Part II

Managing Government Resources

Chapter 7

Managing Central Government Expenditure

It is better to rise from a banquet neither thirsty nor drunk.
—Aristotle

This chapter provides a quick run-through of the entire public expenditure management (PEM) cycle. The key message is 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. Principles and practices of subnational government expenditure are examined in Chapter 8. Here we focus on central government expenditure management. Because of the summary nature of this discussion and the technical dimension of the subject, the reader interested in a fuller explanation is referred to Schiavo-Campo and Tommasi, 1999.

THE OBJECTIVES AND CONTEXT OF PUBLIC EXPENDITURE MANAGEMENT (PEM)

The government budget should be a financial mirror of society's economic and social choices. To perform the roles assigned to it by the people, the state needs to (i) collect sufficient resources from the economy in an appropriate manner; and (ii) allocate and use those resources responsively, efficiently, and effectively.[1] Hence, one should always keep in mind the integral relationship between revenue and expenditure—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, and trade-offs between outright expenditures and tax concessions.

The Three Key Objectives of PEM[3]

Public expenditure management, as a central instrument of policy, must pursue all three overall economic policy goals of economic growth, stability, and equity. Financial stability calls for fiscal discipline; economic growth and equity are pursued partly through allocating 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 PEM: fiscal discipline (expenditure control); allocation of resources consistent with policy priorities (strategic allocation); and good operational management.[4] 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). But in addition, as stressed earlier, attention to proper norms and due process is essential as well.

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 more amenable to technical improvement than is the strategic allocation of resources. Therefore, the allocation of resources is partly influenced by the organizational arrangement of central government discussed in Chapter 3. As Petrei (1998) puts it

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

The focus on public expenditure management should not lead to forgetting 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.

Table 7.1 summarizes these relationships.

Table 7.1
Key Objectives of Fiscal Management

Objective	Revenue Function	Expenditure Function	Organizational Level
Fiscal Discipline	*Reliable forecasts*	*Expenditure control*	*Aggregate*
Resource Allocation and Mobilization	*Tax equity and incidence*	*Expenditure programming*	*Interministerial*
Operational Efficiency *Economy* *Efficiency* *Effectiveness* *Due Process*	*Tax administration*	*Management*	*Intraministerial*

This scheme is a simplification intended to help fix the key concepts in one's mind. The 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. (Chapter 2 discusses the importance of interministerial coordination.)

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.[5] Conversely, it is not likely that internal systems can be improved without a hard constraint. Similarly, the best mechanisms for interministerial 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.

A Word about Sequencing

If you cannot control the money, you cannot allocate it, and if you cannot allocate it you cannot 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, the objective of 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 that must eventually follow; and (ii) have a clear ex-ante sense of how far to push improvements in expenditure and cash control before addressing strategic allocation and management issues becomes timely and necessary.

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. 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 this chapter.

Fiscal Transparency

Neither accountability nor good PEM can be achieved without access to reliable information by all major actors and the public. Box 7.1 summarizes some of the requirements for fiscal transparency, selected from the fiscal transparency code developed by the International Monetary Fund (IMF).

Box 7.1
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 subject to the 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 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 fiscal balance should be reported in budget documents, with an analytical table showing its derivation from budget estimates.

continued on next page

Box 7.1 (cont'd.)

Independent assurances of integrity

- Final central government accounts should reflect high standards, and should be audited by an independent external auditor.
- 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. 1998. Draft Manual on Fiscal Transparency. Washington, DC

THE BUDGET CYCLE: A BIRD'S EYE VIEW

This section summarizes the entire PEM cycle. Throughout the section we shall use the term ministry of finance to indicate the central government entity in charge of public expenditure.

The Budget and Its Preparation

Budget coverage

As explained in the appendix to Chapter 1, the general government consists of the central government and subnational levels of government, and the public sector includes the general government and all entities that it controls (e.g., state-owned enterprises). It is important for each level of government and public sector entity to have its own budget. For accountability and financial control, financial reports should consolidate the operations of the general government and (to the extent 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 may be 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., rules 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; otherwise, such arrangements should be avoided.

Special management arrangements should not be allowed to hamper expenditure control and efficiency in resource allocation. Hence, extrabudgetary funds, special accounts, expenditures financed by external sources, etc., may need separate administrative arrangements but should be submitted to the same scrutiny as other expenditures. For this, they should follow the same expenditure classification system as other expenditure programs. Also, their related transactions should be recorded in gross terms, without "netting out" receipts and expenditures. For efficiency and anti-corruption reasons, it is necessary to know the magnitude of the receipts and the expenditures made from them.

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

Budget preparation

In keeping with the three key objectives of 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 between expenditure programs must be made explicit when formulating the budget. Postponing such decisions until budget execution does not make them any easier, prevents the smooth implementation of priority programs, and disrupts program management.

Because the budget should be the financial expression of government policies, mechanisms for formulating sound policies and ensuring the policy-budget link are essential. These include

- coordination mechanisms for policy formulation within the government (Chapter 2);

- consultations with civil society (Chapter 14);

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

- 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.

A medium-term 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 prepare its budget 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 user friendly format.

Financial constraints must be built into the expenditure programming process, to prevent 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 (within 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,* negotiation, and reconciliation mechanisms to ensure overall consistency between expenditure aims and resource availability.

Budget preparation can be broken down in the following specific activities: (i) preparing macroeconomic framework; (ii) preparing a budget circular, which gives expenditure ceilings by sector and guidelines to spending agencies for preparing sector budgets; (iii) preparing of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the ministry of finance; (v) finalizing the draft budget; and (vi) submitting the draft budget to the legislature. All countries should adopt some appropriate medium-term budgeting perspective, consistent with the medium-term macroeconomic framework, and countries where conditions are conducive should consider implementing a formal multiyear expenditure programming approach.

To choose among expenditure programs and to plan for their implementation, spending agencies need to know the amount of resources allocated to their sector. Since they are accountable for sectoral policy and performance, line ministries should be responsible for preparing their sector budgets within those limits. The core ministries of finance and planning should facilitate and encourage that responsibility, and not usurp sectoral choices to themselves.

Weaknesses in the budgeting process 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 (see Chapters 2 and 3). 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 (notably, tax expenditures, lending, and guarantees and other contingent liabilities) should be scrutinized together with direct expenditure programs.

- Spending limits 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 implementing 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, reviewing and revising the distribution of responsibilities in budget preparation.

- Aid-dependent countries need to pay more attention to programming 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 take 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.

Rolling multiyear expenditure programs contribute to improving budget preparation, mainly by facilitating the setting 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 under the medium-term expenditure framework (MTEF), but less demanding approaches to a multiyear perspective can be adopted. As discussed later, these are a multiyear program of investment expenditure across all sectors (public investment program or PIP) and a multiyear program of all expenditure in a single sector (sector expenditure program or SEP).

To avoid undesirable outcomes and perverse effects, the following principles should be adopted in multiyear expenditure programming.

- Multiyear expenditure estimates can be indicative for the out-years but must be fully consistent with the budget in their first program year.

- Whatever their coverage, multiyear programs must be framed by a multiyear macroeconomic framework, including estimates of aggregate expenditures by function and by broad economic category (wages, other goods and services, transfers, interests, and investments). This requirement applies not only to comprehensive MTEFs, but also to multiyear approaches with a partial coverage (PIPs).

- Multiyear programs should not be used as an excuse for increased claims from spending agencies. Rather, 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 multiyear programs should be less than the projected revenues from all sources.

- The process of preparing multiyear programs should be analogous to the budget preparation process. In particular, such programs should be prepared within the framework of annual expenditure ceilings.

- Depending largely on the country's administrative capacity, multiyear expenditure programs may vary in status (e.g., internal management document or published and official document), coverage (some sectors or programs only, or investment only, or MTEF with aggregate or detailed coverage), and degree of detail (as detailed as the budget or with a more aggregate presentation).

Organizational issues

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

- The center of the government (prime minister's or president's office, etc.) coordinates policy formulation and arbitrates any conflict that may appear in budget preparation. (See Chapter 2 for a coverage of these issues.)

- 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 the overall consistency of the budget with policy and macroeconomic objectives.

- Line ministries and agencies are responsible for preparing their sector programs and budgets, within the policy directions and spending limits decided by the government.

As explained in detail in Chapter 8, assigning of expenditures to subnational government should be clearly made, and arrangements for revenue allocation should follow expenditure assignment. The central government should avoid downloading its fiscal problems onto 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.

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 key objectives of fiscal discipline, resource allocation, and good operational management, certain limits are normally set on the amending power of the legislature.

Budget Execution

It is possible to execute badly a well-prepared budget; it is not possible to execute well a badly prepared budget. However, good budget execution requires more than simply assuring compliance with the initial budget. It must also adapt to intervening changes, and enable good operational management. Control procedures are needed, but should not hamper efficiency or lead to altering the internal composition of the budget, and must focus on the essential while giving spending agencies flexibility to implement their programs.

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:

- a complete budgetary appropriation accounting system, to track transactions at each stage of the expenditure cycle (commitment, verification, and payment) and movements between appropriations or budget items (apportionment, virements, and 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 civil service reform.

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

Budget implementation

In implementing a well-prepared budget, allocative and operational efficiency calls for the following principles.

- Budget funds should be released on time.

- Cash rationing should be avoided (except in emergencies). 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 virements 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 internal controls demand a strong monitoring and auditing system. Commitments and verification controls should be internal, to avoid excessive interference by central agencies in budget management.

- When payment processing and accounting controls are decentralized, central control of cash is required. When payment processing and accounting controls are centralized, a system is needed to assure that payments are made on time and according to the budget and the cash plan, without the central agencies superimposing their priorities. Advances in information technology should allow the government to reconcile the need to decentralize controls for efficiency reasons with the need to assure central control of expenditure.

- Some carryover of appropriations to the following fiscal year should be authorized, at least for capital expenditures, but needs to be regulated.

Cash management and the treasury function

Cash management is carried out to achieve the following: to control total spending, to implement the budget efficiently, to minimize the cost of government borrowing, and to maximize return on government deposits and financial investments. The following are key principles of cash management:

- Centralized cash balances (not to be confused with centralization of payments) is best made through a "treasury single account," although advances in informatics make several treasury accounts feasible. 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 possible); (ii) accounts open under the responsibility of the treasury; and (iii) all transactions recorded in these accounts along the same classification. This model could fit both centralized and decentralized arrangements in PEM, provided that modern information technology is available.

- Cash planning includes (i) preparing an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, preparing monthly cash and borrowing plans; and (iii) weekly review of the implementation of the monthly cash plan. In turn, in preparing monthly cash plans, commitments must be monitored so that arrears or delays in payment are avoided.

- A borrowing policy is set in advance and a borrowing plan is made public. Borrowing by subnational governments must be regulated and should be consistent with overall fiscal targets.

- When contracting external debt, compliance with the budget or multiyear expenditure program should be monitored closely.

The Technical Infrastructure

Accounting

Good accounting and reporting systems are crucial for public expenditure management, accountability, and policy making. Accounting systems are classified as follows.

- *Cash accounting*, which focuses on cash flows and cash balances. Cash accounting is adequate for the objective of expenditure control, provided that it is complemented by an adequate system for registering commitments and reporting on expenditure arrears, or a false picture of the fiscal situation will result.

- *Modified cash accounting*, which adds to cash accounting a complementary period for recognizing year-end payments. (However, this system is normally cumbersome and risky as it may lead to corruption, and should be avoided.)

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

- *Full accrual accounting*, which covers all liabilities and all assets. Accrual accounting, which is used in commercial enterprises, gives an appropriate framework for assessing full costs and performance. However, its requirements of review of data, and technical and administrative implementation capacity are heavy, making it unsuitable for most developing countries and very unreliable if inappropriately or prematurely introduced.

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

- adequate procedures for bookkeeping, systematic recording of transactions, adequate security system, systematic comparison with banking statements;

- use of the same methodology in recording all expenditure and revenue transactions into the accounts (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;

- regularly produced statements (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 transactions) and liabilities; and

- clear arrangements for the retention, access, and security of supporting documents, including computerized records.

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 are

- budget management reports, showing all movements in appropriations and line items (allotments, supplementary estimates, transfer of expenditure between items, etc.);

- accountability reports to the legislature;

- financial reports (consolidated accounts of the general government, statement on arrears, report on debt and contingent liabilities, and report on lending); and

- budget policy assessment reports and line agencies' reports.

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 its proper and effective operation. 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 cost.

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 the continued effectiveness of the system, 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 be defeated by collusion, especially if that collusion involves senior executives who have the power to disarm or bypass the control system. As stressed in Chapter 13, effective accountability requires appropriate external feedback and "voice."

Internal audit is part of an organization's management control structure. Lower-level units are audited by the internal audit office on behalf of top management. Among its most important functions, internal audit tests the management controls themselves and assists senior management in assessing risks and in developing more cost-effective controls.

External audit of government operations is typically performed by a supreme audit institution (SAI), which usually is independent of the executive branch of government and reports its findings to the legislature, the public, or both, 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 management controls and internal audit may require extensive ex-ante or compliance/regularity audit of individual transactions by the SAI. 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. Internal and external audits are complementary, not substitutes.

The credibility of external audit requires that the SAI and its staff be independent of the government 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 designed to reinforce the independence of the SAI, while also providing for its effective management 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 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 have the professional skills required for the audits being performed. For an SAI to move from ex-ante and regularity audits to financial assurance and value-for-money audits, its present staff will have to be extensively trained in these more complex audits, or new professional staff will have to be hired. The cost-effectiveness of value-for-money audits must be demonstrated. In any case, strong compliance and financial audits come first.

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. An audit can give only reasonable assurance that any material errors will be found and reported. But even this level of assurance can be given only if the auditors have access to all needed records and the audit conforms to 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 evaluation). Case studies provide less reliable information about causes and effects but have proven useful in identifying ways of improving efficiency.

For an evaluation to be useful, there must be clear agreement on the matter 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 must often 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 identified or the progress expected.

Implementing a multiyear perspective

As emphasized earlier, a multiyear perspective is important for good budgeting. Such a perspective can be introduced in a variety of ways. The most comprehensive and detailed approach is frequently referred to as MTEF, which is a whole-of-government framework including all government expenditure at a high 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 multiyear 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 should be designed to help build the local capacity needed for eventually introducing more comprehensive multiyear expenditure programming.

The main points relevant to a comprehensive multiyear perspective in budgeting were made earlier when discussing 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 the SEP. The key points applicable to multiyear programming are also relevant to SEPs. However, because it covers only one sector, an SEP must be prepared under a stringent financial constraint flowing from the macroeconomic framework. Otherwise, this partial route to a multiyear perspective is likely to introduce a "needs" mentality, with all the problems such a mentality causes for PEM, or merely provide a "pet sector" for aid donors, with ensuing distortions in strategic resource allocation.

The latter approach is normally applied to investments, and has been common in aid-dependent developing countries under the PIP. PIPs emerged in the early 1980s as a reaction to the rigidities of the fixed development plans of the 1970s, and as a means to improve the programming of external aid, most of which is given for investment. PIPs are on a rolling basis and cover a three- to four-year period. When badly prepared and implemented, PIPs become wish lists of projects or shopping lists for donor monies, 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 foreign aid. Ideally, a strong PIP should do the following.

- 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 as well as investments by other public entities that are financed by the central government.

- Stay strictly within the ceilings set by the macroeconomic framework (although, according to 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 out-years only projects for which a firm decision has been made and financing is highly probable. (In effect, the PIP would then comprise only "ongoing policies," as recommended for multiyear programming in general.)

- Prevent overreliance on external expertise, and foster systematic improvements in local capacity. This may well be the most important requirement. External expertise may be needed. However, if the PIP process inadvertently becomes a mechanism for replacing local responsibility with expatriate experts, it will neither improve the budget process nor contribute to local capacity. This risk, of course, exists in aid-dependent countries whether or not they have a PIP process.

Aid management

In aid-dependent developing countries, all three objectives of government expenditure management require that the recipient government and not the donors should "drive" the allocation and use of aid funds—while respecting, of course, the procedural and fiduciary requirements of the donors concerned. Experience worldwide shows that there are several requirements for effective aid management.

- External resources must be integrated with overall resource use, 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 Asian Development Bank desk, a World Bank desk, etc.) rather than sectoral lines (e.g., a health assistance desk).
- The aid management entity should facilitate, not obstruct, and avoid interfering in ministries' budget proposals or project selection.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Although public expenditure management is separate from tax and customs administration, good expenditure management is very difficult without reliable forecasts of revenue as a starting point.

The management of central government expenditure has three key *objectives* and one requirement for sustainability. The three objectives are expenditure control, allocation of resources in conformity with policy priorities, and good operational management. These objectives may be mutually conflicting in the short run but are complementary in the long run, provided that the requirement for sustainability is also met. This requirement is that the budgeting system must abide by due process and meet the criteria of good governance, including transparency.

Because the budget should be the financial mirror of government policies, its coverage must be comprehensive (including all revenues and expenditure, whether financed locally or through foreign aid, and using the same classification for all expenditure categories), and it must disclose all decisions that have a fiscal impact (e.g., loans) or carry a fiscal risk (e.g., loan guarantees).

The *preparation of the budget* should start with a top-down approach, whereby a medium-term macroeconomic framework allows the definition of the initial spending ceilings—both for overall expenditure and expenditure for each sector. Next is a bottom-up stage, in which the ministries and agencies formulate their spending programs consistent with both the policy priorities and the spending ceilings. The budget is then finalized through a process of iteration and negotiation between the ministry of finance and the spending agencies. Without a hard spending ceiling to begin the process, the budget preparation turns into a list of sectoral needs, which are then difficult to reconcile with overall available resources. But, conversely, without iteration and negotiation to ensure overall consistency between aims and availability, overall fiscal discipline may be achieved at the cost of good sectoral allocation and sound operational management.

It is also important to frame the annual budget within a multiyear perspective, both because expenditure flexibility is very limited on a year-by-year basis while changes in policies require significant reallocation of resources, and because of the need to assess the future costs of today's decisions (especially public investment decisions). Partial multiyear approaches may be useful in moving toward a comprehensive multiyear perspective (MTEF). An SEP is a multiyear program comprising all expenditure for one sector; a PIP is a multiyear program comprising one category of expenditure for all sectors.

Good *budget execution* begins with good budget preparation, but entails more than just assuring compliance of actual spending with the budgeted amounts. There must be mechanisms to adapt to intervening changes, and to achieve a balance between external control and operational flexibility needed by managers. In particular, among other things, budget funds should be released on time and in predictable amounts; transfers between budget items, and some carryover of expenditure to the following year should be permitted but clearly regulated; and internal controls on commitments and verification should be complemented by a strong monitoring and audit system.

Among the *accounting* systems, cash accounting is the simplest, and is adequate for expenditure control; accrual accounting is the most comprehensive, and the most demanding to implement. Most countries find it appropriate to use *modified accrual accounting*, which covers, in addition to cash, liabilities and financial assets. Whatever the basis of accounting, good, clear, transparent, and reliable bookkeeping and reporting are a must.

Without strong external *audit*, the expenditure management cycle is incomplete and risky. An independent audit entity, external to the executive branch, is essential, and should be well staffed and with complete access to requisite information. However, its effectiveness depends on good management controls and internal audit within the spending entities themselves. Operational effectiveness and integrity cannot be achieved only by external scrutiny. Also, before expending resources and staff on audits of performance and efficiency, the basic audits of compliance and financial integrity must be strong and effective.

Directions of Improvement

The approach to improving central government budgeting should be pragmatic, providing a menu of options rather than single "best-practice" models. However, certain principles are universal:

- making sure that changes in PEM strengthen the four pillars of governance (accountability, transparency, predictability, and participation);
- using improvements in public expenditure management partly to reduce opportunities for corruption, both home-grown and imported;
- paying attention not only to fiscal discipline, but also to strategic resource allocation, good operational management, and due process; and
- stretching the horizon of budgeting beyond the immediate future, through a concrete multiyear approach, when feasible, but at a minimum at the level of systematic reflection and dialogue.

In addition to these general principles, experience suggests three practical rules for assessing the merits of recommendations to improve expenditure management in the specific country context.

- Getting the basics right is a must for the process of spending the people's money, especially in poor countries where the people can least afford costly experiments. In the words of the Conference on Fiscal Policy and Reform (2–4 February 1999, Apia, Samoa), "fundamental elements of budgeting preparation, implementation, and monitoring that permit effective control, promote transparency, foster accountability, and ensure legitimacy need to be firmly in place before highly sophisticated concepts of budget management…[are] introduced."

- Any measure to improve public expenditure management in developing countries must raise the country's own capacity to manage its public expenditure. An improvement in public expenditure management designed and implemented primarily by expatriate specialists is no improvement at all; quite the contrary, it may even worsen matters. Neither can improvements last if they are imposed top-down by the central agency with little involvement or implementation capacity of the sector ministries.

- Assess the record of actual success or failure of the measure being recommended by independently obtaining feedback from other countries that have experimented with it.

On *budget preparation*, priority actions are a reasonably comprehensive budget coverage, disclosure of policies that have an immediate or future fiscal impact (e.g., contingent liabilities), and a good expenditure classification. In addition, efficient line-item cash budgeting must be established on a solid basis before considering a move to other budgeting systems.

Hard financial constraints, flowing from a consistent macroeconomic framework, are essential at the start of the budget preparation process, to give the line ministries the predictability needed to design their expenditure programs, in conformity with government sector policy. Good operational management requires that line ministries be accountable for implementing their programs, but they can be held accountable only if they have sufficient authority to design those programs.

To move toward a *multiyear budgeting perspective*, the first priority is to prepare aggregate expenditure estimates by function and broad economic category, and review the forward costs of programs when preparing the budget. As the next stage, multiyear expenditure programs can be prepared, including only programs/projects for which financing is assured—thus focusing only on ongoing policies. As a final stage, a formal and detailed medium-term expenditure framework can be prepared, with the same coverage and degree of detail as the annual budget. To achieve this final goal, a progressive approach can be considered. Aid-dependent countries should first prepare a strong and realistic public investment program (consistent with available resources and without "white elephant" projects). Other countries could focus on other costly expenditure items, e.g., pensions and other entitlements. In addition, preparing a full sector expenditure program for one or two key sectors can yield useful experience in multiyear programming.

Improvements in *budget execution* generally entail enhanced expenditure control, more efficient spending, and better cash management. Improved expenditure control results mainly from timely and predictable release of funds; effective controls and monitoring at each stage of the expenditure cycle (commitment, verification, and payment); clear procedures for registering commitments; and, of course, sound and well-enforced procedures for procurement (discussed later). Improvements in efficiency call for flexible rules for virements; some possibility for carry-over of authorized spending to the next year; and progressive decentralization of controls, but in parallel with a reinforcement of audit and financial reporting. Finally, priority actions for better cash management include a realistic cash plan consistent with the budgeted expenditure; centralization of cash balances (not necessarily of actual payments); and timely tracking of government borrowings and repayments.

In *audit*, efficiency (value-for-money) audits may be considered only after a strong financial and compliance audit is clearly established, and all resources should be concentrated on that basic priority. Similarly, in *accounting* the priority is on establishing a solid cash accounting basis and consolidating the operations of extrabudgetary funds—complemented, however, by a commitment register, accrual accounting for debt, and the recording of contingent liabilities. Further improvements could include modified accrual accounting and the formulation of asset registers—at least for the more valuable assets at risk. A move to full accrual accounting should not be considered until the previous steps are firmly in place (except for public sector activities, where accrual accounting is essential). Finally, *performance orientation* in budgeting can be fostered in several ways other than the formal introduction of quantitative performance indicators or performance budgeting, as explained later.

NOTES

1 As Chapter 1 explains in detail, efficiency relates to the concrete results of government activity, while effectiveness relates to achieving the intended purposes of those activities.

2 In this book, we do not address the complex question of how the people's preference can be ascertained. We do underline, however, the bureaucratic as well as inherently political nature of the process of allocating public monies to various users and beneficiaries. Indeed, Kenneth Arrow proved mathematically almost 40 years ago the "impossibility" of aggregating individual preferences into a single social preference function that is stable, consistent with economic efficiency, 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 in an effort to maximize their own satisfaction" (Petrei 1998).

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

4 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 efficiency of use.

5 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."