Part I: Strengthening Expenditure Management

1. Approach of the Tool Kit: Some Preliminary Considerations

(Perspectives and themes; levels and instruments; structures and styles; and evolution of expenditure management)

A continuing theme associated with the public administration for more than a thousand years has been the management of finances-how they are raised, the purposes for which they were spent, and the benefits of spending. During recent years, particularly during the last three decades, growing attention has come to be paid to financial management in view of the widespread prevalence of several perceptions about governments and about the effectiveness of the fiscal machinery employed by them. Some common perceptions are that governments have not been very successful in adapting the fiscal machinery to meet the changing requirements of macro-economic stability; that the delivery of services leaves a good deal to be desired even when budgets are in surplus; that the allocation of resources is more dependent on the strengths of the lobbies; that in practice there is no strategy to manage expenditures and that most policy responses are tactical; and that there is a considerable waste of money in the activities of government contributing to a poor quality of expenditures. These perceptions amount to a severe attack on the credibility of the governmental management systems. Today's perceptions are tomorrow's political choices and as such they need to be addressed as soon as possible. Such effort is not, by its very nature, a single step but involves constant attention and continuous adaptation. Tomorrow's problems may often be different from those of the past or of today.

(i.) Different Perspectives and Common Themes: The perceptions and the associated language of discussion tend to be different depending on the analytical discipline of the individual. Although there are several legitimate groups which have their own well articulated perceptions, for purposes of discussion, three groups are recognized here – *economists* who are more concerned with the allocation and utilization of resources, *financial managers* who tend to be more concerned with the instruments and thus with the formulation and implementation of the budget, and the *community* which tends to be interested in the overall economic framework and with the benefits received from payments made by it.

In reality, however, the underlying themes are common, as are illustrated in Chart 1. In the following discussion, a mix of the different perceptions are used.

(ii) *Levels and broad instruments:*

(a) Terms: It is necessary to be clear about the terms financial management and expenditure management. Financial management is usually discussed in terms of a broader and a narrower perspective. From a broader point of view, it includes mobilization of resources (revenue collection and administration), allocation of resources, accounting of resources utilized, reporting and internal auditing. In its narrow form, financial management is restricted to accounting and reporting. For purposes of discussion here, the term financial management is used in its broader context with one major exception in that revenue collection and administration are excluded from discussion here. They form part of a separate area but the interactions and linkages

between revenues and expenditures are discussed whenever appropriate Expenditure management covers the same areas of financial management and is used synonymously. It includes expenditure planning, annual expenditure budgeting, accounting, reporting and auditing (internal and external).

(b) Levels of government: All governments are engaged in the provision of goods and services needed by the community. Such provision requires financial resources. The determination of the broad needs of the community and the determination of manpower, money, materials required for meeting those needs are the main tasks of expenditure management. Provision of services is undertaken at various levels of government-central, regional, state, local and state owned enterprises and each level is engaged in planning its expenditures while coordinating with other levels so that there is no overlap. Allocation of expenditure responsibilities for each level is studied as a part of 'Federal Finance'. For analytical purposes, three levels are recognized-central government, general government and private sector. The range of broad instruments is however, common to all governments and essentially involve three pairs of instruments – taxing and spending; lending and borrowing; and selling and buying.

(c) Expenditure instruments: Expenditures cover a wide range and the objectives that governments have for them may be achieved in more than one way-through direct and exhaustive expenditures; through lending and acquisition of financial assets; through the provision of guarantees; through pursuit of non-commercial objectives by state owned enterprises; and through quasi-fiscal activities carried out by government owned financial institutions on behalf of government. The instruments have different degrees of substitutability and together they aim at fulfilling the objectives of government.

Expenditure management revolves around the use of these instruments, their assigned roles, their actual use and the results obtained in the processes. The interrelationships between levels and instruments are illustrated in Chart 2.

(iii) Management structures and styles: Governments being hierarchical organizations tend to organize themselves in terms of institutions, ministries and agencies, each one assigned a specified responsibility, and the necessary powers for carrying out the tasks inherent in that sphere. In turn, each institution devises its own systems to conduct operations within a framework of accountability. Expenditure management follows this general framework. There are organizations with responsibility for specified tasks. Most expenditure management tasks thus revolve around spending agencies, central agencies such as ministries of finance, payment and accounting organizations, and most of these organizations are common to the member countries. The actual working of these organizations may differ from one country to another, depending partly on the structural features such as operational processes and the level of technology and partly on the management styles such as centralization or circumvention. Attention to institutions reveals only part of the picture but the outcome both in terms of policy formulation and implementation are dependent

on the fusion of formal structures and informal styles of working. To illustrate, the laws may specify several forms of control but if they are circumvented in the process of day to day working their effect would be different from what was expected. The relationships between structures, styles and outcome are illustrated in Chart 3. For assessing the efficacy of expenditure management systems, structures, and styles have to be examined together.

(iv) Evolution of public expenditure management: Public expenditure management has evolved over two thousand years. During this period, its course was influenced by several factors. The expenditure management systems in practice today reflect, in varying degrees, the influences of seven paradigms. In physical sciences, each paradigm is replaced by another. In public expenditure management however, the features of one paradigm may continue even as efforts are being made to assimilate the features of the new one. The recognizable paradigms and their features are illustrated in Table 1.

2. Structural Features of Expenditure Management

(Constitution and associated laws; delegated spheres for additional legislation; budget coverage; fiscal year; basis of budget-cash or accrual; gross or net; and classification of the budget).

(i) Constitution and associated laws: The expenditure management system of every government functions within the parameters of the constitution of country and its associated laws. Most constitutions have separate sections that deal with the financial aspects of the working of governments (familiarly known as financial provisions). The provisions specify the tasks, powers and responsibilities of governments in the financial sphere, and could be very broad too detailed in nature. These provisions may also indicate the nexus between the executive and legislative wings and the relative roles of each. Thus, it may specify the fiscal year, the timing of the submission of the budget (annual financial statement), the powers of the legislature, types of expenditures that require legislative approval and those that do not, arrangements to be made for the conduct of government business pending legislative deliberation and approval of the proposals made by the government, relationships with the central bank, powers for domestic and external borrowing, expenditure and revenue assignments to other levels of government, and a variety of other subjects.

There are no normative standards about the coverage of a constitution in regard to the management of finances. Much is dependent on the context in which the constitution was evolved and the political dilemmas it is expected to resolve. In reviewing the adequacy of the constitution for ensuring an effective expenditure management system, it is important to ascertain, in respects other than those specified below, whether the existing framework has any provision that tends to impede modernization efforts.

(ii) Delegated spheres for additional legislation: The constitution of a country may specify, among others, that further legislation may be introduced, either on a permanent basis, or with a sunset provision, i.e. a cut-off period, or on an annual basis. For example, the constitution of India indicates that further legislation would be enacted on the borrowing powers of government and guarantees given by government. These legislations remain to be enacted. It is quite likely that

there are countries where similar indications have been given but remain to be achieved. These delegated areas could be of crucial importance to the management of public expenditures. The review should therefore identify the areas where further legislation was indicated but has not been carried out and the impact of the slippage on expenditure management.

(i) *Budget coverage:* The budget, or the annual financial statement, is the principle vehicle of the government to convey its fiscal policy intentions. The budget is also a tool of management in that the moneys needed for the provision of goods and services are appropriated by the legislature and need to be utilized in compliance with the wishes of the legislature. It is also a tool of accountability in that the government entrusted with the responsibility of implementing policies and programs, informs the representative institutions of the progress made and the results secured.

In view of the above multiple dimensions of a budget, it is expected that all policies and programs that have financial implications are included in the budget. In practice, however, the budget may be so organized as that some transactions are excluded from the budget (e.g. Oil coordination policies in India). In some other cases, either for reasons associated with managerial freedom, or related considerations, some transactions may be carried out through extra budgetary accounts (e.g. Japan), that may be maintained outside the main budget. These accounts may not, in several cases, involve legislative consideration either before obtaining funds or after utilizing them. In some cases, task oriented autonomous agencies may be established with operational freedom in the management of finances and they may be excluded from the budget even though all or most of their revenues are derived from the transfers made from the main budget. In a few cases, revenues may be earmarked for specific purposes and their utilization may be undertaken outside the ambit of the budget. Similarly, selected foreign aid inflows may be organized through tacit or explicit agreements between donors and receiving countries, outside the budget. Both in principle and in practice the coverage of the budget should be comprehensive encompassing all of the financial transactions of the government. It is quite likely however, that owing to the context in which the original legislation was enacted or the decree was issued, the scope of the budget, as specified in law, may be somewhat limited. It is therefore essential to distinguish a legal budget from an analytical budget. The latter should aim at being comprehensive where the laws tend to diminish the scope of the legal budget. An analytical budget should be a consolidated one covering the activities of the central government, its budgetary transactions, the activities of the main autonomous agencies, the budgets of the state and local governments, and the net financial relationships with public enterprises including the financing of their capital outlays. In some of the former centrally planned economics (e.g. Uzbekistan), the law itself distinguishes between a state budget (covering central and local governments) and a consolidated budget which includes in addition to the state budget, all extra budgetary funds.

The preparation of a consolidated analytical budget is considerably facilitated by the use of electronic technology. An important issue relates to the inclusion of autonomous agencies whose policies are funded and controlled by the government. Much is dependent on their role and functions. In each case, however, a careful and judicious review of budget coverage is indicated.

(ii) Fiscal year: Government financial management represents, by its very nature, a continuum. The arrangement of that continuum into annual time slices was made to reflect the linkage between the budget and the national economy, on the one hand, and in some cases, the legislative convenience, on the other. Thus, in most cases, the fiscal years were determined with reference to the agricultural cycle of operations so that forecasts of revenue could be made more accurately. In some cases, fiscal year was largely a matter of colonial legacy.

During recent years, however, the choice of the fiscal year has come up for renewed debate. First, the linkages between the agricultural operations and budget revenues tended to be less important with the gradual growth of the industrial base. Thus, the fundamental premise on which it was evolved came to be questioned. Second, in several countries that are dependent on foreign aid, it became more important, with a view to reduce uncertainty, to wait until the donor budgets have been approved in their own countries. It was more convenient to plan budgets in the receiving countries in the light of firm indications from the donors. Thus, there was a need to change the fiscal year. Third, the possibilities of too many different years proved to be a needless complexity. In several countries, fiscal years of government were different from the tax years used to collect taxes, and both were different from the calendar year with reference to which national income accounts, that in turn exemplified the relationships between the budget and the economy, were prepared. Fourth, some categories of expenditure, e.g., Development or project outlays, did not lapse at the end of the fiscal year but were made available, without new legislative action, for the following year. In several cases, there was a rush of expenditure during the last part of the fiscal year aimed at avoiding a lapse of funds. It is argued that the limitation of a fiscal year tended to introduce avoidable behavioral oddities into the spending patterns and that much of this could be avoided with greater emphasis on medium term planning of fiscal activities: In some countries, there are long liquidation periods during with the transactions of a year are permitted to be concluded. This contributes to delays in the compilation of annual accounts. Finally, in some countries, the fiscal year may start much ahead of the legislative time table (e.g. China, where the fiscal year is the calendar year, and the Peoples Congress, the approving authority, generally meets in April) and resort has to be made to provisional legal arrangements.

In the light of the above discussion, the important issue is whether there is a *prima-facie* case for the review of the fiscal year. The answer is dependent on the problems arising from the existing fiscal year. If it is contributing to more problems than to administrative convenience, it may be appropriate to change the fiscal year, as many countries in the region have done. Change will, in the immediate short term, contribute to statistical discontinuity and adequate arrangements have to be made for the transition. Associated issues of fiscal discipline such as a rush of expenditure or liquidation periods need to be addressed in different ways.

Experience shows that there is one major leakage in the process of compliance with the specification of the fiscal year. In the countries of the Indian sub continent, there is a feature known as Personal Ledger Accounts under which funds may be transferred at the end of the year to avoid lapsing, from the budget account to the accounts of selected officials. Although the procedure was introduced a long time ago to address the problem of the lack of rural branches of banks and treasury offices, and to facilitate the cash requirements of military officials at the front lines, it has come to be a widespread escape mechanism to avoid the rigidity of the fiscal year. These accounts, apart form being a violation of legislative accountability, over states the expenditures and presents a misleading picture of the budget impact. Similar escape mechanisms may be prevalent in the form of deposit and uncleared suspense accounts. Their impact on the observances of the fiscal year and financial management needs to be investigated.

(iii) Basis of budget; cash or accrual; gross or net: Traditionally, budgets and related accounts of government have been maintained in terms of cash, i.e., When cash is received into or paid out from government funds. Even in a cash system, however, not all the transactions may involve movement of cash. Transactions relating to foreign aid or intra-governmental transactions may be mostly recorded in books without any movement of cash. This system was considered convenient as it provided an easy methodology to maintain accounts, to administer related expenditure controls, and to facilitate a link-up with monetary policy in terms of determining the magnitude of debt to be issued and its timing. Over the years, however, there has been a growing recognition of the limitations of cash systems. For example, it does not reveal the real financial picture of the government, not does it permit the development of cost data. In terms of impact, the budget is important when decisions are made to commit or raise resources rather than the actual cash flow. Similarly, the recording of capital expenditure at the time of expensing is hardly indicative of the acquisition of a capital asset and its use. For these reasons, accrual system is advocated for use in governments. Under this system transactions are recorded when a commitment is made (and therefore a liability incurred) or when revenue is earned (when a receivable is recognized) regardless of when cash is received or paid out. The main distinction is that in a cash system, recording of a transaction takes place when cash is paid or received regardless of the timing of the economic event giving rise to the payment, while in an accrual system, it is recorded when the economic event occurs regardless of the timing of payment and receipt of cash. In addition, the accrual system envisages the division of budgets into operational and investment, with the latter having a depreciation account. It will also have a capital charge revealing a payment for the use of an asset by the user departments. Further, balance sheets, sources and uses of funds, etc. statements would be prepared to show the diverse aspects of the financial health of government.

In applying accrual systems to government, selected features of experience may be noted. First, in some countries, a beginning is being made with the introduction of accrual accounting at the local level as integral parts of agreements reached with the World Bank. As an extension of this approach, a distinction is made between accrual budgeting and accounting as progress is made in applying the latter. Second, some countries, e.g. Australia, New Zealand, have moved to full accrual systems covering budgeting, accounting and reporting. Third, some countries, notably in Europe, have taken to the application of modified accrual systems, i.e., without depreciation accounts and capital charges (which, it is argued, are more appropriate for the commercial sector). It is quite likely that the picture will change in the near future as regional organizations (e.g., European community) seek to achieve uniform standards in government budgeting and accounting. Moreover, international reporting (e.g., Government Finance Statistics) is also sought to be done on an accrual basis to permit greater transparency on the financial status of a country.

In the immediate short term, the question is whether efforts have to be initiated to introduce forms of accrual accounting in replacement of the cash system. The reality is that both systems have major attractive features. The cash system, while not reflecting the actual financial conditions, permits the effective use of the traditional controls in government. The accrual system, while more reflective, involves a massive change in the management cultures of government. As such, the issue is not one of having one system to the exclusion of the other, but to have features of both. The use of electronic technology permits, without additional costs, use of programs that capture data at different points of time in the budget process–when funds are committed, when funds are released, when invoices are received, when payments are made, when goods and services are received and when they are used. The more important step is to move toward that technology and to use the data for more effective decision making while providing for greater transparency and accountability.

An associated feature relates to the maintenance of budget and accounts on a gross or a net basis. In most governments, the gross basis is used to reflect the full magnitude of a transaction. For reporting and analytical purposes, however, the transactions may be netted out. Thus, when special or extra-budgetary accounts are consolidated, intrafund transactions are netted out. In some cases, expenditures may be appropriated net of offsets, i.e., some revenue receipts that may be unique to a department. Such expenditure offsets may not fully reveal the fiscal picture and as such, it has to be ensured that estimates are always made on a gross basis. The importance of this comes into greater relief in the context of privatization of enterprises. Normally, a good deal of additional capital may be injected into the enterprises to make them attractive to the investors. Maintaining these transactions on a gross basis enables a clear recognition of all the features of the transaction.

(iv) Budget classification: This aspect refers to the ways in which government financial transactions are categorized in the budget and in the accounts. In analyzing the adequacy of classification systems, it is appropriate to distinguish between purposes and practices. The purposes of classification are, broadly, the following:

- To indicate the broad activities on which government funds are spent, the types of the sources of revenue and the categories of all types of debt formal, and hidden, so as to facilitate the comprehension of the public; viz., the <u>transparency</u> function.
- To facilitate the formulation of policies and the monitoring of their implementation in the spending and central agencies; viz., internal <u>management</u> function; and
- To facilitate the consideration and enactment of the requisite annual budget and other legislation including approval of appropriations by the legislatures; viz., the <u>legislative</u> function.

The classification approaches being as old as the budget has evolved, both in precept and in practice, over the years. Tax revenues have been broadly classified traditionally both by type and organization-e.g. taxes on income; customs and other taxes on international trade. This also reflected the organizational responsibilities in most cases- inland revenues, customs, etc. Expenditures were mostly classified in terms of organizations responsible for spending and in terms of the objects or line-items (hence the title line-item budget) such as wages, travel, utilities, purchases, etc.

There has been a gradual recognition that this type of enumeration of items of expenditure was not particularly illuminating, although it served the traditional control approaches, as it did not show the purposes or activities on which money was spent. To achieve this objective, a type of functional (all transactions were divided into functions-distinct services) and program (transactions grouped into homogeneous categories with major end objectives), and activities (that are more detailed categories of programs) as well as economic (selected groups of objects of expenditure-wages, etc.) classification was evolved. It was expected that these multiple dimensions would be reflected in expenditures. As for debt, the coverage, the range of instruments, as well as importance have grown over the period, and it was expected that full information on the sources of debt would be provided as a part of the budget.

In practice, however, there appears to be a widespread diversity and consequently some problems stemming from inadequate application of the principles. First, the revenue and receipts classification, in general, seems to be adequate although, the categories of debt tend to be too aggregative. In expenditure, categories such as defense, tend to be highly aggregative, contributing to opaqueness. In regard to the other categories, in several countries, the classification follows the organizational lines, with little or no emphasis on program or output orientation. Second, there is often a discrepancy between the classification followed in the development plans and the budget requiring link-up arrangements. Moreover, the annual accounts may also be prepared in a highly aggregative manner. Third, the distinctions between current and capital budgets are not strictly adhered to. Expenditures are frequently shifted from one category to another leading to analytical discontinuities. Some countries have equivalents of capital budgets in the form of investment, development and construction budgets with the coverage varying over the years. As a consequence, the capital formation estimates needed for national income accounts are required to be calculated separately. And, finally, some countries have recently started to participate in the program to publish government finance data in accordance with specified standards and some have even set up web sites so that there is greater transparency on the government activities. These efforts are welcome from any point of view and are likely to be immensely facilitated, if the original classification of the budget is organized on scientific lines.

Classification of government transactions is an evolving activity. Some of the republics of the former centrally planned economies have, taking the advantage of the late comer, been revamping their classification systems. Similarly, efforts are indicated in other countries where for one reason or another, classification may have become out of date and inadequate relative to the purposes it is expected to serve. Moreover, the introduction of accrual accounting would also involve the firm separation of transactions into operational and investment categories.

(v) Areas for review: Expenditure management is to fiscal policy what good sanitary arrangements are for the maintenance of reasonable health standards. They are the essential foundations and as such, it is periodically appropriate to review the designs to ensure their adequacy to the changing requirements of the

society and the government. Important in that review, are the following structural elements:

- Financial provisions of the constitution-are they too restrictive? What changes may be needed?
- Delegated legislation. Have the constitutional intents been fulfilled? If not, what are the gaps?
- Does the budget cover all financial aspects? If extra-budgetary accounts are organized, are there compensatory devices that would permit an overall perspective and facilitate fiscal policy formulation?
- Is the fiscal year choice the right one?
- Where budgets are predominantly cash oriented, how may they be strengthened to reveal the real use of economic resources and the financial status of governments? and,
- Is the budgetary classification adequate to meet its diverse objectives? If not, how may it be improved?

3. Fiscal Policy, Fiscal Discipline and Fiscal Responsibility: A Legal Framework

Fiscal policy, which is dependent on the economic climate, involves the pursuit of several objectives. Important among these, as noted in the previous sections are (i.) *pursuit of economic stability* in which the role of expenditure management is to assist in the determination of the size of annual budget deficit or surplus, and once determined, to ensure that the annual targets are adhered to, (ii.) *delivery of services*. This is primarily a function of the spending agencies but the role of expenditure management is to assist in the determination of magnitude of moneys needed to achieve specified levels of services in conformity with the priorities within a framework of targets relating to time, costs and quality. Equally important, management has to ensure that the intended benefits from expenditure programs are actually reaped by the targeted groups; and (iii.) *pursuit of economy and efficiency*; here the role of expenditure management is to devise approaches that would be conducive to efficient management while internalizing the risks in each area.

Experience shows that there have been many slippages in the fulfillment of these objectives. In addition to the recognition of this failure, there has also been a recognition of the fact that most policies need to be evolved and implemented over a medium term, and that with a view to achieving political consensus it might be more appropriate to specify some objectives as a part of legislation. Such legislation, (usually called as fiscal policy and responsibility legislation) may provide clarity in the overarching themes, while contributing to transparent functioning and thus moving toward the restoration of fiscal credibility of the country.

Toward this end, countries such as Australia, New Zealand, have enacted legislation indicating the broad fiscal policy goals, the levels of deficit and the levels of outstanding debt. Elsewhere, countries in Latin America, e.g. Argentina, Brazil, have enacted similar legislation. In some ways the legislation in Brazil is far more comprehensive as it includes provisions that are generally included in the budget law. In considering the need for new laws, it is useful to distinguish the common law tradition from the civil law. In the former, there is greater reliance on executive orders, while in the latter, there is more emphasis on specifying all aspects in the form of a law. It is generally felt that with a view to ensuring the conduct of governmental affairs within a framework of law, it may be more prudent, to enact a budget law, either independent of the fiscal policy and responsibility law or as a part of omnibus legislation covering all budgetary aspects. Some former republics of the Soviet Union have since enacted (or are enacting) comprehensive budgetary laws after becoming sovereign countries.

The budget laws, in general, deal with three aspects-organizational, transparency and accountability functions. In terms of the organizational aspects, the laws may specify the coverage, basis, budget calendar, budget implementation, accounting, internal and external audit, role of central and spending agencies, role of local governments and related aspects. In fulfilling the transparency function the contours of the government sector, nature, sources and periodicity of fiscal information, observance of relevant internal or international standards, etc. may be specified. From an accountability point of view, it may specify the levels and types of vertical and horizontal accountability, the role of oversight bodies and their functioning. The enumeration of the contents here is illustrative than exhaustive. In addition, the machinery established to deal with fraud and corruption may be specified.

It is expected that legislation of the above types would promote greater cohesion and fiscal responsibility.

Areas for Review

The need for additional legislation is very much dependent on the existing legal tradition and the adequacy of existing legislation. It would be useful to review:

- the existing laws, and
- the current and future policy needs to determine the direction and content of future legal changes.

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