

Part III: Budget Management

1. Budget Formulation

(Scope and importance; approaches to budget; budget circulars; formulation of estimates; review of estimates; processing of draft budget; organizational aspects; issues)

(i.) Scope and importance: The formal expression of annual policy making described in the preceding sections is in the formulation of an annual budget. As noted already, policy formulation is a continuing activity and the preparation of an annual budget, as distinct from other policy planning instruments, involves the compression of a continuum into a highly focused process that has the aim of producing a document for the consideration of the public and the approval by the legislature or its equivalents. Such a budget has several purposes:

- It serves as a report on the status of government finances
- It is an assessment of the current and expected economic situation of the country and an indication of what the government expects to do during the course of the next fiscal year
- It is a document that seeks to inform the public about the benefits that may be expected (including the measures aimed at poverty alleviation) and the sacrifices that may be needed to be made by the community
- It is a financial expression of the various sectoral policies that are being pursued and are likely to be continued during the next fiscal year
- It is a financial action plan for the activities of all government agencies
- It is a signal to markets about the range of borrowing that may be undertaken by the government
- It is the document that serves as the basis for annual financial legislation; and
- It is the main instrument for public financial accountability

In view of the above multiple dimensions, preparation of the annual budget forms the very heart of expenditure management. The budget is larger than an expenditure plan, in that it includes revenue resources and the amounts to be borrowed during the year. A government budget is different from the practices of the corporate sector. The corporate sector may have annual strategy but no explicit budget with the same procedural trappings as in the public sector. The distinctiveness of the government arises for two reasons. First, in government, it is the size of expenditures which determines the amounts of resources to be raised, while in the corporate sector, a major part of the activities is determined by the income. Second, the plans of government have macroeconomic importance in that they seek to influence the direction in which the national economy is moving. The activities of the corporate sector are determined by the national economy. It is for these reasons that greater transparency is urged on the activities of government – What it does? Why it is doing whatever it is doing? What are the costs of government activities? etc.

(ii.) *Approaches to budget:* Broadly, the annual budget involves the preparation of estimates of expenditure requirements for all the activities of government. These include ongoing activities, proposed new activities and the abandonment of existing policies that have not proved effective. The preparation, review and consolidation of estimates of expenditures follows, broadly, two approaches – bottom-up and top-down. To some extent, this division into two categories, for analytical purposes, involves oversimplification and some governments may follow both approaches depending on the type of expenditures.

Essentially, the bottom-up approach, which is also known as the conventional approach, illustrated in [Chart 7](#), involves the preparation of estimates by the various agencies, of the financial resources needed to implement the existing policies and any new policies. These estimates, involve detailed calculations of manpower requirements, the associated administrative expenditure (e.g. consumption of utilities, travel, etc.) and materials and equipment (including replacements) needed. In addition, attention is paid to the amounts to be transferred to other levels of governments, and the amounts needed for the servicing of debt, and for the continuation of the financial portfolio. Estimates are first prepared by the agencies and are processed upwards to the ministries and to central agencies. Eventually, they are finalized and are included in the draft budget. The process is an iterative one, and notwithstanding its extensive use over the years, is considered to be having several weaknesses. As a starter, the spending agencies may not have any idea of the resource constraint and when finally the draft bids are added up, they tend to be considerably larger than the available resources. So, a process of adjustment at various levels becomes imperative, but in as much as the draft estimates acquire legitimacy as the reflections of the demands of the agencies, adjustment ends up as a game in which decisions are made, not with reference to priorities but more on considerations of who thumps the table harder. Intense politicization of the debate makes policy making harder and turbulent. When the legislature enters the fray, the process becomes even more extended, and estimates of revenue tend to be manipulated to suit the requirements. For these reasons, it was felt that the process should be changed to a top down approach, where the central agencies, responsible for macroeconomic management, determine the policies and strategies to be implemented during the next fiscal year in the light of available resources. To that extent, the resource constraint is internalized in the approaches and in the processes of decision making. Each of these aspects is further facilitated in a context of rolling medium term fiscal framework. The stages involved in this approach are illustrated in [Chart 8](#).

The determination of the ceilings is itself a formidable process. It has its origins in the years of fiscal stress experienced during the 1980s and 1990s and in the heightened awareness of the potential implications of a widened fiscal deficit and its adverse consequences, in most situations, on the economy. The ceilings for the most part, are derived in a process of working backward from the potential level of deficit. Working from this level, the ceilings may be expressed as a rate of change for expenditure (where the rate of growth of expenditure is sought to be moderated, the estimated rate could often be lower than the rate of growth witnessed during previous years) or as an absolute value for the policy variable in nominal terms. Thus, the ceilings, as illustrated in [Chart 9](#), may be on total expenditure, or some categories of expenditure (plan and non-plan, or where defense is an important category, defense and non-defense), or for different portfolios (for broader clusters of expenditure, e.g. social; economic;

administrative, etc) and thus move progressively to more specific categories (e.g. travel, consumption of utilities) and others. It should be noted that these ceilings may also apply, in heavily indebted countries, to the conventionally centrally determined outlays such as public debt.

The calculations that underpin the determination of ceilings are themselves derived from assumptions on GDP growth, price level and exchange rates and are therefore liable to change. Such changes need to be absorbed or anticipated in the determination of the total level of expenditure, so that there is adequate margin or latitude. Toward this end, a global reserve may be maintained. Alternatively, the changes may be absorbed through giving up existing programs so that the ceilings could be maintained. Country practices, however, differ widely in this regard and it would be useful to review their adequacy.

(iii.) Budget circular: The budget activates for the next year start with the issue of a budget circular which is the primary instrument of communication to the numerous agencies of the government. It is used, depending on the choice of above approaches, to facilitate budget planning and is expected, in theory, to include a general review of the economic situation and the goals set for the next budget, a review of the trends in the current budget, and an indication of the ceilings within which the spending agencies are required to formulate their estimates. In addition, the circular is expected to identify the high risk areas that have a potential impact on the budget outcome, and following from the diversity of objectives, emphasize the needed improvements in the delivery of services as well as the areas where more economy and efficiency are to be pursued. Moreover, the circular is expected to be unified (comprising all aspects regardless whether they are included in the budget or other accounts) and is to contain the potential contingent liabilities. Further, it is expected to be issued early on so that the agencies have time to internalize the constraints. In a context, where moderation in the rate of growth of expenditure is indicated, it is expected to reveal the strategy and the ways and means framework available for achieving that objective.

In practice, however, the circular may be quite different, usually late in issue, inadequate in coverage and lacking in specific analytical guidance. The data collected for the mid-year review may not be up to date or the experience is not properly analyzed, with the result that the budget for the next year may be a putative exercise updated and repetitive in nature. In some cases, the circular may be seeking information that is either already available or little used in the actual preparation of the budget. As a consequence, the content of dialogue between the spending and central agencies is adversely affected. More important, different circulars may be issued by different agencies concerned with parts of the budget. The circulars in regard to the developmental budget may be issued by the planning agency while the circular in regard to current budget may be issued by the ministries of finance. Each may specify a different timetable and follow different approaches providing opportunities to the agencies to play one central agency against the other. Further, the circulars may not identify the risk areas or the improvements in the delivery of services or the areas where economy is called for. These critical areas, if not properly addressed, tend to reduce the value of the circular and erode into the very credibility of the guidance sought to be provided. In turn, these aspects may reflect the more fundamental

problems affecting financial planning in general. For these reasons, it is important that the adequacy of the circular is reviewed in detail.

(iii.) Formulation of estimates: Expenditure estimates and associated issues are best considered in terms of three levels – (a.) new and continuing outlays, (b.) estimates for various objects or categories of expenditures, and (c.) estimates at a program level.

As noted earlier, a distinction is made between new and continuing outlays to facilitate decision making at various levels. The information compiled for this purpose may not find its way into the budget in the same form as it covers diverse aspects and looks beyond the next fiscal year. In taking decisions about the budget eligibility of a new policy, the recurring and non-recurring financial implications need to be carefully estimated both for program and project outlays. Similarly, data are needed on the continuing outlays too. Justifications are needed to indicate that they need to be continued in the future (public interest test), that they need to be provided by government (role of government test), and that their provision may be done in partnership with the corporate and voluntary sectors. Traditionally, the consideration of these aspects was more implicit than explicit. Recent emphasis on transparency requires, however, that these considerations be made explicit. These aspects are illustrated in [Table 4](#).

Formulation of detailed expenditure estimates following the above stage of consideration, analysis, and policy formulation, involves a detailed examination of the financial requirements of each category of expenditure. In turn, economic, technical, policy factors need to be taken into account and an integrated approach formulated. These aspects are illustrated in [Table 5](#).

The expenditure estimates included in the budget may be in terms of objects of expenditure (conventional item-wise classification) or in terms of programs that reflect the transactions of each agency and to that extent, tend to be different from one agency to another. The estimate expenditure of each program is dependent on its integral components such as, manpower, machinery and money transfers. The combination of these parts and their relative roles tend to be different among programs and the dynamics of their movement during the next year need to be carefully estimated. In most countries, however, the focal point continues to be the object categories shown in Table 5 and not the program categories. The growing emphasis on the delivery of services and the pursuit of economy and efficiency requires that the imbalance in the day-to-day approaches needs to be redressed.

(iv) Review of estimates: Draft budget estimates formulated by every agency are processed through various administrative stages before their final inclusion in the draft budget submitted to the legislature. The stages differ from one country to another but involve a hierarchy of steps discussed in the following section. Broadly, however, the review involves several approaches of scrutiny illustrated in [Table 6](#). The type of the scrutiny shown in the table is expected to precede, in principle, by a detailed sectoral analysis to assess the needs of the individual sectors of the economy and to determine the investment priorities in the sector as well as to evaluate the capacity of the institutions involved. As a part of this scrutiny, the opportunities for partnerships with the private sector may be explored. These steps are likely to be considered as a part of a medium term fiscal framework or as a part of a development plan. To that extent, priority listings may be drawn from these plans. The determination of the annual outlay is

somewhat narrower in focus in that it has to ascertain the actual progress made so that the lags in implementation could be taken into account. As an extension, it may be prudent to compile lists of projects and programs that may be considered for deferral or further scaling down in the context of unforeseen resource shortfalls. The zero-base approach may be used in the event of a severe fiscal crisis. In practice, all the techniques illustrated in the table may not be used; rather, a combination of approaches may be adapted.

The success of review is dependent on two factors – quality of information, and the prevailing approaches toward analysis. In most cases, information is generally weak in regard to the expenditure profiles of programs, as well as in timeliness. (The latter aspect is being addressed through the application of electronic technology). Decision-making is inevitably affected by the information shortages and lags. As for approaches, two types need specific recognition. In several countries, outlays on defense are not subjected to intense scrutiny by the central agencies and greater freedom is permitted to the defense agencies in making internal allotments. In some countries, outlays on running costs are permitted a rate of growth that is in accord with the expected rate of growth of GDP and a detailed analysis is avoided to save time. In all these stages, the endeavor is to arrive at estimates that are reasonably firm while fully reflecting the fiscal strategy. Firm estimates are viewed as hard constraints; if the estimates are viewed as putative, then hard constraints become soft, sending in the process, wrong signals, to the spending agencies and to the community.

Practices in this area reveal some common problem areas. First, the review takes place in a tight time squeeze with the result that some aspects are either glossed over or are deferred to a more detailed analysis during the fiscal year. The latter approach has the effect of extending the budgetary process to the whole year while conclusively indicating the tentative nature of the budget. Second, procedures may be either suspended or undermined. The review adds a dimension of legitimacy that is not dependent on the economic fortunes of a country. Third, several agencies, particularly those that are perceived to have political clout, may get around the opposition or review by the central agencies, and prevent further review and proposals may be included in the estimates without rigorous examination, contributing to potential risks. These aspects merit review.

(iv.) Processing of the draft budget: The draft estimates prepared by each agency are reviewed at the next higher level, e.g. a department or a ministry, to ensure conformity with the budget guidelines and are then further reviewed by the central agencies, such as the civil service commission for personnel, ministries of finance and planning commissions. These reviews may take quite some time and some of the new initiatives as well as ongoing activities may get reduced allocations than proposed. Disagreements between the central agencies and the spending agencies may be resolved at the senior civil service or ministerial levels or may even end up with the cabinet for final resolution. In some countries, the offices of the Prime Minister or the cabinet may play very active roles and new additions may be proposed by them to the budget. This may be applicable particularly to foreign aided projects.

The draft expenditure estimates may then, in some countries be discussed either as a part of the total budget package or independently, with the standing committees of the legislature. In some countries, broad consultations may be held with the representatives of the corporate sectors, e.g. Malaysia, mostly

regarding the tax issues than about expenditures. Consultations with outside bodies about the specifics of the budget is often governed by the privileges of the legislature and a good deal of secrecy may be attached to the draft expenditure proposals.

Increasingly, however, avenues are being explored to hold discussions with the stakeholders and the stockholders so that the expenditure estimates could reflect a consensus.

(v.) *Organizational aspects:* The unique feature of preparation of budget estimates is that the process brings together the activities of all branches of government to a common wavelength during a brief period. The review and consolidation of expenditure estimates takes place at several points depending on the functional orientation of agencies in a government. [Chart 10](#) illustrates a general division of work in governments. It is quite likely that personnel budgets are reviewed by the civil service agencies, while public debt and pension estimates may be reviewed or consolidated by the central banks (where these transactions are managed by them) or autonomous organizations. Foreign aid may be coordinated by other agencies and there may be similar arrangements for other spheres.

In the absence of firm budgetary guidance, there is a potential danger that these agencies may work at cross purposes, may not have a uniform approach to expenditure determination or may believe in exercising excessive, repetitive control on the agencies. Avoidance of these aspects is dependent on the quality of information specification of the role and tasks of each agency, and the actual processes of day-to-day working. Areas for review are the coordination between the finance and planning agencies and between the finance and civil service commissions.

(vii) *Issues:* The formulation of the budget is a vast area and inevitably a number of problems are experienced by governments. Some of the more common ones are indicated below:

(a.) *Coordination issues:* From an organizational point, issues of coordination are experienced in regard to revenue and expenditure planning, personnel planning and formulation of budget ceilings, current and investment budgets, and in the management of aid. Experience shows that, in general, revenue planning is undertaken as a separate exercise with inputs into the budget process at the penultimate stage, which is too late to undertake expenditure adjustments except in broad terms. In several cases, personnel planning and related determination of staff strength for agencies also proceeds as a separate exercise based on work load factors, rather than on resource ceilings. An inevitable consequence is the discrepancy between the level of posts agreed to with the civil service agencies, and the actual level funded in the budget. Moreover, the investment budgets are separately formulated, in several countries, and the coordination with the current budget is minimal. As a consequence, attention to the future years' financial requirements, evaluation of budgetary performance, analysis of policy alternatives, computation and budgetary provision for completed development projects, tends to be minimal. In the area of aid management, experience shows that spending agencies bypass the central agencies and engage in

direct consultations with donors. In addition, problems are also experienced in the provision of counterpart funds.

(b.) *Consultations and hearings:* Spending agencies tend, in many countries, to take the view that consultations between them and the central agencies leave a good deal to be desired. It is their perception that adequate budget guidance is not provided, that there is inadequate understanding of the importance of the programs, that the determination of budgetary allocations is arbitrary and that too much control by the central agencies is exercised in all the phases. As a consequence, spending agencies resort to escape mechanisms such as leasing rather than purchasing, underestimation of financial requirements, earmarking and establishment of extrabudgetary accounts, unbundling approaches to avoid funding ceilings and ghost employees. The alternatives lay in the improvement of all technical areas discussed earlier and in strengthening the formal process of consultations with agencies.

(c.) *Reserves and special accounts:* In some countries, allotment of general account transactions follow the rates of growth of GDP, while allotments from the budgetary reserves and special accounts become the main pieces of negotiations between the central and spending agencies. In some ways, this shifts the attention from the main to the sideshows largely because the size of the budgetary reserve or special accounts is significant. The alternative consists in formulating an integrated framework covering all the areas.

(d.) *Underfunding and performance aspects:* When confronted with resource shortfalls, governments may engage in explicit or implicit underfunding without specifying alternative procedures for service delivery. In the absence of changes in programs and projects, agencies are confronted with hard choices and may pursue soft constraints, such as incurring arrears in payment, in order to maintain service levels. Underfunding is a false choice, and it is appropriate that attention is paid to high-risk areas throughout the process. Similarly, it is also important to pay explicit attention to performance and to the pursuit of economy and efficiency.

(ix) *Areas for review:* The adequacy of technical instruments goes a long way in ensuring that appropriate policies and budgets are formulated. Given the importance of the budget, the following areas may merit regular reviews.

- Adequacy of the approaches to the formulation of budgets: Regardless of whether the approaches are top-down or bottom-up, it is essential to ascertain that the resource constraint is internalized and that specific attention is paid to the three important objectives of stability, service delivery, and pursuit of economy.
- Adequacy of the process in facilitating explicit recognition of the linkages with the major trends and determinants of the economy.

- Formulation of ceilings: methodology and different areas for which they are determined and their linkages to macroeconomic policies.
- Adequacy of the guidance provided through the budget circular and the focus on sectoral strategies, high-risk areas and fall back management procedures.
- Technical bases and their adequacy in the formulation of budget estimates.
- Procedures for review and the dialogue with spending agencies.
- Procedures for processing the budget.
- Fragmentation of expenditure control and procedures for coordination, and
- Attention paid to the issues generally experienced in the phase of the budgetary process.

2. Budget Calendar

Experience of many countries shows that the preparation of the budget may take anywhere from four to sixteen months. This period essentially reflects the time spent in compiling initial estimates by revenue and spending agencies, their review by the central agencies, internal processing with the cabinet, where relevant, or head of the state, and the printing of the documents for submission to the legislature. These procedures, are not however, common to all countries as a good deal is dependent on the legal framework and administrative tradition.

As a checklist, an illustrative calendar is provided in [Table 7](#). This shows the desirable elements in a calendar and when applied to a country, also shows what that country has and the possible directions for strengthening. In countries that are dependent on foreign aid, the framework should provide for adequate consultations with the donors.

3. Expenditure Control: Nature and Process

(Nature; process; implications of portfolio; public-private partnerships – separation of funding from service provision; poverty alleviation programs; and areas for review)

(i.) Nature: Expenditure control, as a concept and as an administrative framework, has not been free from ambiguity and therefore subject to different interpretations. Essentially it refers to an administrative process designed to ensure that the overall objectives of government expenditures are achieved. Thus, it includes the formulation of policy, and the subsequent process entrusted with the task of implementing it. That process, in turn, includes verification to ensure that the existing laws are complied with and that there is a framework of financial discipline which is transparent and provides, at a minimum, for financial accountability, so that the public may be assured, in the absence of market tests, that efforts are being made to secure value for money. In a more narrow way, it refers to the process of verification. (In some European languages, e.g. French, there is no equivalent to the term control, except as a verification process). Here the term is defined in a broad way.

(ii.) *Process:* Expenditure control, in the broad interpretation, comprises four stages in an iterative process. These stages and their components are shown below:

Policy controls

- Macroeconomic policy goals
- Specific sector strategies and goals
- Adjustments for macroeconomic parameters, e.g. Inflation

Process controls

- Release of funds
- Commitment monitoring
- Contract monitoring
- Payment controls

Regulatory taxes

- Specification of accounting standards and systems
- Specification of contract procedures
- Specification of conditions governing lending operations and guarantees
- Other standards (e.g. Personnel; equipment) for government agencies

Efficiency controls

- Specification of performance indicators
- Evaluation

The above stages cover resource allocation, resource utilization and resource use accounting. In the phase of allocation, it permits the determination of the specific role to be played by governments in arranging public services (who will carry out what), their financing, and specifying the organizational responsibilities. In the phase of utilization, the task is to provide services (or to arrange to provide services) within specified costs, quality and time framework. In the last phase, it is to ensure that there is adequate public information (accounts) about the financial transactions. The exercise of these controls, is dependent to a very large degree on the portfolio of a government's expenditures:

(iii.) *Implications of portfolios:* The portfolio of expenditures differs from one country to another. (In a federal set up (as in India, Indonesia, Malaysia and others), substantial sections of the budget may involve transfers to other levels of government. In unitary governments too, there could be major transfers to local levels of government but as a share of total outlays could be less than in the federal types of governments. These transfers may be determined by law, or in several cases, formulae devised through political agreements and may not be

revised annually.) Similarly, transfers to autonomous agencies of government, and entitlement programs to individuals may be governed by laws enacted for the purpose. In these cases where the policies and the underlying controls are determined by law, the scope of expenditure control is somewhat narrow in that its influence on policy is to be internalized at the stage when laws were formulated. During annual operations, expenditure control is, for the most part, limited to the process controls illustrated above.

In regard to the other types of expenditure, e.g. direct outlays, subsidies to public and private enterprises, there is greater scope for the system of expenditure control to have its influence felt in all the four phases. This portfolio illustrates the annual flexibility that a government has, in theory, in manipulating the size and content of outlays. Even that flexibility may be constricted by annual legislation, previous commitments, and the difficulties in going counter to the public's expectations ([Chart 11](#)).

(iv.) Public-private partnerships: The partnerships between government and the corporate (or private including voluntary and non-governmental organizations) sectors cover a wide area including government as a buyer of goods and services, government as a funding agency, government as a coordinator, and government as a regulator. From the point of expenditure control, it is the first two roles, viz. as a buyer and as a funding agency, that are important. As a buyer, governments undertake advance planning (with careful estimates of financial implications) followed by annual or multi-year budgets, determine the conditions for the award of contracts, fund contracts, monitor the implementation of contracts, and evaluate contract performance before the expiry of the warranty. There is, however, a major distinction between the roles in that, it is the government which is the immediate consumer or beneficiary as a buyer, whereas in the case of the latter, services are provided to the public, from the funds of government by agencies that have been contracted for the purpose. These agencies are, for all intents and purposes, outside the government and the only leverage that the government has is through the provisions included in the contract. If the services provided by the contractor are not up to the expectations of the public, then the latter would blame the government as it is the funding agency.

The separation of funding from provision of services poses several tricky issues to the government. Its only means of control is the contract. Even so, in several cases, governments or their audit agencies do not have the power to inspect the financial records of the contracts or any other machinery to ensure that the financial management practices of the contractor are in conformity with generally accepted standards. These standards, if any, are set up by the corporate sector which, in most cases, may not be applicable to non-governmental organizations. Further, it is often difficult to specify the quality of services (e.g. childcare), or to make alternative arrangements in the event of a failure on the part of the contractor. Expenditure control seeks value for money through competitive bidding but may be less than adequate in ensuring the provision of services where that task is entrusted to non-governmental agencies. It is essential to review the adequacy of the machinery, in particular in the area of risk management, in view of the growing share of outlays on contractually provided services.

(v.) *Poverty alleviation programs:* The financial management of poverty alleviation programs has gained in importance, deservedly so, during recent years. This area covers several programs that have different components, and are administered by a large number of agencies. Some of these programs, and the fiscal instruments utilized by them are illustrated in [Table 8](#). The management of these programs involves the specification of eligibility criteria and the types of benefits provided. Many of the programs aim at reaching targeted groups. In practice, the financial management processes reveal several problem areas. These include extensive duplication of programs, ambiguous eligibility criteria, non-recovery of loans extended, open-ended nature of subsidies and extensive fraud in payments, and in the distribution of essential commodities. Each issue, in turn reflects on the expenditure control mechanism associated with the programs. Ensuring that these mechanisms are adequate would go a long way in providing benefits to the deserving groups.

(vi.) *Areas for review:* (for sections 8 & 9) The following areas are candidates for review

- Adequacy of budget calendar
- Adequacy of expenditure control in policy matters, processes, regulatory tasks and in securing performance and efficiency
- Assessment of expenditure portfolio and evaluation of the scope of flexibility
- Review of contractual agreements with the corporate sector in the provision of services
- Review of the adequacy of expenditure control machinery in the management of poverty alleviation programs.

4. Budget Implementation and Resource Utilization

(Nature and importance; tasks; release of budgetary authority and commitment management, contract management; cash management; payment systems and arrears; financial reporting; budget revision; performance orientation; pursuit of economy; areas for review)

(i.) *Nature and importance:* The implementation and resource utilization is the most important phase as the political fortunes of a government are dependent, amongst others, on the fulfillment of the promises held out in the budget. From a macroeconomic point of view, while it is necessary to have the requisite flexibility to adopt to the changing requirements, the budget outcome should, to a very large extent be congruent with the intent. Major slippages could contribute to the widening of the size of the deficit and to the generation of inflationary impulses. From the point of service delivery, it is equally essential that services be provided on time and efficiently. Perceptions of waste and imprudent fiscal behavior are bound to have adverse impact on the fiscal credibility of governments. These dimensions add more to the importance, indeed the crucial nature, of this phase.

(ii.) *Tasks:* Budget implementation is, organizationally, quite different from the formulation phase in that unlike the latter, the former phase involves thousands of decision-making centers, and actions by numerous officials that need to be synchronized if service delivery schedules are to be met. Thus the first task is to

convert the budget into meaningful decision packages and administrative processes. These tasks have to be undertaken, in most civic societies, in a transparent way to meet the oversight requirements of the legislature and the public. The tasks may be undertaken, each in its own way, by the central, in particular, the ministries of finance and the spending agencies. The underlying core or substance is however identical in that the purpose is to ensure prudent budget implementation. These tasks are illustrated in [Table 9](#).

The role of policy controls during budget execution needs to be noted here (other aspects are discussed, in detail, further on). In a number of countries, proposals and policy initiatives may be included in the budget (e.g. commonwealth countries) on the condition that they will be considered in more detail after the approval of the budget and during the fiscal year. To ensure legislative approval (approval in principle) a token grant may be provided in the estimates. Where the size of the token grants are small, then the impact on the budget may be minimal. But where these 'prior approval' cases are large, they tend to have the effect of prolonging the budgetary process into the following year with probable adverse consequences on the policy stances. This aspect needs a detailed review in evaluating the adequacy of the budget system.

The implementation process involves the pursuit of two tracks at the same time. The concern of the spending agencies is to complete the administrative actions needed to secure finances provided for in the budget. The concern of the central agencies is to ensure that there is adequate and timely provision of funds, to enable the spending agencies conduct their operations in a smooth way. Thus, these two tracks have to be conducted concurrently.

(iii.) *Release of budgetary authority and commitment management:* The first step in budget implementation is to have an orderly and time sliced release of budgetary authority. The need for funds is not uniform throughout the fiscal year and there is considerable seasonality both in revenue and expenditure flows. Thus, spending agencies may prepare, advance plans, at the beginning of the fiscal year, showing their requirements by each month or quarter and submit them to the central agencies. The practices in this regard vary from one country to another. Broadly, two types of practices are evident. First, in some countries, spending agencies have the freedom to spend the amounts soon after the appropriation process is completed by the legislature. In some cases, warrants may be needed to be issued by the ministry of finance but these may be conducted, more as a formality than as a substantive control. Thus, the warrants needed for the whole year may be issued in a single bunch. Second, in some countries (including former centrally planned economies), spending agencies prepare advance action plans indicating the budgetary requirements for each month/quarter, which are then reviewed and approved by the central agencies. In the first type, spending agencies have greater freedom, while in the second type, it is subject to continued control by the central agencies. The release by the central agencies may take two forms – release of budgetary authority i.e. Power to commit and spend; and release of budgetary authority and the requisite funds to the agency. In the latter case, the funds would be at the disposal of the agency, in a liquid form.

In general, with growing emphasis on ensuring organized cash management, it is believed preferable to have a quarterly system of release of budgetary authority (apportionment) that reflects, on one hand, the seasonality of requirements, and on the other, seasonality of receipt inflows.

The first step, from the point of view of spending agencies, is to place orders for the goods and services that they require in order to provide services. When these orders are firm, they are considered as commitments – a sort of an explicit contractual understanding to honor the consequential financial implications. For the most part, particularly with continuing expenditures, these commitments are of a continuing type. Thus salaries (to a very substantial extent), utility payments, entitlements, legally specified transfers, interest repayment of debt belong to this type. In regard to new major purchases, implementation of new turnkey projects, and similar capital projects, commitments may be needed afresh. These commitments may be entered into by the spending agencies in decentralized management systems while in centrally managed systems, commitments might need prior approvals by the ministries of finance (visa) which then would also be engaged in the verification of documentation at a later stage but prior to payment, and finally in the payment itself.

These commitments, once formalized, are taken into account in the time sliced release of budgetary authority. In countries that are extensively dependent on foreign aid, the releases may be made by the planning ministries separately from the releases made for current expenditures. In several cases, they are issued on an ad hoc basis and reveal no specific periodicity.

Within the above framework, at least three types of common problems are discernible. First, the need for spending agencies to refer the matter to the central agencies so that the approval of commitment could be obtained, has proved to be a contentious issue. It is argued, from the point of spending agencies, that during periods of fiscal squeeze, expenditures have been pared to the minimal levels and that most of them relate to continuing activities which would have been scrutinized several times. As such, a fresh consideration is at best a new wrinkle, and an irritation without any substantial effect. The central agencies aver that in a context of budget fragility, utmost care should be taken to review matters. This is an area where there may be scope for additional delegation of financial powers and spending agencies may be made more responsible for entering into commitments within specified limits. Further, if there is an electronic recording and reporting system permitting instant access to information, the central agencies would have opportunities to be aware of new commitments. Second, the spending agencies which are the ones with the task of providing government services, seek continuity and certainty in the release of funds. In cash strapped countries, where significant revenue shortfalls may be experienced, the releases may be made, on a monthly basis, and in some cases, even on a daily basis. In these countries, an important task for the finance ministries is to have a daily monitoring of inflows and to regulate outflows within the magnitude of revenues received. The result is often chaotic and frequently there is a pile-up in the arrears. In addition, continuous under funding implies that a budget different from the approved one is being implemented. This changes the very tone of financial management whose main purpose is to achieve a smooth implementation of the budget. And, third, in some countries where the release of budgetary authority is accompanied by the actual release of cash, the procedure implies that there are, in the short term, cash surpluses with the spending agencies which some of them (particularly at the local level) may even reinvest them in government paper to make money. In turn, this leads to an anomalous situation in that the government may be having deficits while its units are cash rich. Notwithstanding all the care taken in the formulation of time slices,

the large scale rush of expenditures toward the end of the fiscal year experienced in some countries, and the carry-over permitted in some countries (to carry forward unspent amounts at the end of the fiscal year) illustrate that the administration of the system leaves a good deal to be desired. These aspects merit a more in-depth review.

(iv) Contract management: As increasingly greater reliance is placed on contracting out services (see the earlier discussion on separation of funding from provision), in addition to the conventional procurement of goods and services for internal consumption, contract management has become an important area in expenditure management. The objectives of government, in this phase, are essentially two – to secure cost savings through promotion of competitive forces, and second, to ensure that there is proper delivery of services. To secure these objectives, governments engage in a good deal of pre-tender activity and in the review of bids. The pre-tender activity includes the determination of the relationship between the proposed contract and organizational goals, timing of the supply and an analysis of the financial implications. This is followed by the coordination of tenders, issue of tenders, review of received tenders, and the final award of the contract. These activities, which are considered to be specialized in nature, may be undertaken either through separate organizations (central tender boards) or through decentralized arrangements. In selected cases of foreign aid, donors may also be co-opted before determining the final award of the contract.

From an expenditure control point of view, the most important considerations are the prices paid, and the quality of the service provided. Contracts may have a fixed-price, or cost plus fixed fee basis, or a combination of these two features with an incentive provision. In a cost plus fixed fee contract, the contractor may have little incentive to procure economies or efficiency. In general, experience shows that the final cost is a multiple of the initial estimate, reflecting in part the frequent changes made in project design. Further, in regard to the services provided, there are very few cost standards either insisted upon or provided. It is also the experience that little attention is paid in government to costs of procurement, costs of shortage, process costs, and holding (or inventory maintenance) costs. Moreover, when procurement is done either through other governmental agencies or through public enterprises, the procedures may be less rigorous, and frequently there may be no competitive bidding at all. In regard to activities and services organized by the non-governmental organizations, particularly in the social sector, the specification of quality is often too general to hold any one accountable for failure in service provision. All these aspects require review with a view to strengthening expenditure management processes.

(vi.) Cash management: Cash management in governments or in the commercial sector has the major objective of reducing the costs of money or cash being used in the entity without adversely affecting the scale of its activities or exposing the entity to risks in meeting its obligations. Underlying this practice is the recognition that money has alternative uses and shall not be left in a liquid state without earning its dues. Reinforcing this approach, the legislatures introduced in some countries a system of exchequer control (establishment of an authority that would work on behalf of the legislature and issue periodic warrants

to implement the budget) or the appropriations were so devised legally as to indicate the ceilings that were to be adhered to during the year.

Cash management has acquired additional importance during recent years in the context of stabilization programs either evolved on the own initiatives of governments or as a part of the agreements reached with international organizations. Cash management is undertaken with a view to ensuring a smooth implementation (to the extent possible) of the budget while avoiding uneconomic transactions stemming from immobilization of resources and borrowing more resources than needed. It arises to meet the different seasonalities in the collection of revenues and in expenditure outflows. In countries that have surplus budgets, it is intended to facilitate the utilization of surpluses so that the maximum return could be obtained. Cash management involves two contrary elements viz., acceleration in revenue collections and moderating the disbursement of funds without adversely affecting the scale of operations of agencies. Further, it is intended to formulate a common framework with reference to which the central bank, where it is involved, may prepare its plans for ensuring sufficient liquidity in the economy. Cash management is not a substitute for a budget nor is it intended to be an instrument to arbitrarily reduce, in the name of pursuit of macroeconomic stability, budgetary outlays.

In practice, cash management recognizes that there may be lags in the receipt of revenues. In particular, three types of floats are commonly noticed. Revenue collection agencies may reveal a *processing float* in that a lag is experienced in depositing the taxes paid by the public. In some cases, a *mail-float* may be experienced indicating the lag between the mailing of a check and its receipt and inclusion in the consolidated funds of the government and, finally, a *clearing float* may be experienced revealing the time taken in the check clearing system. In addition, government agencies may be having short-term cash deposits in the banking system pending payment for commitments already entered into. In this context, governments may be borrowing even when they have resources available internally.

Cash management involves a good deal of cooperative working partnership between the central and spending agencies. The latter, (which admittedly do not have information on the seasonality of revenues) have a better understanding of the seasonality in expenditure flows and of the lumpiness in payments. As a first step, therefore, agencies prepare draft plans indicating cash requirements for meeting their expenditure needs. These are then assessed in the light of revenue availability and borrowing capacity and ceilings are communicated to the agencies within which they are required to manage their finances. These ceilings ensure that there is government-wide observance of fiscal discipline, which may be further reinforced when banks also observe these ceilings. In formulating the ceilings, the entire gamut of transactions of government are considered excluding non-cash transactions that arise from foreign aid and intra-government transactions. If the gap between the resources needs and availabilities is too large, governments have the option either to accelerate revenue collections, reimbursement of pending foreign aid collections, or to defer, provisionally, some expenditures. Arrears reflect a failure of budget implementation and should not be resorted to. The adequacy of existing procedures of cash management should be periodically reviewed to ensure that they are serving the purposes for which they were designed.

(vi.) *Payment system and arrears:* Traditionally, the payments made to government and made by it were conducted by a treasury which was also a part of the ministries of finance or their equivalents during periods of monarchy. The primary emphasis during those periods was the safe custody of money and good book keeping so that the King's wealth was not subjected to pilferage and defalcation. With the emergence of democratic forms of government, the same form continued and reliance of the treasury system was considered necessary in the absence of a banking system with branches in the rural areas. With the gradual growth of the banking system, however, the importance of the treasury system came to be reduced.

In general however, the experience of many, including industrial countries, shows two distinct approaches toward payment, which for purposes of convenience, may be called as centralized and decentralized. In the centralized system (e.g. France), all commitments made by agencies are subject to prior approval by the treasury. Later, the documents relating to payment are reviewed by them and arrangements made for payment through cash or check. The detailed accounts are compiled by the agencies, but the treasury has direct up to date knowledge of the cash flows. Even after computerization, these procedures continue, largely because of the mainframe operations, which were located in the ministries of finance. In the decentralized systems (e.g. U.K., Sweden) there is a sliced release of budget authority within which agencies have the power to make commitments, to spend the money, and to account for it as well as be accountable for the total management of finances of the agency to the legislative oversight bodies. The underlying approach is that a central agency cannot keep an oversight on all transactions and that this responsibility was best left to the agencies so that a conducive and responsible behavior be promoted for heightened financial conscience in the agencies.

The need for a centralized treasury system has come to be considered again during the 1990s in the context of modernizing the financial management systems in the former centrally planned countries. Some countries in this block have installed a treasury system under which the existing functions of the ministry of finance were separated and established as a treasury to facilitate budget implementation. The framework of relations between finance ministry and agencies in some of these republics is illustrated in [Table 10](#). It shows that there are adequate safeguards for the ministry of finance to ensure prudent fiscal behavior in the agencies. The treasury system contributed to a consolidation of all accounts into a single account, and became, in several cases, an agency for verification. But because of the increased network, it contributed to more expenses, without commensurate benefits. Arguably, it also contributed to avoidable centralization.

In the context of application of computer technology, substantial sections of payments are conducted both through centralized and decentralized methods. In several cases, payrolls are organized on a centralized basis (although big agencies have their own payrolls) and pensions, public debt payments may also be centralized while all other payments may be made by agencies or by a centralized treasury. The importance of treasury as a focal point has been reduced, however, with an independent computerized system of payments, and simultaneous access to information.

The second aspect of payments relates to the instruments of payments. The traditional payment of cash continues to be the most dominant form in most countries, followed by checks (or payment authority) and electronic transfers.

Experience shows that the processing of cash payments are labor intensive and expensive while electronic payments are quick and less expensive, and facilitate a quick compilation of accounts. More significantly, necessary investment may be made by the corporate banking sector than by the government. Increasingly, more governments are moving to electronic payments, as it is economical.

The third aspect of payments relates to the arrangements with the banking system. In most cases, these arrangements are made with the central bank or with commercial banks (some of them owned by the government). Some arrangements may not always be transparent and in several cases, short-term advances may be made by the banking system routinely without charges. (On the other hand, government deposits may not also receive interest). In view of the proposed independence of the central bank, the relationships between government and the banking system should be reviewed and made more transparent while extending the market discipline to government transactions.

Payment controls have in recent years also contributed to the accumulation of arrears in payment. Many governments faced by resource shortages, do not honor their own pledges to pay, inevitably contributing to arrears. When arrears are anticipated, the vendor internalizes them and includes them in the prices quoted. More important, arrears represent an involuntary, zero-rate lending by the public to the government. As a control, arrears reflect a failure of the system and therefore are best avoided. But where they arise and are accumulated, it is important to have complete data on the age profile of arrears and a strategy formulated to their clearance and avoiding their recurrence.

It is important therefore, to review the existing payment arrangements, the instruments of payment, the arrangements with the banking system and the arrears and to explore the alternatives, including the progressive application of computer technology.

(vii.) Financial reporting: Financial reporting has several facets and different end uses. For purposes of expenditure management, end users comprise two distinct groups – internal and external. The internal group, in turn comprises – spending or administrative agencies, central agencies – e.g. ministries of finance and planning ministries. The external group comprises the legislature, public and international financial institutions as well as donors. Although, the end-use intent in each case is different, the source of information needed by all is the same, viz. accounting system. From an organizational point of view, it is necessary to review as to how the basic data are compiled, the frequency with which they are compiled, and the coverage of the material.

From the point of agencies, their primary interests lay in ascertaining the current budgetary status – the extent to which budgetary authority has been committed, authority available for new commitments and payments remaining to be made. This type of data may be maintained either by a central agency responsible for compiling accounts or in a decentralized system by the agencies themselves. In the former case, experience shows that there may be long lags in the compilation of data and to that extent the immediate needs of monitoring may not be met by the system. In such cases, reliance may be placed on the daily data furnished by the central bank. Such data are too aggregative in nature and may not be of much use to the spending agencies, although they illustrate, for the central agencies, the overall financial status. The spending agencies have an intent in ascertaining the physical progress, or issues in the delivery of services,

in areas which are of strategic importance to them. Toward this purpose many agencies have set up, to reflect their interests, management information system. In countries where EDP systems have been introduced, financial information, including analysis of budgetary variations, has become routine and any standard off-the-shelf software also provides these data.

The interests of the central agencies could be more generic. For example, the ministry of finance would be interested in monitoring the broad trends in budget implementation, in the levels of borrowing and in the flexibility needed for the remainder of the fiscal year. The needs of planning agencies could be both macro and micro in nature. From a macro angle, their interests are in ascertaining the progress made in the implementation of the development plan and from a micro point, the status of key projects that have a vital impact on the overall out turn.

The external users include the legislature, the public and the International Financial Institutions (IFIs). In some countries, depending on the legal provisions, periodic data are submitted to the legislatures. In countries that are dependent on borrowing, monthly information is published, including by the central banks, on government finances. In countries that are more technologically oriented, governments provide data on an up to date basis. Many countries are also participating in the program of observance of international standards in the dissemination of financial information and to that extent considerable progress has been made in making government finances more transparent.

Notwithstanding the rapid progress, largely through the impetus emerging from the growing application of computer technology – four aspects remain to be addressed. First, in several countries, data on foreign aid reveal problems of coverage, valuation and timeliness. Second, data on finances during the intra-year period may reveal a trend that may not be sustained through the year as year-end adjustments (which tend to be massive in some countries) may change the picture. These factors underline the importance of reviewing financial information with caution. Third, most of the data are on a cash basis and to that extent provide only a partial picture, as liabilities are excluded. To address this issue some countries (e.g. New Zealand) have taken to accrual accounting and to the publication of balance sheets at six monthly intervals. Fourth, the information published is mostly addressed to the investing public, rather than the general public whose interests may be less financial and more on the delivery of services and expenditure benefits.

(viii.) Budget revision: Although the intent is to secure congruence between budget intent and outcome, it is also necessary that the system is endowed with a degree of flexibility as rigidity could contribute to a triumph of process over purpose. Toward this end, three techniques are utilized. These are virement or re apportionment, supplementary or mini-budgets, and surrender of savings or provision for carryovers.

Virement is essentially intended to empower spending agencies, within overall budgetary limits, to shift proposed outlays from low priority to high priority areas. In some cases, these powers may be administered by the agencies while in a few cases, prior consultation with central agencies may be needed. The intent in placing limits on this technique is to minimize departures from the purposes approved by the legislature.

The movements in the economy may not always adhere to the predicted paths. Growth rates for GDP may be slower than forecast and inflation rates may

be higher than anticipated. Besides, there may be policy changes needed. All of these, in turn, necessitate changes in the budget. Toward this purpose, supplementary budgets seeking additional allocations may be proposed. In the countries that follow the commonwealth traditions, supplementary budgets may be submitted to the legislatures thrice a year (the timetables of the legislatures provide for this). In some cases, where more fundamental changes are indicated, mini, mid-term budgets may be prepared. In general, however, greater reliance on supplementary budgets sends wrong signals on the viability and credibility of the annual budget.

Experience also shows that vast amounts may remain unspent at the end of the fiscal year. As underspending in one year, according to the perceptions of spending agencies, may lead to reduced allocations in future years, efforts may be made to engage in spree spending on low priority areas. To avoid this and to promote orderly management some countries have permitted selective carryovers to the future years. This could, in principle, contribute to the implementation of parallel budgets – one for the current year and another comprising the carryovers from previous years.

In evaluating the need for revisions, it is essential to distinguish the policy changes, from the change in the assumptions about national aggregates and technical factors.

(ix.) *Performance orientation:* During recent years, there has been a growing recognition of the need to balance the emphasis of control by shifting somewhat from compliance to rules to improved productivity, performance and effectiveness. Toward this end forms of performance budgeting were tried in various countries (e.g. Australia, India, Malaysia, Philippines, Sri Lanka, etc.). Performance oriented budgets have some common ingredients: (i.) performance objectives – a statement of measurable objectives that are proposed to be achieved with the annual budget outlays, (ii.) a performance oriented classification that seeks to link up proposed objectives with the transactions of the agency, (iii.) a set of performance measures or indicators to show how the objectives have been achieved. Measures are deemed to be the quantitative expressions of outputs or results, while indicators are proxies for outputs or results. Indicators are usually provided where there are substantial difficulties in the measurement of outputs, (iv.) a system of performance oriented reporting that goes beyond the financial reports and covers the distinctive features of the activities, and (v.) a system of performance oriented audit.

The system, which has been evolving over the years, seeks to provide a window of opportunity to indicate efficiency through three approaches – (a.) target vs. actual, where the targets are associated with the objectives sought to be achieved, (b.) historical series of data on performance. Selective data such as cost or workload factors may be presented to illustrate the progress made by the agency; and (c.) through appropriate benchmarking with comparable activities in the corporate or other sectors. Through these measures, the system serves to provide a framework for a possible performance based contract between the agency and the legislature or the public.

The performance-based budgets pose their own quota of problems. Government services being somewhat unique may not lend themselves to easy measurement. Some measures, such as costs, require several changes in the supporting infrastructure. Further, performance oriented budgets contribute to supply driven expenditures in that once a bridge or a norm is established

between desired objectives, provision of complementary financial resources becomes obligatory. Its particular appeal lies in shifting the emphasis from inputs to results and in providing links to the delivery of services. Where such services are provided by contractors, it provides an improved empirical basis to link outlays with results.

The introduction of variants of this approach, despite inherent appeal, have not made much headway and where implemented, have not replaced the traditional system. At the same time, there is a recognition that this dimension is too important to be ignored, particularly in a context, where making public organizations more efficient has become an imperative, not an option, of the times. The progress made in this regard needs an in-depth review.

(x) *Pursuit of economy:* Budgetary practice makes a distinction between economy and efficiency, the former reflecting a more economical use of given resources and the latter concerned with greater than scheduled achievement with given resources. Both of these firmly belong to the managerial realm during the phase of budget implementation.

In envisaging economy and efficiency, a goal that is shared without any qualifications by all, three factors need to be explicitly considered – (i.) the nature of economies, (ii.) the mechanism for securing them, and (iii.) the incentive structure for the agencies to pursue them. Economies in many cases tend to be *ad hoc* with minimal life duration. The annual calls for reducing utility consumption, purchase of office equipment, deferral of salary increments are of this type. Economies, to the extent secured, have at best, a contribution for that fiscal year and tend to catch up in later years. Real economies should be more durable and should seek improved or alternate ways of service delivery at a lower cost. The second type requires a mechanism, such as evaluation. Evaluation seeks to improve agency and program effectiveness through a review of the rationale of programs, and identification of the areas of strengths and weaknesses and deriving lessons for improvement. In order to be effective, there should be effective links between the budgetary process and evaluation. An advance program of evaluation, reflecting the priorities and high-risk areas of the budget, needs to be formulated annually. A separate organization for the purpose may add to the objectivity; undertaken by agencies, the technique may be used to support their agenda rather than to secure an optimal mix of programs and activities.

The agencies may have little incentives to seek economies if such efforts lead to reduced future budget allocations. In some countries, e.g. Australia, agencies are permitted to retain half of the moneys saved to be utilized for agreed projects. Similar incentives may be needed to make the search for economics a regular budgetary mechanism.

(x.) *Areas for review*

- Contract management: centralized or decentralized; management of controls: service delivery
- Cash management; adequacy and its contribution to total budget management
- Relative roles of policy, process, regulatory and efficiency controls in the process and the balance in emphasis

- Delineation of tasks between central and spending agencies and their implications for centralization and decentralization
- Adequacy of procedures for time-sliced release of budget authority and monitoring of commitments
- Payment systems; authority for issue of checks; use of different instruments; application of technology; arrears accumulation and their implications
- Financial reporting; forms; content; bases and periodicity and end use
- Budget revision; procedures and their impact
- Performance orientation; current practices and future plans; and
- Pursuit of economy; present practices and plans for improvement.

5. Project Implementation and Expenditure Control

(Nature and scope; MTEF and PIP; role of spending agencies; cost management; Pace of aid utilization and implications; contract management and areas for review)

(i.) Nature and scope: From an expenditure management view, there are three distinct phases in the implementation of projects. Apart from the pre-budget stage and associated appraisal, annual expenditure management involves the link of public investment plans with the medium-term plans, payments for the work completed and their implications for cost controls, and where relevant, for foreign aid, and reaping the benefits from projects. To facilitate these tasks, many governments have compiled detailed project profiles and specification of milestones for completion are also compiled. In the payment phase and important distinction is discernible from other payments. For the bulk of non-project payments, the task of verification of documentation is part of the responsibilities of the accounting staff. For projects all payments are subject to a detailed review, prior to payment, by the engineering staff and the role of the accounting staff is relatively minor.

(ii.) MTEF and PIP: Role of spending agencies: As noted previously, some governments have been engaged, during recent years, in the preparation of MTEF and medium term public investment plans as well as annual plans. The experience in this regard provides, as yet, a mixed picture revealing the need for considerable progress to be made. In several cases, spending agencies do not appear to have the capacity to undertake these plans. In some cases, the approach continues to be one of compiling shopping lists uninfluenced by the resource picture with the result that the annual review becomes a long and contentious one. To that extent, the procedural conveniences of instruments such as MTEF are not fully exploited in practice. Moreover, the political forces and the need for inclusion of projects for gaining benefits of visibility would appear to dominate the technical and financial considerations.

(iii.) Cost management: The role of expenditure management is a significant one in the course of project implementation and experience shows that this is also an area where it has been a major failure. In several cases, the completed cost is vastly different from the estimated or contracted cost, largely due to initial underestimation, frequent design changes, wrong assumptions on technical

matters such as exchange rate and prolonged delays in implementation. Delays are partly due to administrative reasons and partly due to financial factors. Experience shows that in some countries, delays are extensive in the procurement of sites for construction. To minimize this impact, some governments have been trying to include projects in budgets only after sites have been acquired. In other cases, routine Underfunding of projects has contributed to further delays. It appears more prudent to make estimates of completed costs that are more realistic. The accounting system should shift its emphasis from routing compliance of rules, to the management of costs; Revisions of costs make cost recovery a more difficult exercise.

(iv.) Pace of aid utilization and implications: Most projects as defined by governments, are funded by donors or from loans obtained from IFIs. Here again, experience shows that the pace of utilization, reflecting the general pattern, is remarkably less than forecasts. Such slow utilization has a different, and frequently, a costly impact, on the finances of a country. Most loans have commitment charges that have to be paid even if the funds are not utilized. Such payments to the donors and IFIs could, in some years, be higher than the aggregate inflows from these sources contributing to an overall negative flow. The slow utilization could be the result of both the administrative and financial factors described above. An overall negative flow does not help the political situation any more than what it does to the image of the expenditure management system.

(v.) Contract management: Implementation of projects involves regular contact with contractors and monitoring of their activities. Experience shows that there is a major difference in the approaches of the contractee and the contractor. The contractee has to keep, in view of the enormous implications, one eye on the aggregate fiscal picture; the contractor is, however, more narrow in his perspective in that the task for him is to complete the job at hand and move on to other jobs, and to that extent may follow a divergent path in spending than the ceiling constricted approaches of governments. In turn, this needs, that where cash ceilings are indicated, they should be calculated, with one eye on the aggregate picture and another on the links with the physical stages of project work. This is a complex task and if not performed effectively, could contribute to arrears in payment.

(vi.) Areas for review

- Review of the capacity and approaches of spending agencies for integrating annual plans with medium term rolling forecasts
- Review of cost systems and identification of factors (and their controllability) contributing to cost overruns;
- Review of foreign aided projects and measures that can contribute to enhanced pace of utilization; and
- Review of relationships with contractors so that there could be improved understanding in the determination of cash ceilings.

6. Management of Fiscal Crisis

(Nature and scope; measures taken, program effectiveness, risk management, and areas for review)

(i.) Nature and scope: Fiscal crisis can be both a medium term, or a short-term issue that arises during a fiscal year. The reference here is to the latter type. Several issues reflecting the developments in the economy arise during the implementation of the budget in a fiscal year. These developments, to the extent not anticipated, could involve changes in the directions of budgetary policy and a budget outcome different from the intent. The economy could experience sudden and severe shortfalls in revenues, or in those countries dependent on foreign aid, changes in the plans of donors might in turn need substantial changes in the budget. How are these crisis managed? What has been the response of expenditure management machinery in dealing with this type of fiscal crisis? What are the lessons of experience?

(ii.) Measures taken: Experience shows that governments take a range of actions aimed at containing fiscal crisis. The underlying rationale behind these efforts is to ensure, as far as possible, that the size of the budget deficit has not widened as a result of revenue shortfalls. Broadly, the following measures are taken to limit expenditures or to reduce them to reflect the changing revenue resources during the year. (i.) As a short term economy measure, unfilled personnel positions may be deferred, held in abeyance or abolished; (ii.) In several cases limits are also placed on some elements of running costs – utility consumption, foreign travel, etc.; (iii.) Frequently across-the-board cuts are imposed on all budgetary activities in the form of percentage reductions from the approved appropriations; (iv.) major capital projects, which have not yet made significant progress may be deferred; (v.) during recent years, distinctions have come to be made between essential or core and non-core expenditures and budgetary payments may be limited to essentials such as wages, debt payments and other selected categories of expenditures, and (vi.) in several cases substantial payment arrears may be incurred.

(iii.) Program effectiveness: The above approaches reveal several problem areas that have a vital impact on the credibility and effectiveness of the proposed programs. These issues have their roots in the systemic aspects of expenditure management. First, experience shows that the approaches to crisis management suffer from severe handicaps. There is little anticipation of the impending crisis and consequently little preparation in the formulation of the contingent programs. The delays in the identification of the problems contribute to delays in policy formulation and there is, in general, little consultation with the spending agencies. Second, most reductions sought have become, in several cases, hardy perennials (e.g. continuing exhortations to reduce personnel and other outlays) with the result that the spending agencies seek to provide slack in their budget estimates to overcome the short-term reductions. Third, most measures aim at object categories without an assessment of the expenditure profiles of programs or their impact on programs. The result is that the delivery of services is severely affected while full payments are being made for wages. Fourth, the accumulation of payment arrears has severely eroded the credibility of governments, and fifth, in countries with complex legal provisions, limiting or reducing approved budget estimates requires prior legislative approval, and this has often been a tortuous

exercise. Overall, the working of the machinery shows that there is little anticipation and when crisis arrives, the policy packages are ineffective.

(iv.) *Risk management:* Given the mutual reinforcing mechanisms between the budget and the economy and in view of the inherent vulnerabilities of the economy, it is prudent, as recent experience of some governments shows, that efforts are made to install risk management as a feature of expenditure management machinery. Risk management involves the recognition, and consequently preparedness, to deal with three types of risks – macroeconomic, program and financial. Macroeconomic risks deal with the major vulnerabilities of the budget and how they may be addressed. This in turn could involve the establishment of notional contingency reserves that could be invoked in the event of unexpected slack or changes in the exchange rate. In the event of a major resource shortfall, this could imply, the formulation of policy packages aimed at containing or reducing outlays in terms of programs in the light of full assessment of the impact of proposed reductions in outlays on delivery of services. These efforts have to be made both at the level of administrative agencies and the central agencies and in planning for risks, the known, presumed, and as yet not fully known factors have to be taken into account and internalized at the program level. Financial risks are associated with the acquisition and management of financial assets and contingent liabilities. As a part of this approach, the factors affecting the provision for loans, and contingent risks stemming from guarantees have to be considered and alternatives explored. These approaches have the potential of substantially augmenting the capacity of governments in facing mid-year fiscal crisis.

(v.) *Areas for review*

- Availability of information to anticipate fiscal crisis
- Process of formulating action packages and a review of their adequacy
- Consultation between central and spending agencies in the above process; and
- Procedures for identifying and dealing with macroeconomic, program and financial risks.

7. Resource Use Accounting

(Nature and scope; features; issues; and areas for review)

(i.) *Nature and scope:* Although accounting is considered by many to be a single and unified field, yet in practice, government accounting has developed, over the years, as a separate field. It has gone through a good deal of evolution, and it is safe to assert that it is still evolving in several countries. The crucial issue now raised is whether governments should move over to accrual accounting has been considered earlier. The discussion here relates to the other aspects of accounting, which, for purposes of discussion, are summarized in [Table 11](#).

(ii.) *Features:* Government accounting continues, in several cases, to be based on single entry bookkeeping method, and is cash oriented. The primary purpose of accounting is to record the budget transactions as they take place and compile

appropriation accounts that are rendered to the audit agency for its scrutiny. To a large extent, therefore, the classification followed is mostly identical to the budget system. Through a systematic compilation of data, it enables budget management at each and every stage. It also assists in the compilation of national income accounts. Until recently, there were few efforts to develop costing except in regard to major projects, but owing to the imperatives of the fiscal situation, attempts are being made to develop costing methods, either as integral parts or on a supplementary basis of the accounting system.

(iii) Issues and areas for review: Although in principle the system should function effectively largely because of its simple design, yet in practice several common issues are explained. First, organizationally, it is found that the compilation of accounts takes a long time and there are inordinate delays in the submission of intra-year and year-end accounts. As a consequence, decisions that are to be made are rendered difficult and implementation of the budget suffers, as a consequence. In part, this may be due to the centralization of accounts in a single organization set apart from the spending agencies. It is argued that separation of accounting from the spending agencies has contributed to a reduced financial consciousness in the agencies. In part, the year-end accounts may be delayed due to the extended complementary or liquidation periods. Second, government accounts lack, for the most part, standards that specify the treatment of the items, and that are in accord with the generally accepted accounting principles (GAAP). As a result, in analyzing historical series, considerable attention has to be paid to the inflation factors. Third, the links with performance reports, where available, remain tenuous and activity based costing remains a distant and as yet an elusive goal. Fourth, the final accounts may be too brief or too summarized to be of much use to the spending agencies and to the public at large. Because of the continuing cash orientation and lack of inflation adjustment, the picture of assets and liabilities can be incomplete and misleading.

To address many of the above issues, vigorous efforts are being made to make large investments in the application of electronic technology and to that extent, a transition is being experienced in several countries. In order to assess the current status and the future directions of government accounting, the following areas need to be reviewed.

- Current status of the basis and where it is cash, efforts made to complement it with elements of accrual accounting
- Compilation of detailed accounts to assist in budget monitoring
- Efforts made to install costing methods
- Efforts being made to develop accounting standards; and
- Organizational factors contributing to delays in the compilation of accounts.

8. Internal Audit and Evaluation

(Distinctions; and areas for review)

(i.) Distinctions: Internal audit and evaluation reflect, in some measure, the concluding stages of expenditure management within the

executive. The former is intended to ensure compliance with the relevant laws. It consists of a systematic review of all operations of an agency so that the interrelationships between inputs, activities and outputs could be looked at afresh and the agency management advised about the findings. It is generally organized as a part of the office of the head of the agency and its role is a concurrent one, in that it undertakes reviews even as the activities are undertaken. Internal audit, is interpreted in some quarters, in a narrower way as consisting of verification of vouchers before payment. This routine function is sustained in the payment process discussed earlier. In this section, internal audit is interpreted in its broad connotation.

Evaluation, unlike internal audit, is mostly done at the conclusion of a program or a project and is more concerned with the impact of resources used and the benefits generated. It seeks to provide useful data, to the management, on securing an approach that has the potential to improved cost management. More specifically it seeks to stimulate an awareness of the issues in policy formulation, implementation and impact. As a result, information is provided, to those interested on the effectiveness of the organizations, their methods and procedures and the schedules used. Organizationally, it may be undertaken by the agencies themselves or established as a separate agency. Each year, an agenda may be developed, reflecting the concerns of the public, executable and the legislature, consisting of the areas that may be evaluated, and a design may be either a sample survey, a case study approach, a field experiment or the use of already available data.

(ii.) *Areas for review:* In view of the growing importance of financial accountability and the need for pursuing economical and efficient ways of program and policy delivery, it would be prudent to review the existing facilities available for the purpose. It may be noted that most governments have yet to make a beginning in this respect and as such, where there is no existing machinery, the plans and intents of governments may be ascertained. More specifically:

- the functional effectiveness of internal audit
- scope, functioning, and impact of the evaluation machinery on policy and program delivery, need to be reviewed.

9. Intergovernmental fiscal Management

(Scope; grant management; lending and contingent liabilities; and areas for review)

(i.) *Scope:* Intergovernmental fiscal management is technically viewed as an integral part of federal finance, but is considered here for two reasons. First, macroeconomic stability requires the pursuit of fiscal goals by the central and other levels of government. Fiscal perversity or major fiscal slippages may, by widening the size of the fiscal deficit, have adverse impact on macroeconomic stability. Second, in several countries, many services which are funded by transfers from the central budget are actually provided by the regional, state and local governments. The effectiveness of service delivery is dependent, among others, on the conditionality specified and on the capacity of the local administrative machinery.

(ii.) Grant management: Transfers from the federal or central government essentially take the following forms – devolution of taxes; specification of subventions (which among others may be for purposes of budgetary management) in permanent or annual law and associated transfers; discretionary grants, and loans including relent funds from donors and international financial institutions. In addition, central governments may provide guarantees (with associated contingent liabilities) to the lower levels of government.

From an expenditure point of view, there is little control that can be exercised in regard to devolutionary transfers, and statutory subventions. These transfers take place routinely, and in some of the former centrally planned economies, the shares of the lower levels of government are automatically retained in the banking system. The system of expenditure management has a role primarily in regard to the determination of bulk grants or specific conditional grants, and in some cases, contributions by the lower levels of government. Traditionally, the pattern was to specify the conditions for the use of grants in extensive detail. During recent years, however, there has been a trend toward bulk grants and empowering the lower levels of government to use their flexibility keeping in view the general goals. Moreover, there may be cases where general mandates (e.g. Road safety; environmental standards) may be issued by the central government without provision of funds. In these cases, funding the mandates creates additional demands on the resources of lower level of governments.

Experience shows that broadly two issues are encountered in the management of grants. First, grants may not be released in time. More specifically, when central governments experience fiscal stress, they tend to underfund the transfers. This contributes to a good deal of uncertainty at the lower levels and contributes to major problems in service delivery. On the other hand, it is argued, that the lower levels of government cannot be immunized from the general fiscal stress and that sacrifices should be common for both levels of government. Second, from the grantor's point of view, the only machinery available for ensuring that the purposes of grants are met is to rely on the system of financial reporting and occasional inspections. Neither has proved to be sufficient.

(iii.) Lending and contingent liabilities: Governments at the central level also extend loans to lower levels of government. In some cases (e.g. India), funds received from international financial institutions may be relent to lower levels of government at different rates of interest and amortization schedules to compensate for the assumption of risk. Relending takes place because of the restrictions on the local governments to borrow from foreign resources. Moreover, guarantees are also offered.

From an expenditure point of view, two considerations are important. First, the loans, which technically constitute financial assets for the central governments, may be converted to grants and thus a hard constraint may become a soft one. This also changes the composition of the financial portfolio of the central government. Second, in the absence of proper arrangements, when the lower levels of government default on the loans, the repayment liability may be taken over by the central government with the inevitable consequence of a widened fiscal deficit.

(iv.) *Areas for review:* Given the importance of the role played by lower levels of government, it is appropriate to review:

- The existing arrangements for grant determination, conditions associated with them and the adequacy of the machinery to ensure their fulfillment; and
- Arrangements for extending loans and guarantees and their management.

10. Debt and Contingent Liability Management

(Scope; sinking funds etc; record maintenance; areas for review)

(i.) *Scope.* Debt management is appropriately considered to be a part of the conduct of monetary policy. During recent years, however, the responsibilities of the central bank as the debt manager of the government are being reduced and returned to the government. The scope of discussion here is limited to the more technical aspects of organization of repayment funds and the maintenance of public debt registers, regardless of the agency responsible for its maintenance.

(ii.) *Sinking fund etc:* Until the end of the Second World War a distinction was made between unfunded debt and funded debt. The former usually consisted of funds held by the government in a trust capacity and utilized for financing budget needs without the issue of formal instruments of debt. These funds, usually called, public account or trust funds are quite substantial in size and frequently consisted of provident funds, employee retirement funds, contractors' deposits etc. These were called as unfunded largely for the reason that there were no amortization schedules and no sinking funds to fund their repayment but were organized on the principle of inflows financing the outflows. Parts of these amounts are paid interest and some parts such as contractors deposits may not be paid any. In the interest of proper discipline, however, it is appropriate that this segment is recognized as public debt (only that part utilized by the government).

In most countries, public debt is treated in a separate chapter in the budget and is conducted on a centralized basis, usually by the ministries of finance, or autonomous agencies set up for the purpose. Where it is managed by the latter, it may not be adequately shown in the budget at all. A major feature of a separate chapter is that the costs of the debt service are not recognized by the spending agencies that use the loan proceeds (the proceeds do not have separate identity once they enter the stream of consolidated funds of the government). Some countries (e.g. Chile) have started showing the project loans and associated debt servicing as a part of the outlays of the concerned spending agency in the hope that this will promote a heightened awareness of the costs of debt servicing.

To enable repayment for recognized loans, many countries organized sinking funds (funded debt) and contributions were made into the sinking funds based on the amortization schedule of the loan. The repayments, when due, were made from these funds. Sinking funds, however, fell into disuse after the second world war largely reflecting the view that the magnitude of debt was too high (larger than GDP in some cases) and that the credibility of the government was to be seen, not in terms of the size and procedures of sinking funds, but in terms of the overall macroeconomic policies. During recent years, however, there has been an advocacy for the revival of these funds

on the ground that they may be helpful in shoring up the credibility of governments in the markets.

As noted earlier, governments are also engaged in relending to levels of government. The proceeds of loans are organized, in a few countries (e.g. Indonesia) into separate funds, which are then used as sources of short-term financing of the central budget. The scope for the use of these funds arises largely because of the differences in the amortization schedules between those from the primary and secondary lenders.

An equally significant aspect relates to the guarantees and to the maintenance of contingent liabilities. Some countries have enacted laws governing the issue and terms of guarantees and the arrangements for the recognition of contingent liabilities. In others, however, these are recognized only when the liability is invoked, in turn contributing to budgetary volatility.

(iii.) Record maintenance: Considerable progress has been made, over the years, in the maintenance of external debt records and reporting of data in conformity with international standards. In regard to domestic debt, however, the maintenance of the debt register reveals that there are long lags between the purchase of instruments and their accrual recording. These lags have, in some cases, contributed to the development of secondary markets which are also informal. Selective progress has been made in the computerization of these records but admittedly, more remains to be done.

(iv.) Areas for review: It is appropriate to review:

- The arrangements for the unrecognized debt
- Arrangements for showing the costs of public debt for projects in terms of users
- Organization of sinking funds and other amortization funds
- Procedures relating to guarantees and contingent liabilities; and
- The procedures for the maintenance of national debt registers.

11. Post Budget Control: Audit and Legislative Control

(Scope; types of audits; legislative consideration; issues in effectiveness; areas for review)

(i.) Scope: Audit, like other aspects of government financial management is considered to be of vital importance for securing accountability in a civic society. In recognition of this, many countries, including the former centrally planned economies, have established offices of audit on an independent basis. In many countries, the office of the audit, established under separate legislation, is usually endowed with a good deal of independence so as to secure unbiased assessment of the government's financial performance.

The scope of audit remit differs from one country to another. The broad range is illustrated in [Table 12](#). In many countries, the audit may be limited to the central government. (In India, the Auditor General audits the accounts of state governments in addition to compiling accounts; the separation of accounts is limited to the central government). In a few countries, the scope of audit may also involve supplementary audit of state owned enterprises by the audit office. The powers of the audit office to review the accounts of organizations/contractors

receiving funds from government may be very limited. To overcome legislative restrictions, audit agencies may be asked to look into the books as a part of conditionality attached to the transfers from government. These arrangements are somewhat ad hoc.

(ii.) Types of audits: Audit is generally viewed as an activity that takes place largely after completion of the fiscal year. In reality, however, the practices differ and there is audit on an a priori basis, concurrent basis and a post-priori basis. Although a priori audit is not common, it still takes place in some industrial countries (e.g. Italy). This audit involves participation in the financial control process and transactions are reviewed by the audit agency before they take place. Concurrent audit takes place even as the financial transactions are being concluded and to that extent the views of audit may be taken into account in making decisions. For the most part, however, audit is conducted after action is completed. This audit comprises, broadly, three elements. The judicial audit, which is less common, puts the agency in a quasi-judicial status in that the audit agency is not only responsible for the audit of accounts, but also to identify and pass judgments on delinquent officials. Financial audit (which includes, administrative and appropriation audit) includes examination of whether operations have been carried out in compliance with existing laws and regulations, and whether expenditures were contained within appropriations (and in case of excesses, they are regularized *expost facto* by the legislature on the recommendations of the audit agency) and whether the broad purposes of the legislature have been met. Performance audit, relatively of recent origin, involves the examination of the pursuit of economy, efficiency and effectiveness and whether more value could have been obtained. In addition, audit agencies may also undertake, mostly at the behest of the legislature, special or investigative audit of specific areas or transactions. This may involve scrutiny of selected policies introduced by governments prior to elections (e.g. New Zealand).

(iii.) Legislative consideration: Audit is generally viewed as an organization aimed at assisting the legislature in the conduct of financial affairs of the country. It is for this reason, that audit reports are considered by the legislatures and action proposed. In the absence of such action, audit reports would have reduced value serving only the transparency function. Accountability implies that the reports be considered by an oversight body. Procedures in this regard differ among countries. In the commonwealth type of countries, audit reports are first examined by the Public Accounts Committee – a committee of the legislature – and its findings are submitted to the whole house. In all these cases, however the reports are first considered by the audited bodies and by the government.

(iv.) Issues in effectiveness: Although audit is an important and a venerable function, its effectiveness, some contend, is limited for following reasons. First, audit is precluded in most cases, from reviewing policy aspects. Limiting attention only to the financial transaction does not enable a full perspective on the financial viability of policies. Second, in a context where a greater share of transactions is being carried out by autonomous agencies, non-governmental organizations and contractors, the limited remit of the audit agency and its lack of access to their records, limits the scope of audit. Third, performance audit remains for the most part, at an early stage and more progress remains to be made. Finally, the

overall purpose of audit is to have a more effective financial management system but the improvements brought about as a result of audit are few and far between.

(v.) *Areas for review:* The following areas merit review.

- Organization of the audit agency, its independence and statutory powers
- Remit of the audit agency and complementary efforts by others to complete the audit of all levels
- Emphasis on the type of audit and plans to undertake performance audit
- Links between legislative committees and the audit agency and adequacy of arrangements to ensure action; and
- Overall impact of the audit work on the financial management system.

