For the first time, there have been attempts to reduce excess capacity and to close underused facilities in Kazakhstan. A reasonable compromise is to mix flexibility in the use of funds with a system that ensures accountability for the effective use of funds to control corruption or simply unwise uses. These mechanisms should be worked out throughout the implementation of the new treasury system.

The Practice and Consequences of Budget Sequestering. The repeated shortages of funds have created harsh budgetary conditions over the past several years. Spending managers have found themselves repeatedly rejustifying and redrafting budget plans as cuts were made in allocations. In an effort to meet the balanced budget conditions, the central and subnational governments have been operating on a very conservative basis in the execution of the budget with some sort of sequestering in place; that is, authorizations for disbursement in excess of revenue collections have not been allowed. Although such responsible

budget practices are laudable, especially because of the present macroeconomic conditions in Kazakhstan, they also carry the risk of significant perverse results. Because payment of wages and salaries takes highest priority (despite the accumulation of arrears to employees), sequestration means that expenditures of other types must bear the brunt of sequestration. Thus, relatively small reductions in available spending may imply large percentage deductions in nonpayroll expenditures. Without a detailed plan from policymakers on priorities for all items in the budget, sequestering de facto empowers those officials in charge of budget execution with the right to redirect budget priorities. The room for distortion is larger, the smaller the share that is eventually executed out of the planned budget. The lack of intersectoral reallocation, fostered by sequestering, favors the delay of program completion. Overall, sequestering allows little continuity in policy implementation, and it may be too costly a mechanism of deficit control. At some point of budgetary shortfall, it becomes more desirable to adopt a revised budget plan. An improvement, now being pursued, is to establish a strong system of expenditure controls, while allowing spending units to plan their spending ahead of time. An even more effective approach, indeed, an essential one, is to have a sound budget formulation system which focuses more on allocating expenditures within a framework of realistic revenue estimates. Even with strong expenditure controls, unless the budget itself is realistic, it creates expectations which cannot be realized, thus forcing MOF to resort to sequestration; this makes budget policy and formulation meaningless.

As budgetary conditions and control mechanisms have improved, sequestration has yielded to the release of funds based on forecasts of revenues. This has improved the capacity of ministries and subnational governments to plan. It is hoped that further improvements will allow monthly or quarterly releases of funds.

Extensive Use of Budget Arrears. The central government, and most subnational governments as well, appear to have used arrears or the postponement of payments due as a source of regular financing.¹⁴ Arrears can be quantified as the difference between cash payments and payment orders. Arrears may also arise by delaying the processing of incoming bills prior to the writing of payment orders. The actual size of the arrears is not known but at

¹⁴ Arrears on the expenditure side may mirror, but are not justified by, taxpayers' arrears on the revenue side of the budget.

least at the subnational level they are very sizable. The level of arrears should become more readily apparent through better reporting. The lack of a warrant system in the past, in combination with the use of cash accounting, helped governments hide a portion of their budget deficits. The amounts in arrears should be shown in reports as memorandum items attached to the budgets. Current plans are to improve this type of reporting. From a practical viewpoint, carrying arrears only offers governments temporary relief. Prices charged by suppliers will tend to be adjusted upward to compensate for the additional financial costs of delayed payment. More often than not, total costs for governments will be higher when arrears are significant.

Poor Control of the Budget Deficit. Perhaps the most significant deficiency in the budget execution process has been the lack of effective control of the budget deficit at the central and subnational levels. Controlling the budget deficit not to exceed the level at which it was programmed is the most basic measure of performance in budget execution. In Kazakstan, much of the budgetary deficit can be traced to the liquidation of intra-enterprise debt. As noted in Chapter 1, the budget was roughly in balance for regular operations in 1994. The budgetary process was not sufficiently oriented toward containment of the budget deficit, despite the fact that this should have been one of its essential aims at the central level, and that subnational governments are supposed to operate with balanced budgets. Past budgetary practices let spending units commit funds when funds were not available or accumulate arrears. These issues are again being addressed by the new treasury system.

Accounting System. Proper control of budget execution requires the existence of a good system of public accounts (Jaruga 1990; Jónsson 1990; Premchand 1995). The accounting system must be capable of producing accurate, detailed information for the officials implementing programs and summarizing information for higher authorities and the public at large on a regular, timely basis. The current system of accounting is still basically the one the Soviet Union introduced in the 1960s, establishing centralized accounting systems for all individual spending units. Perhaps the most serious limitation of accounting practices has been that they fail to perform adequately the two major functions of an accounting system: (i) to provide controls over an organization's spending, and (ii) to provide information to the management. MOF has been preparing a new chart of accounts to be introduced as part of the full deployment of the treasury system.

Budget Reporting and Information. The reporting system of

the past produced a considerable amount of information, but this information was not always as timely, useful, accurate, or complete as it should be. All spending units, including *oblast* governments, reported monthly to MOF on the use of their funds; and *rayon* and city governments reported to *oblasts*. Information on budget execution was also received from NBK and STC. However, the information from all these sources was often inadequate and late. MOF has been planning a new reporting system that will correct these problems.

Procurement Practices. Purchasing procedures are an important part of budget execution and financial management. Procurement practices by public entities still need to undergo major changes reflecting economic reforms. Spending agencies must carry out their own purchases, and they must do so in an environment where the banking system is not functioning well for payment transfers, hard currency is in short supply, and many suppliers have disappeared. Because cash is in short supply, agencies at all levels must sometimes rely on barter arrangements.

There is, at all levels of government, a lack of standardized procurement procedures. Government agencies typically lack quarterly and monthly purchasing plans, competitive bidding requirements for contracts above a certain level, standardized specifications for procurement, and regulations to prevent conflicts of interest.

Training. As in other areas of the budget process, the reforms suggested here will require a significant investment of resources for personnel training.

Recommendations on Budget Execution

- *Continue with deployment of the Treasury Department.* A critical step in the modernization of the budget execution process will be the final deployment of the treasury system within MOF. The Treasury Department should control the financial execution of the budget and of the extrabudgetary funds, at both subnational and central levels. The project under way, sponsored by the World Bank and IMF to establish the new treasury within MOF, appears to address most of the problems identified with budget execution.
- *Use budget classification in the execution phase.* The IMF budget classification system now being used in preparation of the budget should also be used in the execution of the budget, to ensure the correspondence of executed

expenditures with approved budget authorizations. The new treasury network will perform this type of monitoring.

- *Personnel allocation decisions should be in the budget.* Even though it is desirable that budget managers be given discretion and flexibility in the use of funds, the budget still should be the basis for personnel allocation decisions. The budget should contain adequate detail to provide for control over both positions and pay. Adequate controls over establishing positions and hiring staff are essential to effective financial management. Effective reform in this area may be impossible without civil service reform.
- *Institute commitment accounting for investment expenditures.* This will be a key tool to improve the overall efficiency of capital expenditures and to control the problem of unfinished projects both at present and whenever subnational governments take over some capital investment responsibilities.
- *Implement better control of the budget deficit.* All levels of government need to deploy current plans to ensure that budget limits are not exceeded.
- *Reform the accounting system.* The undergoing reform of the accounting system should have the goal of supporting the control of budget execution. The accounting system should record all financial and nonfinancial transactions, and should produce timely, accurate, and meaningful financial reports. It should use the same classifications and concepts as the budget so that financial reports compare actual to budgeted spending (Asselin 1994).
- *Improve the reporting system.* Equally important is to go ahead with current plans to improve the reporting system. A modern budgeting process requires the establishment and maintenance of a coordinated two-way system of reporting for both policy setting and budget management and control. The communication system must be fully automated and include all units actually executing the budget. It should also include extrabudgetary activities and loans, as envisaged in the draft budget law.
- *Reform procurement practices.* General rules for the procurement of goods and services need to be applied to encourage more effective use of funds and to prevent fraud. These rules should include the following: (i) require purchases only from lowest-cost sources, except in unusual circumstances; (ii) require special approval of high-cost purchases; and (iii) prohibit purchases from those who have

a business or family relationship or any other conflict of interest with those doing the purchasing. Similar rules concerning the use of cash, the hiring of personnel, and the use of funds for travel and other purposes should be developed.

BUDGET CONTROL, AUDIT, AND EVALUATION: ISSUES AND NEEDED REFORMS

Background on Budget Compliance

In theory, three different budget compliance functions are required in this phase of the budget cycle: (i) internal control and audit carried out by the government agencies themselves, to check the legality of disbursements; (ii) external audit carried out ex post by an independent institution or one that reports exclusively to the legislative branch of government, to verify the legality and correct use of funds by the different spending agencies in the executive branch; and (iii) the evaluation of budget programs, carried out by several institutions, with emphasis on outcomes and performance with the purpose of improving the effectiveness of government expenditures. These three modes of compliance are complementary and reinforcing.

Budget compliance measures and practices may be the weakest link in the budget cycle of Kazakhstan. Internal audit and control practices were strong and effective under the Soviet Union, but these institutions have been transformed and weakened during the past four years of transition. Internal ex post audit is carried out by the State Committee on Financial Control, an agency now under the authority of MOF. Having authority over all central government agencies and all subnational executive bodies, this committee has its central office in Almaty, division offices in the *oblasts*, and departments in *rayons* and cities. The general perception is that audit activities have been relaxed and that they are especially weak at the subnational level.

Ex post monitoring and audit are weak at all levels of government. In late 1995, external ex post audit at the central level was not being conducted because of the dissolution of the Parliament by Presidential Decree earlier in the year. In 1996, a committee called "Calculating Committee" was established under Article 66.9 of the new Constitution to oversee execution of the republican budget. At the subnational level, Clause 18 of the Law on the Budgetary System provides that external audit and control

of subnational government budgets should be carried out by auditing commissions of the *maslikhats*. Although this is the proper approach to external audit at the subnational level, it is unclear how well (indeed, whether) this institution has been working.

Need to Rebuild Internal Compliance

Internal control and audit in theory should be carried out by each spending unit in the entire public administration. The objective is to prevent and uncover breaches of administrative and accounting regulations and the fraudulent use of funds. Internal control of compliance with the objectives and procedures of the administrative unit should be carried out by those in charge of the ordinary operations of the administrative unit. Internal audit of the financial and administrative operation should be carried out by specialized personnel of the internal audit unit within the administrative unit who do not participate in the planning or operation of the programs they audit.

The State Committee on Financial Control has emphasized matching disbursements with budget authorizations; it has paid less attention to auditing expenditure programs. There is also a lack of specific regulations for financial transactions addressed to those public officials in charge of managing public funds.

Recommendations for Internal Audit Reform

The following steps should be taken to improve internal audit:

- *Strengthen ex ante controls.* This should be one of the main objectives of the new treasury at both the central and subnational levels.
- *Establish rules and regulations for administrative sanctions.* There is a need to use personal sanctions to exert an effective control on personnel misusing financial resources of the state. Many countries use a system of shared responsibility for infractions or the fraudulent use of funds. The proposed national budget law provides for both criminal and civil penalties for misuse of public funds. Specific regulations need to be developed to effectively enforce this provision.
- *Establish rules and regulations for the management of public funds.* There is also a clear need to establish rules and regulations for conduct of public officials in the handling of public funds, procurement, conflict of interests, and other

aspects of financial transactions and the discharge of public functions.

- *Establish explicit rules and procedures for internal audit and control.* To increase the effectiveness of ex post administrative controls, it is necessary to define precisely the legal framework backing the ex post controls, the methods and instruments for the ex post controls, and the procedures to be followed during the ex post audit.
- *Keep the State Committee exclusively in charge of internal audit.* The institution now most clearly in charge of internal audit, the State Committee on Financial Control, needs to concentrate more on internal audit and less on other peripheral functions. Adequate means and training programs should be provided to the State Committee to increase its effectiveness.
- *Complete and reinforce the external audit function.* An effective system of budgetary compliance cannot rest exclusively on internal audit and control mechanisms. The executive branch of government ultimately cannot be expected to be strict and objective about its own operations. A fundamental component of most budget systems is the existence of an audit institution that is either fully independent (see Box 6.5 for the case of Germany) or that reports exclusively to the legislative branch of government (see Box 6.6 for the case of the US). Such institutions are charged with the final oversight and ex post audit of all budget expenditures. The main objective is to prevent and uncover inappropriate or fraudulent use of funds. As indicated, this external function is at present not operative at the central government level and it appears to be hardly operative at the subnational level.
- *Establish an external audit.* There is a need to overcome the lack of a tradition in external audit. In particular, the Soviet Union never had an independent ex post audit function in the budget process. At the central level there is a need to implement the external audit institution. At the subnational level it is necessary to develop the external audit committees dependent on the *maslikhats*.
- *Establish an effective budget evaluation function.* Budget evaluation should become an integral part of the budgetary cycle in Kazakhstan. The evaluation function is a complement of the traditional functions of internal and external audit. The focus of the evaluation function is on the effectiveness of public expenditure programs. The evaluation function

has become an integral part of modern budgeting systems (see Box 6.7). Budget and public policy evaluation use rigorous methodologies in combination with ex post performance data. This allows re-examination of the relevance of the program objectives vis-à-vis the problems and the needs initially identified, and of the correspondence between the resources allocated to the program and final performance (Ball 1993; Gore 1993). Ultimately, budget evaluation provides critical information and feedback to policymakers in the formulation of new budgets.

- *Evaluate budget practices.* Budget evaluation practices are essentially nonexistent in Kazakhstan. This is largely a result of a budgetary tradition in the FSU that put no emphasis on evaluation of programs and a little emphasis on finding the most economical way to accomplish budget objectives. No budget program at any government level in Kazakhstan appears to have been reassessed in response to a formal evaluation program. Current budget reviews are not expected to produce suggestions on ways to economize, and budget managers are not given any incentives to economize in the use of these funds.
- *Assign budget evaluation responsibilities.* Responsibilities for budget evaluation should be assigned to the external audit institutions at the central and subnational levels and to budget departments of the subnational governments and of MOF. The relevance of the latter assignment is the fast feedback and response of budgetary policies to the findings of program evaluations.

The budget department of MOF and similar units at the subnational level should be in charge of (i) developing evaluation policies, (ii) designing the methodology for formal evaluation plans, (iii) coordinating findings and recommendations for government-wide application, and (iv) supervising evaluation programs by the sectoral departments (see Box 6.8). The evaluation units should provide guidance on cost measurement and on possible management improvement in ministries and other government agencies. These units should also assist problematic ministries and other spending units in devising plans for retrenchment based on an identification of core and noncore activities. The units in charge of evaluation should undertake formal reviews of efficiency in selected areas of government, including the operations of extrabudgetary funds.

To facilitate decisions on the allocation of resources between competing functions, the budgets should include “performance measures.” These measures indicate the specific results expected if the request is approved. At present, the budget generally includes information only on inputs, although information on expected output is provided at times for some programs. For example, at present, budgetary provision for hospitals is made on an input basis, according to numbers of medical and ancillary staff employed, requested provisions for maintenance of premises, and equipment purchases. However, there is no quantification of the outputs to be sought through deployment of these resources in terms of numbers of patients treated and types of treatment; therefore, there is no basis for determining whether the hospitals are providing value-for-money.

Box 6.5. German Federal Audit Office

The control of the federal finances in Germany is exercised by the Federal Audit Office. The control of state agencies in each of the *Länder* (state) is performed by the audit office of the respective *Länder*. Under the Constitution, the Federal Audit Office oversees the accounts of the federal government and examines the cost-effectiveness and conformity with the law of its budgetary and economic management. Under the Constitution, the members of the Federal Budget Office enjoy the same independence as judges. This model contrasts with the Anglo-Saxon tradition which makes the comparable institution an agency exclusively responding to Parliament.

- *An Independent Agency.* A Law of 1985 specifies that the Federal Audit Office shall assist both the government and Parliament. The office itself determines what will be subject to audit and the modalities of such audit. Nevertheless, because effective exercise of control over the budget by Parliament presumes assistance from the Audit Office, it maintains direct relations with the different legislative bodies, submitting numerous reports to budget committees, audit committees, and to specialized committees regarding any law having a fiscal consequence.

In the German Federation, the audit offices of the different *Länder* are independent from each other. However, given the multiplicity of joint actions, cooperation among these offices is a daily matter, facilitated by the fact that there is a

single budget law applicable to all *Länder*, and the structures of the administrations are similar. But in contrast, for example, to the French audit organization, Germany's Federal Audit Office does not have judicial authority, and its decisions are not directly enforceable. Instead, it limits itself to criticism and advice.

- *A Control Agency.* The competence of the Federal Audit Office is mandated in the Constitution, and it includes controlling the financial management of all federal agencies, ministries, the Office of the President, and Parliament. In addition, its authority extends to all public industrial and commercial establishments, the Central Bank, the banks governed by public law, the enterprises legally dependent on the federal government, and the public law agencies receiving subsidies from the federal budget.
- *An Advisory Function.* On the basis of experience gained in the course of its audit work, the office is able to provide advice when it participates in the annual budget negotiations between the Finance Ministry and the other departments and in the deliberations of the Parliamentary Budget Committee.
- *Consensual Appointment of President and Vice President.* The president and vice president are appointed for 12-year terms of office; they are elected by Parliament, by secret ballot, upon nomination by the government, and appointed by the President of the Republic. This serves to ensure that they will enjoy extensive trust and collaboration, which facilitate the impartial performance of their duties.
- *Well Staffed.* The office has 400 examiners, who are experienced officials selected for their familiarity with the matter under examination and the decision structures. Their audit can, therefore, go beyond accounting verification of budget sections and focus on global examination of administrative procedures and the impact of public policies. The office is even empowered to examine decisions likely to have a financial impact, such as construction of public buildings or facilities. It can also draw attention to possible weaknesses or irregularities even prior to execution and require corrections. The criteria for audit are, pursuant to the law, a good relationship between cost and result of budget programs and conformity with the rules and principles of financial management.
- *Effects of the Audit Reports.* The Audit Office first communicates its findings to the department or entity audited with the objective of first exchanging views. Then it summarizes the findings of its audits in its annual report to

Parliament and the government. A part of this report relates to the federal budget and property accounts, but the principal focus is on budgetary and economic management. The findings of the audits are examined by the Parliament's Audit Committee, which utilizes this information in preparation for the next year's budget debate. The Parliament's Budget Committee may also make its approval of any new appropriation for an agency contingent upon correction of the problems identified in the audit.

The Audit Office reports, therefore, serve as important instruments for public information and public policy by encouraging the administration to collaborate in the correction of mistakes. Finally, the Audit Office can notify Parliament and the government at any time of matters of special importance, if it wants to draw the attention of Parliament or public opinion to certain problems.

Source: World Bank (1995a).

Box 6.6. The General Accounting Office of the United States

This respected institution shares numerous common features with the higher audit and control agencies of other countries, but it has the special characteristic of being dependent on Congress. The chief functions performed by the General Accounting Office (GAO) are assistance to Congress in its legislative capacities and in the exercise of its oversight functions, evaluation of federal government programs and operations, including the functioning of the federal services, and the formulation of rules to be applied in the effecting of public expenditures. GAO is empowered to audit any operation or program financed wholly or partially with public funds. However, GAO does not get at all involved in state and local issues. Each state has its own independent budget audit office.

- *An Agency Answerable to Congress.* Around 80 percent of the GAO's workload is generated directly by Congress, and the rest consists of studies undertaken at its own initiative. GAO findings are set forth in reports addressed to congressional committees, presentations made to members of Congress, and legal and financial opinions relating to bills. It produced 880 reports in 1989. In the same year, GAO's Comptroller General and his staff made 220 depositions to Congress. The presentations to committees or individuals are intended to set out the results and recommendations in the GAO reports, and also to provide useful information in the hearings of other persons or institutions testifying before

Congress. A report is published each year in which GAO underscores questions warranting special attention from Congress. This report mentions recommendations that have not been acted upon so that Congress can take such factors into consideration when examining requests for budgetary appropriations. To preserve an objective approach in the controls and audits GAO conducts, the Comptroller General has recently instituted a periodic audit of all control sectors.

- *A Consensual Appointment.* GAO is headed by a Comptroller General who is appointed for 15 years and selected by the US President from a slate of candidates proposed by a committee made up of members of the two main political parties.
- *An Institution with Substantial Means.* GAO has a staff of 5,100 possessing varied qualifications: accountants, engineers, economists, computer specialists, among others. It is organized in divisions dealing with functional matters, such as public contracts, human resources, the environment, and national security, and in methodological divisions, including evaluation of public programs. Great importance is assigned to the methodological approach, with each audit comprising an evaluation phase in which the staff examines the justification for the audit, its cost, possible methods of evaluation, the objectives to be attained, and the areas that will be checked. This approach facilitates a detailed plan of the audit program, together with a meaningful ex post evaluation of the audit itself.
- *An Institution that Lays Down Accounting Rules.* As guardian of the integrity of the managers of public funds, GAO has issued rules governing the internal control systems of federal agencies. It constantly monitors their management methods to evaluate the global management policy of the federal services and to keep Congress and the executive informed.

Source: World Bank (1995a).

Box 6.7. International Practices in Budget Evaluation

International experience shows a variety of approaches to budget evaluation (Diamond 1990). It is common to find that budget evaluation is carried out using a wide range of institutional resources. Budget evaluation is carried out by institutions traditionally in charge of ex post external audits, institutions carrying out internal audits, budget planning offices, and sometimes private sector institutions under contract, including universities and research institutions. Countries, such as Belgium, Chile, Japan, and Switzerland, have assigned responsibility for budget evaluation to their supreme audit institutions, thus expanding their traditional roles in control and audit.

In other countries, the evaluation function is entrusted to the Budget Office. In Argentina, the recent Law on Financial Management and Control Systems of the Public Sector of 1992 gives the National Budget Office, which is primarily responsible for the formulation of the national budget, the responsibility for determining the norms and procedures for the evaluation of all budget expenditure programs and to carry out these evaluations.

In Canada, the Office of the Comptroller General, an office dependent upon the Treasury Board primarily in charge of internal government audits, has been given the responsibility of developing program evaluations. To this end, all spending units in the government are required to prepare five-year evaluation plans with the goal of facilitating a systematic review and assessment of their programs' operations and results.

The approaches followed in some countries are more complex. In the US, the evaluation function is actually accomplished by a number of agencies, all of which use a more or less common methodology. However, most program evaluations are carried out by GAO, the supreme audit institution in the country. GAO has a specialized department in charge of carrying out the evaluation of public expenditure programs. Often, these evaluations in the US are actually carried out by academic and research institutions under contract with GAO.

In Germany, evaluations are carried out by several institutions, including individual ministries and the independent Federal Audit Office. Parliamentary commissions also conduct evaluations for legislated programs and new policies and social experiments.

In France, budget evaluation programs are coordinated by the Supreme Council for Evaluation (le Conseil supérieur de l'évaluation). The Supreme Council does not have a large staff and does not perform

many evaluations itself. Instead, the role of the Council is to distribute funds for evaluation purposes through a competitive bidding system. Qualifying institutions bid for particular evaluation projects, presenting in their bids a detailed description of the methodology to be followed in the evaluation.

In some countries, periodic evaluations of certain programs have been routinely inserted in the legislation enabling the program, or in the text of the budgetary appropriations. This approach has been used often in France, where there are plans for a more systematic use. Potentially, each legislative proposal would be accompanied by an evaluative study quantifying as precisely as possible the impact of new policies.

Source: World Bank (1995a).

Box 6.8. How is Budget Evaluation Performed?

- *Timing and Coverage.* Evaluations are carried out periodically during the execution of budget programs or ex post. However, not all government activities need to be evaluated on a regular basis because in some cases the costs of evaluation may be higher than the benefits produced. The areas to evaluate should be chosen carefully and in accordance with objective criteria. Because there are disagreements on the importance of particular evaluations across the different branches of government, it is common for evaluations to be carried out by different institutions.
- *Content.* Evaluations should contain a critical analysis of financial and physical performance for the final outcomes of the programs, an explanation of the deviations in results from stated objectives, and recommendations for policymakers and those responsible for the budget program to implement the necessary changes.
- *Methodology.* The methodologies used for evaluation rely heavily on the social sciences. The evaluation of a budget program relies heavily on the measurement of its efficiency and performance. The general object of these techniques is to establish on a scientific basis the relationships between the resources used in a program, the actual outcomes, and the initial objectives of the program. The use of sophisticated methodologies have had the benefit of elevating the discourse to higher and more objective standards. These methodologies also have facilitated the demonstration of conflict between

the declared objectives of a program and those actually pursued in the implementation of the program, or the disclosure of perverse or undesirable effects. But ultimately, the effectiveness of these methodologies depends on how explicitly performance indicators for the program have been defined. In this respect, two different approaches have been developed for budget evaluation. In the older tradition in countries where budget evaluation has been performed for many years (such as Australia, the United Kingdom, or the US), evaluation has been based on bureaucratically defined standards with less explicit performance indicators. Recently, those countries with the most innovative approaches to public financial management, such as Argentina and New Zealand, have put more emphasis on the definition and quantification of performance indicators for individual spending units. This facilitates significantly the evaluation of each individual agency performance.

- *Measuring Efficiency.* Two different types of efficiency are generally identified. Technical efficiency refers to the correct use of available technologies. It is achieved when the maximum level of output is obtained with the inputs actually used. Allocative or economic efficiency refers to the production of a level of services or output with the least possible cost. The achievement of allocative efficiency presumes that technical efficiency is being attained, but, in addition, that the input combination or technology used is the one that minimizes the costs of production. The techniques used for the measurement of efficiency range from simple analysis of input ratios, to regression techniques relating unit costs to levels of output, to frontier analysis. The latter is a more sophisticated use of statistical data recognizing the difference between the most efficient units of production (those on the frontier) and other less efficient units. The practical application of the concept of efficiency to the public sector is made more difficult by the multidimensional nature of the public function and the complexity of quantifying actual outputs.
- *Measuring Performance.* Efficiency is part of the measurement of performance. However, the strict measurement of efficiency is not always possible due to the lack of data. In addition, performance is a wider concept which includes (besides efficiency) the concepts of quality of the goods or the standards of service provision, and the overall quality of the contribution by a particular organization. Performance also implies a degree of accountability for the

results achieved, and consequently a potential reaction by decision makers or by the public at large.

The measurement of performance generally relies on the use of performance indicators. These indicators should help relate the objectives of the program, the resources allocated to the program, and the actual outcomes. Common indicators include (i) volume or number of cases handled; (ii) average productivity and costs; (iii) time frame for task completion; (iv) demand for the service versus availability of the service; and (v) general fulfillment of the overall goals of the organization. To be useful for management control and policy making, performance indicators have to be compared to anchors or benchmark indicators. The latter can be represented by particular norms or standards, time series of past experiences, actual performance in similar activities, or performance in control groups. Data on benchmark indicators have become more available by the increasing adoption of management information systems in the public sector.

- *Evaluation.* By itself, evaluation has the objective of improving program and agency effectiveness and it is viewed as an aid to decision making and management. Management-oriented evaluation seeks to stimulate awareness in three areas: (i) policy and program formulation; that is, to what extent objectives are still relevant, what new objectives are desirable, and what the clients' needs are; (ii) program implementation; that is, the suitability and effectiveness of organizations, their methods, procedures and time tables; and (iii) the impact of completed programs; that is, the distribution of benefits, other unintended effects, and possible wastage of resources.

Once programs to be evaluated are selected, an initial determination needs to be made regarding the kind of information required and the sources of that information. It is also necessary to determine over what period of time the questions will have to be answered. Determining the design of the evaluation involves a choice between a sample survey, a case study approach, a field experiment, or the use of data already available. The process of evaluation begins with data collection and analysis and concludes with reporting to the relevant authority. Accountability is incomplete if the findings of an evaluation are not made available to the general public. Timeliness of the reports and concrete clients on the policy-making side are crucial for relevance. These aspects underscore the importance of systematic and sustained evaluation practice.

Sources: World Bank (1995a); Premchand (1993).

Developing meaningful measures will not, in most cases, be an easy task. But having some way to quantify outputs is critical to the evaluation function. Typically, simple measures will not serve the desired function. For instance, simply using the numbers of properties privatized as a measure without regard to the amount of money raised or the effects on the *oblast* or *rayon* economies would be shortsighted. Similarly, counting students without considering whether they are learning anything would also be inadequate as a policy guide. Performance measures will have to be tailored to each budget program activity with direct involvement of the implementing units.

There are other benefits to be derived from this difficult exercise besides controlling the use of public funds. In particular, the formulation of explicit evaluation benchmarks and measures for budget programs obliges policymakers to be more specific in ascribing expected outcomes to government programs. For the evaluation function to be effective, data on budget execution for the preceding year have to be produced on time and their evaluation systematically factored in the budget preparation, specifically to reduce those expenditures that are least cost effective.