Chapter 1. AN OVERVIEW OF PUBLIC EXPENDITURE MANAGEMENT

This chapter has two objectives. First, it places public expenditure management (PEM) in the broader context of the role of the state, good governance, macroeconomic policy, and the changing environment (especially in information and communication technology). To view PEM only through a technical prism would fundamentally distort the picture. Second, the chapter provides a quick run-through of the entire expenditure management cycle. This chapter can therefore serve as a map of the book for the thorough reader, as well as a stand-alone sketch of the key issues for the busy public official (who should also read the last section of the concluding chapter 17). For both types of readers, we hope this brief overview will at least bring home the point that the management of public expenditure is neither a purely technocratic issue nor suitable for simple quick fixes, on the one hand, yet is always amenable to some practical improvement, on the other.

A. THE OBJECTIVES AND CONTEXT OF PUBLIC EXPENDITURE MANAGEMENT

1. The meaning and role of public expenditure management

The budget should be a financial mirror of society's economic and social choices. In order to perform the roles assigned to it by its people, the state needs, among other things, to: (i) collect resources from the economy, in sufficient and appropriate manner; and (ii) allocate and use those resources responsively, efficiently and effectively.[1] Public expenditure management pertains only to (ii), and is thus only one instrument, albeit a key instrument, of government policy. Hence, although this book focuses on PEM, readers are advised to always keep in mind the integral relationship between revenue and expenditure—i.e. between the money collected directly or indirectly from the people (and, in most developing countries, from aid donors), and the use of that money in a manner that reflects most closely the people's preferences.[2] Also, close cooperation between tax and budget officials is a must for many areas, e.g., budget forecasting, macroeconomic framework formulation, trade-offs between outright expenditures and tax concessions.

The question of the mechanisms by which the people's preferences are ascertained, political accountability is obtained, and government action is monitored, is central to politics and very important, but outside the scope of this analysis (as well as beyond the mandate of international development institutions).[3] Nevertheless, the analysis and discussion throughout this volume is largely predicated on the existence of *some* government legitimacy, *some* measure of legal and political accountability, and *some* separation of powers among the executive, legislative, and judicial branches of government. As a logical extreme, it would in theory be conceivable to "improve" PEM in a kleptocracy designed exclusively for the benefit of the power elite (as for example in Mobutu's Zaire), but it would certainly not assist the country's economic development. (The elements of good governance are summarized in the next section.)

That said, *public expenditure management is instrumental in nature*. There is a necessary distinction between the expenditure *policy* question of "what" is to be done, and the expenditure *management* question of "how" it is to be done. It is true that attempts to set hard boundaries between policy and implementation eventually lead to unrealistic policies, ad hoc implementation and, over time, both bad policy and bad implementation. However, the distinction between the soundness of PEM procedures and processes and the goals that they are meant to achieve remains very important. Among other things, the mechanisms, techniques, skills, and data required for good PEM are different from those needed to formulate good policy.[4] Accordingly, the analysis and discussion herein is generally applicable regardless of the economic orientation, strategic priorities, or policy choices of the government in question.

At the same time, however, it is fundamental to realize that *public expenditure management is country-specific*. PEM approaches and recommendations must be solidly grounded on the economic, social, administrative, and implementation capacity realities of the specific country. Like any other technology—from water pumps to agricultural fertilizers to construction—public expenditure "technology" must be appropriate technology, in terms of (i) local factor endowments, (ii) local institutions, and (iii) real local needs. Hence, *any* PEM innovation generated abroad must be carefully analyzed in the light of the local context and rejected, adopted, or adapted as needed. Particularly important for the analysis of applicability is an evaluation of the country's institutional framework and the availability of relevant and reliable data and sufficient skills. As an analogy, the scarcity of licensed builders, heavy

construction equipment, and firm soil in a particular location doesn't necessarily mean that houses shouldn't be built there, but certainly counsels against the building of skyscrapers—particularly when they may not be wanted in the first place. At the very minimum, external and national change agents must be mindful of the Hippocratic injunction "First, do no harm" (as well as today's colloquialism "If it ain't broke, don't fix it").

2. The policy context and the objectives of PEM

a. The policy context

The key goals of overall economic policy are conventionally defined as growth, equity, and stability.[5] It has long been understood that these three goals are complementary over the long-term. Economic growth provides the resources needed for poverty reduction, but cannot be sustainable if it is not accompanied by sufficient stability and equitable policies. Unstable economic and financial circumstances are inimical to growth, and typically hurt the poor most. But stability in a context of persistent economic stagnation and poverty is hardly a desirable outcome. In the short-term, however, these goals may be mutually conflicting, and a sound resolution is required (and hence a robust institutional mechanism) that takes all three into consideration in a coherent policy package.

b. The three key objectives of PEM[6]

As noted, public expenditure management is instrumental in nature. As a central instrument of policy, it must pursue all three overall economic policy goals. Financial stability calls, among other things, for fiscal discipline; economic growth and equity are pursued partly through allocation of public money to the various sectors; and, most obviously, all three goals require efficient and effective use of resources in practice. Hence, the three goals of overall policy translate into three key objectives of good public expenditure management: *fiscal discipline (expenditure control); allocation of resources consistent with policy priorities ("strategic" allocation); and good operational management.*[7] In turn, good operational management calls for both efficiency (minimizing cost per unit of output) and effectiveness (achieving the outcome for which the output is intended).[8] But in addition, as stressed earlier, attention to proper norms and due process is essential as well. This book shall return again and again to these three key objectives, but a few general considerations are advanced below.

There are linkages between the three key objectives of PEM, their corresponding major function, and the government level at which they are mostly operative. Fiscal discipline requires control at the aggregate level; strategic resource allocation requires good programming, which entails appropriate cabinet-level and interministerial arrangements; and operational management is largely an intraministerial affair. It should be stressed, however, that fiscal discipline and operational management are amenable to "technical" improvement than is the strategic allocation of resources. As Petrei, 1998 puts it:

> *"Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population's preference. The allocation of funds results from a series of forces that converge at different points of the decision-making process, with an arbitrator who ruled according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want. In any event, the effort made at this stage of the budget process to collect and analyze information is less than at any other stage."*

Our focus on public expenditure management should not lead us to forget the essential link between revenue and expenditure. The triad of PEM objectives can easily be expanded into a triad of *fiscal* objectives. Fiscal discipline results from good forecasts of revenue as well as expenditure; strategic allocation has a counterpart in the tax incidence across different sectors; and tax administration, of course, is the revenue aspect of good operational management of expenditure.

The scheme below summarizes these relationships.

Objective	***Revenue Function***	***Expenditure Function***	***Organizational Level***
1. Fiscal discipline	*Reliable forecasts*	*Expenditure control*	*Aggregate*
2. Resource allocation and mobilization	*Tax equity and incidence*	*Expenditure programming*	*Interministerial*
3. Operational efficiency *a. Economy* *b. Efficiency* *c. Effectiveness* *d. Due process*	*Tax administration*	*Expenditure management*	*Intraministerial*

This scheme is a simplification, intended to help fix the key concepts in one's mind. Reality is more complex. First, as noted, the three objectives may be mutually conflicting in the short run (and trade-offs and reconciliations must be made) but are clearly complementary in the long run. For example, mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Second, good aggregate budgetary outcomes must emerge from good outcomes at each level of government. For example, while fiscal discipline must ultimately be manifested at the aggregate level, it should emerge as the sum total of good expenditure control (and reliable revenue forecasts) in each ministry and agency of government, rather than being imposed top-down.

Therefore, an overall expenditure constraint is necessary but not sufficient for good PEM; on the contrary, imposing the constraint *only* from the top may result in misallocation of resources and inefficient operations. Typically, such top-down aggregate limits are intended to root out waste, fraud, and corruption. But waste, fraud, and corruption are hardy weeds. If the top-down limit is imposed *in isolation* and without any attention to the internal workings of the public expenditure system, the outcome may well be to underfund the more efficient and worthwhile activities, precisely because they do not carry benefits for the individual

bureaucrats and their private "partners"[9]. (Conversely, improving the internal systems without a hard constraint is not credible.) Similarly, the best mechanisms for inter-ministerial coordination are worth little if the sectoral expenditure programs are inappropriate or inconsistent with overall policy. Finally, management and operational efficiency cannot normally be improved except in an overall context of fiscal discipline and sound allocation of resources—to which good management itself makes a key contribution.

c. Complicating the issue

Reality is more complex in other ways as well. Although fiscal discipline, strategic resource allocation, and operational efficiency are in general the three key objectives of PEM, in most countries the budgeting system is expected to achieve a variety of aims. A. Premchand lists eleven dimensions of public expenditure management (Table 1).[10] Most of these dimensions can be readily reconciled within the triad of PEM objectives, and some are in effect different formulations of the same objective. However, the reality is that all these dimensions—duplicative or not—have come to be associated with public budgeting at various times. Because it is manifestly impossible for any budget system to conform to all these dimensions at the same time, a strategic decision is needed regarding which one or two or three of these dimensions to focus at a given time in the specific country concerned. Thus, although we will continue to refer throughout this book to the triad of PEM objectives, the inevitable simplification should be kept in mind.

{Insert Table 1}

d. A word about sequencing

If you can't count the money, you can't allocate it, and if you can't allocate it you can't manage it. Fiscal discipline, in many ways, comes first; resource allocation and operational efficiency come next. This is literally true in those few developing countries that have extremely weak revenue forecasts and cash management systems. In those countries, improving expenditure control is first and foremost, and any effort at addressing the other two objectives of PEM would be futile and possibly counterproductive. However, it is essential to: (i) design and implement improvements in expenditure control in ways that do not jeopardize the improvements in sectoral allocation and resource management which must eventually follow; and (ii) have a clear ex-ante sense of how far to push improvements in expenditure and cash

control before it becomes timely and necessary to address strategic allocation and management issues.

In countries where expenditure control and cash management are already minimally acceptable, none of the three PEM objectives of expenditure control, resource allocation, and good operational management should be pursued in isolation from the others (just as the overall policy goals of growth, stability, and equity are interrelated). Improvements in one or another area can and should go forward as and when circumstances permit (see the “torto-hare” approach to reform outlined in chapter 17). But a coherent vision of the entire reform process is needed to prevent “progress” in any one objective from getting so far out of line as to compromise progress in the other two, and thus the public expenditure management reform process in its entirety. Hence, a multiyear perspective is essential for good PEM. Specific reform priorities and sequencing considerations for each of the major components of PEM are suggested in the last section of chapter 17.

3. The institutional context

Several developing countries have accepted technical advice for decades and introduced innovations in their budgeting systems, to the point where the formal PEM system appears robust and coherent in every respect. Yet, efficiency of public expenditure remains poor, corruption is endemic, and public services are of worse quality and even less accessible than they were at the start of the “reforms”. Why? One explanation is found in the institutional dimension of the budget process.[11]

Colloquially, the term ”institution” is used as a synonym for “organization”. However, institutions are best understood as *rules*, and are thus distinct from the organizations that function under them.[12] To use a sports analogy, the game of football (soccer) is played better or worse depending on the players, but all players must adapt to the same rules; the “institution” of football does not change unless the basic rules are changed (e.g., by allowing the use of hands). Budgetary outcomes are profoundly influenced by institutions. Because institutions comprise both formal and informal rules, many technical “improvements” have failed because they were in conflict with the less visible informal rules and incentives. (This is especially true in very small countries and in multi-ethnic societies.)

Thus, for example, the tendency to overestimate revenues may stem from concrete incentives to do so rather than from technical weaknesses. (Two “stages” are normally involved here: first, the forecasts are deliberately manipulated to ensure the continued functioning of the patronage system; second, when expenditures must be cut owing to “unexpectedly” low revenues, cash rationing is used as a way to favor client and kinship groups.) Or, in a multi-ethnic country, a performance bonus scheme for budget officials may be perfectly designed on the surface but fail to produce improvements if it is inconsistent with the informal rule that demands that managers use their power to help members of their own ethnic group. Indeed, under these circumstances, the “innovation” may lead managers to manipulate expenditure forecasts and outturns in the interest of “their” people, and thus to a less efficient system.

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

- A design failure to take into account key informal rules is likely to lead to a failure of the budgeting reform itself. (As repeated elsewhere in this book, it was the unexposed part of the iceberg that sank the *Titanic)*;

- *Durable* institutional change, in general, and public budgeting, in particular, take a long time to be implemented successfully (a result of what Douglass North called “path dependence” [North, 1991]);

- One way to improve the *overall* institutional framework is to make the informal rules more visible;[13]

- Budget organizations and new units can be merged, restructured, recombined and created, but no change in behavior (and hence in budgetary outcomes) will result unless the basic rules, procedures, and incentives change as well. For example, simply merging a Ministry of Finance and a Ministry of Planning will not do much by itself to improve coordination of current and investment budgets.

4. The governance context

a. The link between governance and development

The risk of relativism inherent in the earlier statement that PEM "technology" is country-specific is obviated by the universal relevance of certain fundamentals of governance. The link between good governance and economic development has long been understood by many scholars, development practitioners, and, above all, the average man and woman in the developing countries themselves. However, a variety of considerations (primarily, the Cold War) kept governance away from the official concern of development institutions, and hence outside the technical advice and financial support for PEM improvements. Since the end of the 1980s, however, perceptions and policies have changed dramatically.[14] Even the remaining alleged exception to the link between governance and development (the East Asian "miracle") collapsed under the weight of the financial crisis that began in Thailand in July 1997 and quickly spread to Indonesia, Korea, and to a lesser extent to other Asian countries. It is now clear that fundamental public and corporate governance weaknesses were among the structural causes of the crisis. Since then, references to "Asian values" to justify practices inimical to good governance have been conspicuous for their absence.

b. The components of good governance

There is a general consensus that good governance rests on "four pillars": accountability, transparency, predictability, and participation. Accountability means the capacity to call public officials to task for their actions; transparency entails the low-cost access to relevant information; predictability results primarily from law and regulations that are clear, known in advance, and uniformly and effectively enforced; and participation is needed to supply reliable information and to provide a reality check for government action.

It is clear that none of these four components can stand by itself; each is instrumental in achieving the other three; and all four together are instrumental in achieving sound development management. For example, accountability mechanisms in the budget process are hollow if there is no reliable financial information, and meaningless without predictable consequences. Furthermore, all governance concepts are universal in application but relative in nature. Accountability is a must everywhere, but does not become operational until one

defines accountability “of whom”, “for what”, and “to whom”. Transparency can be problematic when it infringes on necessary confidentiality or privacy. Full predictability of inefficiency or corruption is not a great advantage. And it is evidently impossible to provide for participation by everybody in everything, and unwise to use participation as an excuse to avoid taking tough but necessary decisions.

c. Governance and public expenditure management

The relevance of these concepts to the various aspects of public expenditure management will be brought out throughout this volume. A few generally applicable considerations are provided below.

Lack of *predictability* of financial resources undermines of strategic prioritization and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for nonperformance to boot). Predictability of government expenditure in the aggregate and in the various sectors, is also needed as a signpost to guide the private sector in making its own production, marketing, and investment decisions.

Transparency of fiscal and financial information is a must for an informed executive, legislature, and the public at large (normally through the filter of competent legislative staff and capable and independent public media). It is essential not only that information be provided, but that it be *relevant* and in understandable form. Dumping on the public immense amounts of raw budgetary material does nothing to improve fiscal transparency. The IMF assembled in 1998 a Code of Good Practices on Fiscal Transparency (see Box 1 and Annex I), which underlines the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. While not all the specifics of the Code necessarily apply to all countries, its principles are generally applicable to developing and transition economies as well as developed countries.

Box 1
Selected Requirements for Fiscal Transparency

Clarity of Roles and Responsibilities

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

Public Availability of Information

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

Open Budget Preparation, Execution, and Reporting

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

Independent Assurances of Integrity

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

Source: International Monetary Fund (only a few requirements are shown here; see Annex 1 for more details).

Appropriate *participation* by concerned public officials and employees and by other stakeholders is required for the sound formulation of expenditure programs; participation by external entities, for the monitoring of operational efficiency; and feedback by users of public services, for the monitoring of access to and quality of the services.

Accountability is needed both for the use of public money and for the results of spending it. Because, through overuse, the term "accountability" has acquired mantra-like qualities (and has no exact translation in many languages), it is helpful to unbundle it at the outset. Effective accountability has two components: (i) answerability and (ii) consequences. First, answerability (the original meaning of the word "responsibility") is the requirement for central budget officials and sector ministry personnel to respond periodically to questions concerning where the money went and what was achieved with it. The dialogue itself matters, much more than any bean counting or mechanistic recitation of outputs. Second, there is a need for predictable and meaningful consequences (not necessarily punitive; not necessarily

monetary; not necessarily individual). This should be self-evident. However, the need for consequences of some sort is so often disregarded in practice that one must make the elementary point that without consequences, “accountability” is only an empty and time-consuming formality.

Largely because the PEM system, must be accountable both for the use of the public money and for the results of spending it, accountability in public expenditure management has two dimensions. Stronger *internal accountability* of budget system personnel to their superiors may be necessary, but is more applicable to “overhead” PEM activities (e.g., policy advice, macroeconomic forecasting, etc) than to sector ministries responsible for services to the public. For the latter, *external accountability* is needed as well. Particularly with the dramatic improvements in information and communication technology (see below), feedback from service users and the citizenry can now be obtained at low cost and for a greater variety of activities, and is an essential adjunct to improving efficiency and effectiveness of service delivery. Strengthening external accountability is especially necessary in the context of initiatives for greater decentralization or managerial autonomy, when new checks and balances are required to assure that access to and quality of public services is not compromised as a result.

There is also an inevitable “accountability trade-off” between clarity and relevance. Accountability can be clear and direct for narrowly-defined tasks, but is necessarily vague for broad and hence more relevant outcomes flexibility. Care must be taken not to dump responsibility for government malfunctioning solely on the public managers. Without predictability and clear lines of responsibility, the “new accountability” reduces to simple scapegoating of civil servants for the failures of their political masters.

d. A word about “performance”

All accountability must be for performance. Of course. But *“performance”, too, is a relative and culture-specific concept*. Government employees could be considered “well-performing” if they always stick to the letter of the rules, in a system where rule compliance is the dominant goal; if they account precisely for every cent of public money, in a system where protection of resources is the dominant goal; if they obey without question a superior’s instructions, in a strictly hierarchical system; if they compete vigorously for individual influence and resources, in a system where such competition is viewed positively; if they cooperate

harmoniously for group influence, in a system where conflict is discouraged; and so on. Whenever the word “performance” is heard, the immediate question should be: “In terms of what?” It is essential to understand that administrative cultures are not inherently superior or inferior (so long as they abide by the governance fundamentals discussed earlier), and that they evolve in response to concrete problems and incentive structures. Even when an administrative culture has become badly dysfunctional, it is still necessary to understand its roots if one wishes to improve it in a durable way.

This book’s general definition of performance is *the achievement of agreed results within the funding provided, without diluting their quality and respecting the prevailing norms of due process*. (With respect to public expenditure management, of course, performance should be assessed by reference to the three objectives of expenditure control, strategic allocation and good operational management). This definition attempts to bridge the gap between the traditional paradigm of public administration as “probity and propriety” and the “New Public Management” paradigm of “policy and performance”.[15] (Annex V summarizes the debate on the NPM.)[16] Our view is that “policy and performance” are indeed the appropriate model, but must be accompanied by respect for due process in order to be *sustainable*. In sum: (i) results orientation is necessary in PEM, *but* (ii) results must be properly defined, *and* (iii) an exclusive focus on results without consideration of process will not only destroy the process but eventually produce bad results as well.[17]

5. Corruption and public expenditure management

Although corruption in government is often identified with large procurements and major public works projects,[18] public expenditure is hardly the only source of potential corruption. Tax administration, debt management, customs, ill-designed privatization, the banking system, etc., can be equally troublesome in that respect. But certainly, one major route to improving PEM (and, of course, improving the quality of governance as well) is to reduce the opportunities for corruption in the process and punish corruption when it occurs. The reverse is also true: a major way of reducing corruption is to strengthen PEM. Quite aside from any moral or legal consideration, corruption weakens fiscal discipline; distorts the allocation of resources; harms operational efficiency and effectiveness; and, obviously, is antithetical to due process.

Definitions of corruption can be extremely complex. The simplest definition is as powerful as it is short: c*orruption is the misuse of public or private office for personal gain.* "Misuse" (unlike abuse") covers both "sins of commission" (i.e., giving illegal favors), and "sins of omission" (i.e., deliberately turning the other way). And the inclusion of the term "private" in the definition of corruption underlines the fact that there cannot be a bribe received without a bribe given. In the context of developing countries, this points out that much corruption is externally generated. Clearly, attention needs to be paid to the "imported corruption" as well as to the homegrown variety.

A remarkable, indeed historic, convergence of actions and policies has occurred in this area in just two years, 1997 and 1998, as a natural outgrowth of the earlier recognition of the governance-development nexus. The World Bank enacted an official policy against corruption in September 1997. Other multilateral development banks (MDBs) followed suit rapidly. The anticorruption policy of the Asian Development Bank was approved in July 1998 (see Annex IV for a summary), and anti-corruption cooperation among the MDBs has been strengthening since then[19]. At the same time, as noted earlier, the IMF promulgated the Code for Fiscal Transparency. Finally, the Organization for Economic Cooperation and Development (OECD—the "developed countries' club") succeeded in negotiating in December 1997 a landmark convention against bribe-giving, which entered into force at the end of 1998 (Annex ___). For the first time in history, the convention makes the bribing of foreign officials a crime at par with national laws concerning bribery of national officials—in all member countries of the OECD.[20] (In parallel, the OECD also adopted a set of principles for ethics in the public service—see annex II.)

Box 2
The Semantics of Corruption

The definition of corruption is clear, but one must beware of assuming that the same term reflects the same reality in different developing countries. While in some countries the word "corruption" may be reserved only for million-dollar bribes, inch-deep highway surfaces, and nonexistent schools, in other countries the word is used to include minor irregularities or minuscule conflicts of interest. In one South Asian country, for example, a major newspaper reported in a front-page article of September 1998 that:

> *The Government is to work out a modality next week to take action against Parliamentarians who are engaged in business activities with state or public institutions, the Minister announced. He cited the Supreme Court judgement on the case. The court decided that one parliamentarian was not suited since he was managing a petrol shed. "We know about several others who have fixed the official telephone to their business places in a way that Parliament has to pay for their telephone charges (equivalent to tens of dollars). We cannot allow this situation to continue anymore", the Minister said.*

Clearly, these practices are inappropriate and do fit into the strict definition of corruption. There is also a "slippery-slope" argument that zero tolerance is required if corruption is not to eventually become a large problem. But, in comparison with the level of corruption in other countries, such practices as quoted above are trivial. The terms used, however, are often identical. Therefore, a finding that corruption is widespread must be interpreted carefully in the light of just what is meant by corruption in the specific country's context.

Thus, although many economists, country officials, and development professionals had always been aware of the inefficiencies and inequities of corruption, it is only recently that the taboo on even mentioning the "C word" has been removed and a clear consensus has emerged: in the long run, corruption (i) is bad for economic efficiency and growth; and (ii) hurts the poor most. Corruption is increasingly being seen as neither beneficial ("grease for the machine"), nor inevitable ("the way the system works"), nor respectable ("everybody does it"). This new consensus has been translated into actual policies of international organizations and governments around the world. Although the process is only beginning, and most of the implementation lies ahead (and corruption will of course never entirely disappear), for the first time in contemporary history there is a concrete opportunity to reduce substantially "the cancer of corruption".[21]

6. The macroeconomic programming context

Macroeconomic and financial programming has been dominated for well over a generation by the simple but powerful model developed by Jacques Polak (Annex III) and used in virtually all stabilization programs supported by the IMF.[22] Adjustment in government revenues and expenditures has always been important in that model, partly through its (monetary) impact on domestic credit and money creation, and partly through its (Keynesian) influence on national income and the demand for imports. Furthermore, since the early 1990s,

the rediscovery of the economic costs of excessive fluctuations in exchange rates has reduced the emphasis on currency devaluation as an instrument of economic and financial adjustment. As under the Bretton Woods system operating in the postwar period until 1973, the IMF has come back again to regard the exchange rate as a nominal “anchor”, and the burden of adjustment has correspondingly shifted to the fiscal side.[23]

The degree of fiscal adjustment is normally measured by the reduction in the overall government deficit. The fiscal deficit, obviously, is determined by both revenue and expenditure. Hence, by definition, a fiscal policy focused entirely on public expenditure adjustment would be incomplete. But in practice, the change in macroeconomic programming emphasis toward fiscal adjustment has coincided with a major rethinking of the role of the state—toward downsizing and the shedding of many earlier functions.[24] Measures on the revenue side do remain important in most developing countries—but away from short-term tax increases and toward actions that broaden the tax base and raise the elasticity of the tax system with a view to long-term revenue expansion. However, the downsizing of the role of the state has naturally led to greater reliance on public expenditure reductions as an instrument of fiscal adjustment.[25] In turn, sustainable expenditure reduction is a chimera unless the expenditure *management* system is in reasonable good shape. Hence, the current emphasis on public expenditure management and its key role in macroeconomic programming.

7. The genie outside the bottle: information and communication technology (ICT)

It is impossible to provide a good overview of the context of PEM without some reference to the informatics revolution. The monumental change wrought in every field by the new information and communication technology is still only in its initial phase. The subject of ICT is too vast to be adequately discussed in this volume. Nevertheless, Chapter 14 provides a brief summary of opportunities, issues, and concerns raised by ICT developments for the public sector in general and PEM in particular. And annex X presents a full description of an ICT-intensive integrated financial management information system, as an illustration of what may be possible, and as an eventual objective to aim for when and where country needs and capabilities permit. But a few general considerations should be raised here.

First, *ICT is a tool,* immensely powerful yet essentially no different from a photocopier or a car, in the sense that user needs and requirements must come first and dictate whether and how the ICT tool should be used. For certain functions, pencil and paper, or a telephone, or a face-to-face meeting, or a visit to the library, are far more effective than computers or the Internet. This obvious point must be stressed because there are frequent instances when governments, consultants, or donor agencies encourage computerizing anything in sight. Indeed, many would argue that IT innovation is now largely supply- and marketing-driven rather than dictated by the needs and requirements of the users. It is essential to assess realistically and compare the costs of a given ITC change with the actual benefits expected from it.

Second, *neither the ICT "techie" nor the "public manager" should work in isolation from each other.* As noted, improvements in effectiveness stem largely from better rules and procedures in the sector concerned. To apply advanced ICT to obsolete or inefficient rules and processes means in effect to computerize inefficiency. Doing the wrong thing faster is not progress. On the other hand, the absence of relevant ITC knowledge risks either costly mistakes or missed opportunities for dramatic service improvements.

Third, *ICT cannot substitute for good management and internal controls*. Indeed, the introduction of computers can give a false illusion of tighter expenditure control, in cases where a large part of the expenditure cycle occurs in parallel outside the computerized system.

Fourth, faster and integrated public financial management information systems carry correspondingly *greater potential risks* for the integrity of the data, and can even jeopardize the financial management system in its entirety if developed carelessly and without sufficient checks, controls, security and virus protection[26]. Also, it is often argued that ICT reduces the corruption. In fact, computer technology eliminates almost all opportunities for corruption for those who do not understand fully the new technology, but opens up new corruption vistas for those who understand the new systems well enough to manipulate them.

To sum up, the adoption of more advanced ICT should meet the following criteria: (i) Always fit the user requirements and the real objectives of the activity; (ii) assure that the more advanced ICT goes hand in hand with improved rules and processes; (iii) protect data and systems integrity; and (iv) aim at an integrated strategy and avoid a piecemeal approach (which can fit specific needs but adds up to a ramshackle and even dangerous system). Note,

however, that an integrated approach requires compatibility and coordination, but not necessarily a single system.

That being said, ICT offers a wonderful potential for increasing government accountability, transparency, and participation; improving the efficiency and effectiveness of public sector operations; widening access to public services; and disseminating information to the public and getting feedback from relevant stakeholders and service users. With specific reference to PEM, among other things, information and communications technology can help solve the centralization/decentralization dilemma, by making relevant data easily available at all government levels; vastly facilitates budget analysis and programming; and improves the timeliness of budget information.

B. THE BUDGET CYCLE: A BIRD'S-EYE VIEW

This section assembles the concluding "key points" segments of the various chapter of the book and in effect summarizes the entire public expenditure management cycle, for the convenience of the busy policymaker or the reader interested only in a brief overview. Readers interested in the detailed analysis and discussion of each topic, instead, would be well advised to skip this section entirely, go directly to chapter 2 and following chapters, and use this section later only as a memory aid. (Recommendations on directions for reform and appropriate sequencing are assembled in the last section of Chapter 17.) Throughout the book we shall use the term "Ministry of Finance" to indicate the central government entity in charge of public expenditure.

1. The budget and its preparation

a. Budget coverage

The "general government" consists of the central government and subnational levels of government. The public sector includes the general government and all entities that it controls (e.g., state-owned enterprises). Each level of government and public sector entity should have its own budget. For accountability and financial control, reports should consolidate the financial operations of the general government and (to the extent it is possible) the financial activities of all entities controlled by the government.

The coverage of the budget should be comprehensive. The budget should include all revenues and all expenditures of the government whatever the arrangements for managing separately some particular programs, the legal provisions for authorizing expenditures, and the financing source.

Operational efficiency requires taking into account the specific characteristics of different expenditure programs when designing budget management rules, e.g. concerning transfers of resources for one budget item to another. When there is a strong link between revenue and benefit, earmarking arrangements may be considered to improve performance in public services delivery; they should otherwise be avoided.

Special management arrangements should not be allowed to hamper expenditure control and efficiency in resources allocation. Hence, extrabudgetary funds, special accounts, expenditures financed by external sources, etc., should be submitted to the same scrutiny as other expenditures. For this, they should follow the same expenditure classification system as other programs. Also, their related transactions should be recorded in gross terms, without "netting out" receipts and expenditures.

In addition to direct spending, all policy commitments and decisions that have an immediate or future fiscal impact, or generate fiscal risks, should be disclosed and scrutinized together with direct spending (tax expenditures, contingent liabilities, loans, and quasi-fiscal expenditures).

b. Budget preparation

In keeping with the three key objectives or PEM, the budget preparation process should aim at: (i) ensuring that the budget fits macroeconomic policies and resource constraints; (ii) allocating resources in conformity with government policies; and (iii) providing conditions for good operational management. Hard choices and trade-offs must be made explicitly when formulating the budget. Postponing such decisions until budget execution prevents a smooth implementation of priority programs, and disrupts program management.

The budget is the financial mirror of government policies. Therefore, mechanisms for formulating sound policies and ensuring the policy-budget link are essential. They include:

- Coordination mechanisms for policy formulation within the government;

- Consultations with the civil society;

- Adequate means for legislative review of policies and the budget;

- Regulations to reinforce the budget-policy link, notably (i) systematic review of the resource implications of a policy proposal; (ii) supremacy of the budget over other regulations on fiscal issues; and (iii) specific powers of the legislature in budgetary matters.

The preparation of a macroeconomic framework should be the starting point of budget preparation. The degree of sophistication of macroeconomic projections depends on technical capacities within the country, but every country should frame budget preparation within a macroeconomic framework, based on realistic assumptions, without overestimating revenues or underestimating compulsory expenditures. To commit the government explicitly and to ensure public accountability, the fiscal targets and macroeconomic projections should be published, in a “userfriendly” format.

Financial constraints must be built into the expenditure programming process, to avoid the problems arising from “open-ended” approaches, i.e. excessive bargaining, and avoidance of necessary choices. Annual budget preparation (as well as any expenditure program) should be organized as follows:

- A *top-down approach* which consists of: (i) defining aggregate resources available for public spending over the planned period (derived from a sound macroeconomic framework); (ii) establishing sectoral spending limits that fit government priorities; and (iii) notifying line ministries of these spending limits, early in the budget process;

- A *bottom-up approach* which consists of formulating and costing sectoral spending programs for the planned period within the given sectoral spending limits; and

- *Iteration* and reconciliation mechanisms for eventual overall consistency between aims and availability.

Budget preparation includes specifically the following activities: (i) preparation of the macroeconomic framework; (ii) preparation of a budget circular, which gives guidelines for the preparation of sector budgets and expenditure ceilings by sector; (iii) preparation of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the Ministry of Finance; (v) finalization of the draft budget; and (vi) submission to the legislature. All countries should adopt some appropriate medium-term perspective on budgeting, and countries where conditions are conducive should consider implementing a formal multi-year expenditure programming approach.

To choose among programs and to prepare their implementation plan, spending agencies need to know the amount of resources allocated to their sector. Within those limits, since they are accountable for sectoral policy and performance, line ministries should be responsible for the preparation of their sector budgets.

Weaknesses in budgeting depend in large part on political factors and on the organization of the government, e.g. lack of coordination within the Cabinet, unclear lines of accountability and overlaps in the distribution of responsibility. Mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires improvements in the following directions:

- Decisions that have a fiscal impact should be scrutinized together with direct expenditure programs (notably, decisions related to tax expenditures, lending, and guarantees and other contingent liabilities);

- Financial constraints must be built into the start of the budget formulation process, consistent with policy priorities and resource availability. Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget preparation process;

- Policy coordination mechanisms that fit the country context are needed, with particular attention to the budget-policy link. The medium-term fiscal impact of policy decisions must be systematically assessed;

- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have participated in designing the programs and have authority for managing them. This requires, in a number of countries, review and revision of the distribution of responsibilities in budget preparation.

- Aid-dependent countries need to pay more attention to the programming of expenditures financed by external aid and should scrutinize their budget as a whole, regardless of the source of financing and despite the fact that the project approach adopted by donors may favor fragmentation in budgeting.

Implementing new policies and making shifts in the composition of expenditure takes time. In the short term, most expenditures are fixed. Thus, assessments of forward costs, including the recurrent costs of investment projects, are required when preparing the budget, and the total costs of investment projects of a significant size (and their implementation schedule) should be reviewed when preparing the budget and shown in the budget documents or in annexes to the budget.

The preparation of rolling multi-year expenditure programs contributes to improving budget preparation, mainly by facilitating the preparation of the ceilings that should frame the preparation of the annual budget, and by increasing predictability in sector management and efficiency in public spending. A formal and detailed program covering all sectors has recently become known as a Medium-Term Expenditure Framework (MTEF), but less demanding approaches to a multi-year perspective can be adopted.

To avoid undesirable outcomes and perverse effects, the following principles should be adopted in multi-year expenditure programming:

- multi-year estimates can be indicative for the outyears but must be fully consistent with the budget in their first program year;

- whatever their coverage, multi-year programs must be framed by a multi-year macroeconomic framework, including estimates of aggregate expenditures by function and by broad economic categories (wages, other goods and services,

transfers, interests, investment). This requirement applies not only to comprehensive MTEFs, but also to multi-year approaches with a partial coverage (public investment programs, sector expenditure programs);

- multi-year programs should not be allowed to be used as an excuse for increased claims from spending agencies. They should focus on the forward impact of policy decisions to be made in the annual budget under preparation, and exclude new programs that are not funded with certainty. Therefore, the total costs identified in the multi-year programs should be less than the projected revenues from all sources.

- the process of preparation of multi-year programs should be analogous to the budget preparation process. In particular, it should be framed by annual expenditure ceilings.

- depending largely on the country's administrative capacity, multi-year expenditure programs may have different status (internal management document, published and official document, etc.); different coverage (some sectors or programs only, or PIP only, or MTEF with aggregate or detailed coverage); different degree of detail (as detailed as the budget or in a more aggregate presentation).

c. Organizational issues

The responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined and delimitated:

- The center of the government (Prime Minister, President office, etc.) coordinates policy formulation and arbitrates any conflict that may appear in budget preparation.

- The Ministry of Finance sets the guidelines for budget preparation, scrutinizes budget requests and ensures the coordination of the budget preparation process, as well as budget the overall consistency of budget with policy and macroeconomic objectives.

- Line ministries and agencies are responsible for preparing their sector programs and budget, within the policy directions and financial envelopes decided by the government.

Assignment of expenditures to subnational government should be established on a clear basis, and arrangements for revenue assignment should follow expenditure assignment. The central government should avoid downloading its fiscal problems on to subnational governments. Accordingly, increased expenditure assignments must be balanced by compensatory measures on the revenue side. Certain mandates of overriding national significance may not specifically carry additional resources, but should be the exception to the rule.

In order to ensure both efficiency and fiscal discipline, incentives and sanctions are needed. Subnational governments should benefit from savings they made, but protective measures are required in case of mismanagement or budget overruns.

The legislature has a key role in reviewing and approving the budget. For this, adequate capacity and resources are needed. However, to achieve the three objectives of fiscal discipline, resource allocation and good operational management, certain limits on the amendment power of the legislature are normally set.

2. Budget execution

It is possible to execute badly a well-prepared budget; it is not possible to execute well a badly prepared budget. However, budget execution requires more than simply assuring compliance with the initial budget. It must also adapt to intervening changes, and enable operational efficiency. Procedures for controls are needed, but should not hamper efficiency nor lead to altering the internal composition of the budget, and must focus on the essential while giving spending agencies flexibility to implement their programs.

a. Assuring compliance: Expenditure control

The budget system should assure effective expenditure control. In addition to a realistic budget to begin with, a good budget execution system should have the following:

- complete budgetary/appropriation accounting system. It is necessary to track transactions at each stage of the expenditure cycle (commitment, verification, payment) and movements between appropriations or budget items (apportionment, virements, supplementary estimates);

- effective controls at each stage of the expenditure cycle, whatever their form and organization;

- A system for managing multi-year contracts and forward commitments;

- A personnel management system, which should include staff ceilings in countries undertaking a civil service reform.

- Adequate and transparent procedures for competitive procurement and systems for managing procurement and contracting out.

b. Budget implementation

When a well-prepared budget is being implemented, allocative and operational efficiency call for the following principles:

- Budget funds should be released in a timely manner.

- Cash rationing should be avoided (except in emergency). A budget implementation and a cash plan must be prepared, but should be based on budget estimates and take into account existing commitments.

- Supplementary estimates must be strictly regulated and their number limited.

- Virements (transfers between items) are justified, but should not lead to altering the priorities established in the budget. Rules for virement should be set up to allow for both management flexibility and control of the major items.

- Internal controls (within line ministries) are generally preferable to ex ante controls performed by central agencies, but to do so a strong monitoring and auditing system is mandatory. Commitments and verification controls should be internal, in order to avoid excessive interference of central agencies in budget management.

- When payment processing and accounting controls are decentralized, a central control on cash is required. When payment processing and accounting controls are centralized, a system is needed to assure that payments are made in a timely manner and according to the budget and the cash plan, without superimposed prioritization by the central agencies. Advances in information technology should permit to reconcile the need to decentralize controls for efficiency reasons and the need to assure central control of expenditure.

- Some carry-over of appropriations should be authorized, at least for capital expenditures, but needs to be regulated.

c. Cash management and the Treasury function

Cash management has the following purposes: aggregate control of spending, efficient implementation of the budget, minimization of the cost of government borrowing and maximization of return on government deposits and financial investments. The key principles are:

- Centralization of cash balances. This centralization (not to be confused with centralization of payments), should be made through a "Treasury Single Account". A Treasury Single Account is an account or a set of linked accounts through which all government payment transactions are made. It should have at least the following features: (i) daily centralization of the cash balance (when it is possible); (ii) accounts open under the responsibility of the Treasury; and (iii) transactions recorded into these accounts along the same set of classification. This model could fit both centralized and decentralized arrangements in public expenditure management, provided that modern information technology is available.

- Cash planning is essential. It includes: (i) the preparation of an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, the preparation of monthly cash and borrowing plans; (iii) weekly review of the implementation of the monthly cash plan. In turn, in order to prepare monthly cash plans, it is necessary to monitor commitments in order to avoid arrears generation or delays in payment.

- Borrowing policy needs to be set in advance, and the borrowing plan must be made public. Borrowing by subnational governments must be regulated, and should be consistent with overall fiscal targets.

- External debt should be contracted in accordance with the budget or a multi-year expenditure program, and monitored closely.

3. The technical infrastructure

a. Accounting

Good accounting and reporting systems are crucial for public expenditure management, accountability, and policy making. Accounting systems are classified along the following categories:

- *cash accounting*, which focuses on cash flows and cash balances. Cash accounting fits the need for expenditure control, provided that it is complemented by an adequate system for registering commitments and reporting on arrears.

- *modified cash accounting*, which adds to cash accounting a complementary period for recognizing end-of-year payments. (This system normally adds trouble and risk, and is generally to be avoided.)

- *modified accrual accounting*, which covers in addition liabilities to cash and *financial* assets. Modified accrual accounting gives a complete framework for registering liabilities and expenditures;

- *full accrual accounting*, which is similar to the accounting systems of commercial enterprises and covers *all* liabilities and assets. Accrual accounting gives an appropriate framework for assessing full costs and performance. However, it has heavy data, technical, and administrative implementation requirements which make it unsuitable for many countries and will affect the reliability of the system if inappropriately or prematurely introduced.

Whatever the basis of accounting, the accounting system should have the following features :

- Adequate procedures for bookkeeping, transactions registered systematically, adequate security system, systematic comparison with banking statements.

- All expenditure and revenue transactions should be registered into the accounts according to the same methodology (including expenditures from funds and autonomous agencies, and aid-financed expenditures).

- Common classification of expenditure along functional and economic categories.

- Clear accounting and well-documented procedures.

- Statements regularly produced (see reporting below).

- Systems for tracking the uses of appropriations (“budgetary accounting”) at each stage of the expenditure cycle (commitment, verification, and payment).

- Clear procedures and full disclosure of budget financing operations (“below the line”) and liabilities.

- Clear arrangements for the retention, access and security of supporting documentation including computerized records.

b. Reporting

The reporting system must be designed to fit the needs of the different users (the legislature, the public, budget managers, policy decision-makers, etc.). Minimum reporting requirements include:

- Reports on the management of the budget showing all movements on appropriations and line items (allotments, supplementary estimates, virements, etc.).

- Reports for accountability to the legislature.

- Financial reports: consolidated accounts of the general government, statement on arrears, report on debt and contingent liabilities, and report on lending.

- Reports to assess budget policy, and line-agencies' reports.

c. Management control, audit and evaluation

Management controls, (also called "internal controls") are the policies and procedures put in place by the managers of an entity to ensure the proper and effective operation of the entity. There are many kinds of management controls. Developing an effective system of controls requires, first, a careful assessment of the risks facing the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable costs.

Management controls are a basic responsibility of any manager. To be effective, the management control system must have the strong support of the entity's leadership. Policies and procedures must be observed consistently throughout the organization. Irregularities revealed by the control system must bring prompt and effective corrective action. To assure continued effectiveness, both the risks facing the organization and the control system, itself, must be reassessed frequently.

No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities will be detected. At the same time, even well-designed controls can defeated by collusion, especially if that collusion involves senior executives who have the power to disarm or bypass the control system. As stressed

earlier, effective accountability requires appropriate external feedback and “voice”.

Internal audit is part of an organization’s management control structure. It performs audits of lower level units on behalf of the top management of the entity. Some of its most important functions are to test the management controls themselves and to assist management in assessing risks and in developing more cost-effective controls.

External audit of the government is typically performed by a separate organization, the SAI, which usually reports its findings to the legislature and/or the public, as well as to the audited entity itself. SAIs may perform several types of audits, including ex ante audits, compliance/regularity audits, financial (assurance) audits and value-for-money (efficiency) audits. The appropriate audit emphasis depends on the particular circumstances of each country. Weak or non-existent management controls in government organizations may require the SAI to conduct extensive auditing of individual transactions in an ex ante or compliance/regularity mode. However, this is an inefficient use of audit resources. An SAI in these circumstance should work with the legislature and the Ministry of Finance to implement a coherent strategy for building effective systems of management control.

The credibility of external audit requires that the SAI and its staff be independent of the governmental units being audited and have unrestricted access to required information. This independence is typically set forth in the legal provisions establishing the SAI. The SAI must guard this independence zealously but, at the same time, its effectiveness depends on maintaining a professional, cooperative relationship with the legislature, the government and the entities being audited.

There are several organizational models of SAI designed to reinforce independence while also providing effective management of the SAI as an organization. Most are variations of the “office” model, headed by an Auditor General reporting to the legislature (typical of Commonwealth countries) or of the “court” model, in which the auditors have the status of law court judges (as for example in France and Italy). Combinations of these two basic models are also seen in some countries.

To be effective, the SAI’s audit staff must possess the professional skills required by the audits being performed. For an SAI to move form ex ante and regularity audits to financial assurance and value-for-money audits will require extensive training or the hiring of new

professional cadres to perform these more complex audits.

The SAI, especially one pursuing strategic objectives such as improved management controls or undertaking more advanced types of audits, needs an effective means of communicating audit results and a sound approach for encouraging appropriate corrective action.

No audit, however thorough, can provide absolute assurance of detecting every irregularity or error. An audit can give only reasonable assurance that any material errors will be found and reported. Even this level of assurance that any material errors will be found and reported. Even this level of assurance can be given only if the auditors have access to all needed records and the audit was performed in accordance with generally accepted auditing standards.

Program evaluation is a systematic effort to identify and measure the effects of government policies and programs. The more sophisticated forms of evaluation, experimental design and time series analysis, involve the collection and statistical analysis of large volumes of data to isolate reliably the effects of the program from other factors that might have caused these effects (“impact evaluations”). Case studies provide less reliable information about causation but have proven useful in identifying ways of improving efficiency.

For an evaluation to succeed, there must be clear agreement on the question being examined and the data required to provide a reliable answer. Those performing the evaluation must have the professional skills and resources needed to collect and analyze the data. The evaluator often must depend heavily on the cooperation of operating units to gain needed access and to collect needed data. Program evaluation itself, like value-for-money audit, must show that it is cost-effective relative to the improvements to be identified or the progress expected.

d. Implementing a multi-year perspective

As emphasized earlier, a multi-year perspective is important for good budgeting. There are a variety of approaches for introducing such a multi-year perspective. The most comprehensive and detailed approach is frequently referred-to as a Medium-Term Expenditure

Framework (MTEF), which is a whole-of-government framework including all government expenditure, at an appropriate level of disaggregation. Such a full-fledged framework has heavy data and implementation requirements, and in many developing countries can be wasteful or even counterproductive if introduced prematurely or implemented badly. Fortunately, partial approaches to the necessary multi-year perspective exist and can be considered—especially in developing countries. However, in addition to improving the budget process in the short term, such partial approaches must be designed to help build the local capacity needed for an eventual introduction of more comprehensive multi-year expenditure programming.

The main points relevant to a comprehensive multi-year perspective in budgeting were made earlier under the discussion of budget preparation. The main points relevant to the partial approaches are summarized here. The two main partial approaches to medium-term programming are one that incorporates all government expenditure in a particular sector, and one that incorporates all expenditure in a major expenditure category.

The former approach is comparatively recent, and has become known as a Sector Expenditure Program (SEP). Basically, the key points applicable to multi-year programming are also relevant to SEPs. Because it covers only one sector, however, it is even more important that an SEP be prepared under a stringent financial constraint flowing from the macroeconomic framework. Otherwise, this partial route to a multi-year perspective is likely to introduce a “needs” mentality—with all the problems such an mentality causes for public expenditure management—or merely provide a “pet sector” for aid donors, with the ensuing distortions in strategic resource allocation.

The latter approach is normally applied to “investment”, and has been common in aid-dependent developing countries under the name of Public Investment Program (PIP). PIPs emerged in the early 1980s as a reaction to the rigidities of the “development planning” of the 1970s, and as a means to improve the programming of external aid—most of which is for investment purposes. PIPs are on a “rolling” basis and cover a 3-4 year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor moneys, and can harm the expenditure management process. However, like a good SEP, a well-prepared PIP can improve the process as well as strengthen the recipient country’s control over aid. Ideally, a strong PIP should:

- include only economically sound investment projects that are clearly related to government policy. (For the out-years, the evaluation of projects may be indicative, but projects must always meet the “double sense” criterion of “development sense” and “common sense” before they are included in any form for any year). Procedures to prevent the birth of “white elephant” projects are especially important.

- cover all central government investment and investments by other public entities which are financed by the central government;

- be strictly framed by the ceilings derived from the macroeconomic framework (but recall the iterative nature of macroeconomic programming--public investment should never be defined as a mere residual derived from the other fiscal and macroeconomic targets);

- include in the first year only projects for which financing is *certain*;

- assure that adequate complementary local funding is included in the annual budget. “Counterpart funding” problems are likely in any event, but are a certainty if the aggregate budgetary provision for investment is insufficient;

- include in the outyears only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only “on-going policies”, as recommended for multi-year programming in general);

- prevent over-reliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important requirement. External expertise is needed. However, if the PIP process becomes inadvertently a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process, nor contribute to local capacity, nor, of course, lead toward a more comprehensive approach to multi-year expenditure programming. This risk, of course, exists in aid-dependent countries whether or not they have a public investment programming process.

e. Aid management

In aid-dependent developing countries, all three objectives of PEM require that the recipient government and not the donors should "drive" the allocation and utilization of aid funds—while respecting, of course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are ten major requirements for robust aid management. Among these, the following are essential:

- external resources must be integrated with overall resource utilization, and thus included in the budget;

- there should be one, and only one, aid management entity (preferably in the Ministry of Finance) covering all external aid, including technical assistance;

- aid management should be structured along donor lines (e.g., an ADB "desk", a World Bank "desk" etc.) rather than sectoral lines (e.g., a "health assistance" desk);

- the aid management entity should function to facilitate, not obstruct, and avoid interfering in ministries' budget proposals or project selection.

f. Information and communication technology (ICT)

The key messages in this area were summarized earlier in this chapter. We only underline here the fundamental point that, like all technology, **ICT is a tool**. It can be used appropriately or inappropriately, for good or for bad purposes, and its potential and risks must be *understood* and appropriately taken into consideration. In particular, it is sometimes thought that advanced ICT closes the door to corruption. However, while it eliminates corruption opportunities for some, it opens up new ones for others who are better able to understand and manipulate the technology.

4. Strengthening public expenditure management

a. The role of performance indicators

Greater performance orientation in public expenditure management is a goal, and must not be confused with any specific means of encouraging it. In particular, better performance in budgeting should never be confused with "performance budgeting", which may lead to better or (more often) worse performance depending on circumstances. Performance is a relative concept, which can be defined in terms of effort or in terms of results. The subjective dimension of performance should never be neglected, and genuine effort should be recognized, or it will no longer be exerted. However, it is advisable in most cases to define performance in terms of objective measures.

Objective indicators of performance can relate to:

- input—the resources used to produce a service (e.g., doctors). The corresponding criterion is "economy".
- output—the service itself (e.g., number of vaccinations). The corresponding criterion is "efficiency".
- outcome—the purpose achieved by producing the service (e.g., lower morbidity). The corresponding criterion is "effectiveness".
- process—the manner in which inputs are procured, outputs produced, or outcomes achieved (e.g., good "bedside manners").

The output of one stage is an outcome of the previous stage and an input into the next. Thus, in activities close to the ultimate user, the output-outcome link is direct and outputs are a good way of contracting with service providers. In upstream activities instead (e.g., medical research) the measurement of performance is much more ambiguous. We stressed earlier in this chapter the "accountability tradeoff", by which accountability can be strong or broad but not both. In any case, the *quality* of the service requires explicit monitoring, or quantitative performance indicators will inadvertently lead to lower quality. The selection of appropriate performance indicators, therefore, depends on the nature of the service as well as the circumstances of the country in question. The only general rule is that — in those cases when performance measurement is demonstrated to be appropriate and cost-effective— performance should be assessed according to that *combination* of input, output, outcome and process indicators which is realistic, cost-effective, and suitable for the specific activity, sector, and country.

Among the several caveats the risk of counterproductive behavior ranks high. It is essential to think carefully about the impact on actual behavior of using any specific indicator of “performance”. For example, when an aboriginal tribe in Australia was told that its subsidies would depend on keeping sanitary facilities clean, they did so most effectively by cleaning the toilets thoroughly and then closing them to the public. With these caveats, good performance indicators can be extremely helpful in fostering greater economy, efficiency, and effectiveness, if they meet the “CREAM” criterion: they should be Clear, Relevant, Economic, Adequate, and Monitorable. If any one of these requirements is not met, the indicator should not be used. When indicators are used, the next question is setting the appropriate target: the general rule is that a target should be challenging but achievable.

Contracting out—the transfer to the private sector of the implementation of activities previously performed by government is in a sense a logical extension of performance orientation (and belongs, as well, in the realm of the third PEM objective of good operational management). Contracting out is the transfer to the private sector of the delivery (not the financing) of government services. It offers the potential for efficiency increases both in the delivery of the service contracted out and, through the “market-testing” effect, in the government delivery of other services. However, contracting out also calls for great caution, and requires, among other things:

- a competitive environment;
- definition of the business need and of the activity to be contracted out;
- coordination with other related governmental activities;
- careful consideration of the quality of private management;
- protection of transparency and of service quality;
- specification of performance standards (which meet the CREAM criterion) and of consequences for non-performance;
- experienced contracting staff or advisors; and
- very close monitoring of contractor’s performance.

The risks associated with contracting out are particularly great in the case of Build-Operate-Transfer (BOT) arrangements, whereby a private entity finances and builds the facilities, then recoups its investment through an exclusive concession to operate them, and finally transfers then back to the government. This does not mean that BOT arrangements

should be avoided, but that governments must be mindful that the complexity of such arrangements provides greater opportunities for corruption. Also, risk assessment is essential, for the government may well be obliged to foot the bill if the private contractor bankrupts or defaults.

b. A strategy for reform

It would be a gross oversimplification to attempt to summarize further the summaries of general reform recommendations shown in Chapter 17, to which the reader is referred. The general prescriptions for a successful reform strategy are, in fact, the same as the broad themes of this book: (i) never transpose into a different social and economic context reforms introduced elsewhere, without a realistic assessment of their impact and requirements and appropriate adaptation if necessary; (ii) never move beyond the basics until certain that the basics have been set right; (iii) never hope for a quick-and-easy technical solution to complex and long-standing budget process problems; and above all (iv) keep the local authorities firmly in charge of the reform process, and never assume that the “experts” are invariably right. Competition and contestability can be as effective in screening out bad ideas as they are in screening out bad products. Therefore: (i) question; (ii) question; and (iii) question some more. If the advice is good and the experts are right, they will be able to answer to everyone’s satisfaction. More importantly, local officials can then implement the reforms themselves, with external advice, certainly, but in a supporting rather than a controlling role.

[1] As Chapter 15 explains in detail, efficiency relates to the concrete results of government activity, effectiveness relates to the achievement of the purposes for which those activities are intended.

[2] In this book, we do not address the complex question of how population preference can be ascertained. We do underline that the process of allocating public moneys to various users and beneficiaries is not only bureaucratic but inherently political as well. Indeed, Kenneth Arrow proved mathematically almost 40 years as the "impossibility" of aggregating individual preferences into a single social preference function that is stable, consistent with economic efficiency and hot dependent and not dependent on coercion. (See Arrow and Scitovsky, 1969.). Other contributions, known collectively as "public choice theory" look at the budget as being determined by a market-type medium- whereby "rational individuals converge or an effort to maximize their own satisfaction" (Petrei, 1998).

[3] By contrast, the question of whether it is the aid donors' or the host government is preferences that determine the pattern of public spending is a central issue for PEM in developing countries and is considered at length in chapters 4 and 16, and elsewhere in the book.

[4] On the revenue side, there is a similar distinction between tax policy and tax administration although, again, the two are clearly interrelated.

[5] Summarized in the ADB mission statement as: socially and environmentally sustainable economic growth that reduces poverty (see ADB, 1999).

[6] These are often called levels (e.g., by Campos and Pradhan, 1995). However, the term can easily be misinterpreted as implying a logical sequence or a hierarchy among the three.

[7] The latter two objectives of strategic resource allocation and good operational management are easily recognizable in the distinction traditionally made in economics between allocative efficiency and use efficiency.

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

[9] Petrei (1998, p. 338) concludes that in Latin America "pressure to spend less has led to better spending in many cases, but in many others it has led to the opposite result."

[10] Among other publications, in his presentation on public expenditure management at the Asian Development Bank in Manila on November 18, 1998.

[11] Among others, see Schiavo-Campo, 1994; and Campos and Pradhan, 1995.

[12] See, among others, North, 1991 and Williamson.

[13] This point is different from the codification of custom, which is sometimes wrongly advocated as a way of giving greater weight to informal rules. Contrary to stereotype, customary rules do adapt to changes in circumstances. But, when codified into formal law, custom loses its natural adaptability and becomes a straightjacket on change. (See Hughes, 1997.)

[14] References to World Bank Governance and Development 1992; ADB, 1995; ADB, 1998.

[15] Stewart and Ransom, 1988.

[16] The pragmatic approach of this book eschews ideological positions or advocacy of particular models (or, for that matter, opposition to particular models). However, because the "New Public Management" has entered the international lexicon, and has alternatively been sanctified or demonized, we thought it useful for the reader to have available the summary of issues presented in Annex II.

[17] Chapter 15 discusses in some detail performance measurement and its applications to the budget process.

[18] See Tanzi, 1998.

[19] A Working Group of the multilateral development banks has been formed and meets periodically to exchange information on progress of activities and to coordinate efforts.

[20] Until then, the United States had been the only country to penalize US companies that bribed foreign officials, through the 1979 Foreign Corrupt Practices Act.

[21] In the words of World Bank President James Wolfensohn in his speech at the 1996 Annual Meetings of the World Bank and IMF, which in many ways set in motion the official chain of events.

[22] See his "The IMF Monetary Model at Forty", IMF Working Paper No.97/49, April 1997. The model is naturally more applicable to complex economies in relatively stable circumstances (for which the basic relationships among monetary, fiscal and real sector aggregates can be presumed to remain approximately constant), than to developing countries in turbulent environments. In all cases, however, it is at least a useful starting point. A readable and short summary is presented in Polak's "The IMF Monetary Model: A Hardy Perennial", *Finance and Development*, December 1997. Because of the utility of this brief article, it is reproduced as Annex VI, by permission.

[23] These revisions in approaches are (loosely) related to two important principles of international economics. First, there is the "two-out-of-three" rule enunciated by Charles Kindleberger (Kindleberger, 1958). Of the three objectives of balance of payments equilibrium, economic policy autonomy, and fixed exchange rates—a government can have only two. Autonomy and fixed rates will eventually produce external imbalances; autonomy and external equilibrium will require exchange rate adjustments; and fixed rates and external equilibrium demand some sacrifice in economic

policy autonomy. (This principle is at the root of the Maastricht convergence criteria for European monetary union.) The changing approaches to the international system also reflect the more recent scheme, which posits a three-way trade-off among the capacity to stabilize the economy and fight recessions; the external openness that permits international capital flows; and stability in external trade and exchange rates. As Paul Krugman views the dilemma, the international system can meet two of these objectives, but not all three at the same time – and changes in international circumstances will produce a different choice among the three objectives. Accordingly, the policy issue revolves around the least costly alternative from abandoning one of the three (Krugman, 1998, http://www.mit.edu/~krugman/triangle.html).

[24] See World Bank, 1997.

[25] The extent of the downsizing can be seen, among other things, by the sharp reduction in government employment worldwide from the early 1980s to the early 1990s. (See Schiavo-Campo, 1998.) In transition economies of the former USSR, instead, the key issue is the collapse of government revenue. In these countries, public expenditure has already contracted far beyond any desirable point; arrears have been accumulating; and better public expenditure management is wholly secondary to the imperative of strengthening tax administration and collection.

[26] Indeed, the first advice to a government moving from a manual public accounting and recording system to a computerized one should be to keep the manual ledgers going alongside the new system until the new system is working well, and is secure and free of risk.