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FOREWORD

Reflecting the evolving needs of Asia and the Pacific, the Asian Development Bank has been transforming itself from primarily a project lender to a broad-based development institution. This transformation is consistent with the international consensus that the development impact of external assistance is crucially linked to the soundness of the recipient country’s economic and social policies.

The successful implementation of such policies is in turn linked to the quality of governance and the caliber of a given country’s public sector. It is in recognition of this linkage that the ADB approved in 1995 a policy paper on Governance for Sound Development Management, and in July 1998 an Anti-corruption Policy. These policies on governance and anticorruption can only be translated into practice by significant and sustained improvements in the efficiency, integrity, and effectiveness of public-sector management, and also in accountability and transparency of corporate and financial governance in the private sector. This is indeed one of the many lessons of the Asian financial crisis. The Bank is determined to heed these lessons and help its member countries turn crisis into opportunity for renewed economic and social progress on a new and stronger basis. Among the many areas of public-sector improvement, strengthening the management of and accountability for public expenditure is central.

The challenges faced by developing countries are to strengthen fiscal discipline, bring resource allocation in line with policy priorities, create an enabling environment for public financial managers, and protect due process. The Bank can assist by putting at their disposal the basic conceptual framework, the principles of good budgeting, a synthesis of international consensus on desirable reforms, and the lessons of international experience, both the successes and the failures. This book is one step in this direction. It is our hope that it will prove of
practical value and of interest. It is based on a selection of papers presented at two major events organized by the ADB: a Seminar on Public Financial Management and Accountability at the 1999 Annual Meeting and the ADB-organized module on the same subject at the World Conference on Governance in Manila in June 1999. Our sincere thanks go to all the eminent contributors, as well as Marilyn Pizarro for research assistance, Me-an Asico for copy-editing, Merly Mallion for organizational assistance, and Ruby de Vera for production assistance.

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Chapter 1

Governance, Corruption, and Public Finance: An Overview

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Introduction

Growing attention has been directed in recent years to the role of government. Governance in general and corruption in particular have been much discussed because of the way they affect, and are affected by, the role of government. Dictionaries generally define “governance” as government. Thus, good governance is good government. In recent writing, however, governance has taken on a more substantive, though still not precisely defined, meaning.

Good governance is an essential part of a framework for economic and financial management which also includes: macroeconomic stability; commitment to social and economic equity; and the promotion of efficient institutions through structural reforms such as trade liberalization and domestic deregulation.

Poor governance may result from factors such as incompetence, ignorance, lack of efficient institutions, the pursuit of economically inefficient ideologies, or misguided economic models. It is often linked to corruption and rent seeking. A good part of this paper will thus deal with corruption. However, it should be understood that corruption is not identical with poor governance, which extends well beyond corruption, although poor governance often leads to corruption and corruption is an important element of poor governance.
Before dealing with governance and corruption issues vis-à-vis public revenue and public expenditure, I would like to note two simple relationships emerging from international experience: (i) corruption is generally less frequent in richer countries; and (ii) there is a negative correlation between the rate of growth and corruption. Thus, more corrupt countries tend to be poorer, and to grow slower (if at all).

Corruption

Views about corruption have undergone a great change in recent years. Not too many years ago, the economic successes of the countries of South East Asia were attributed by some observers to a presumably positive impact of corruption on facilitating decision making. However, after the crisis of 1997–1998, these views changed and many observers, both inside and outside the crisis countries, blamed corruption for the crisis. For example, it was pointed out that some individual investors had been able to borrow very large sums from banks at low rates, sums which had been invested in highly questionable projects. After the crisis there has been a strong interest in increasing the transparency of institutions and in promoting more arm’s length relationships in economic deals. Whether this interest will generate concrete changes remains to be seen.

Corruption has also attracted a lot of attention in Russia, Pakistan, Kenya and many other countries. Many observers have connected the poor functioning of these economies to various governance problems. In fact, there is now a growing awareness among economic observers and economists that these governance problems have a negative impact on economic performance. For this reason, the new architecture for the world financial system is paying a lot of attention to transparency and governance issues. Standard and codes of conduct are being developed and countries are being urged to adhere to them.
Several international organizations including the Asian Development Bank, the International Monetary Fund, the Inter-American Development Bank, the OECD, and the World Bank have intensified their work in this area and have been promoting a campaign against corruption and for more transparent and well-governed economies. The work of these institutions has been complementary and with a common objective, namely, to promote good governance and by so doing to improve the quality of policy making. It is hoped that this improvement will reduce the frequency and severity of financial crises and will promote economic growth.

Until recent years, some economists presented what could be called a romantic view of corruption. Such a view made corruption seem almost a virtuous activity. For example, it was argued that corruption “oiled the economic mechanism” or “greased the economic wheel” and made economies more efficient by removing rigidities which put obstacles to investment and economic activity in general. Some argued that corruption allocated investment to the most efficient uses—because the most efficient investors would be able to pay the highest bribes. Some argued that even the efficiency in the use of time could be improved by corruption because those whose time was most valuable could save on its use by paying the highest bribes to move in front of bureaucratic lines. Finally, it was even argued that corruption made it possible for the government to keep wages low—because the bribes that the public sector employees received made them accept lower wages. Low wages allowed taxes to remain low and low taxes stimulate growth. Various theoretical articles supported these somewhat unorthodox and at times even bizarre conclusions.

This romantic view of corruption has been replaced, in more recent years, by a more realistic and much less favorable view. In fact, the more recent view is that, rather than being the oil that lubricates the economic mechanism, corruption is the rust that slows it down. It has been argued that rigidities created
by regulations are not God given but are, rather, man created and thus endogenous to the system. Once bureaucrats realize that they can take advantage of regulations, they will produce more of these. There will thus be more regulations and these will probably become less transparent. The highest bribes will be paid not necessarily by those most efficient at producing but by those most efficient at rent seeking. Furthermore, the potentially most able individuals will channel their energies towards rent seeking rather than towards socially productive activities. It has also been pointed out that corruption is contagious so that its nefarious effects spread with the passing of time and affect a progressively larger proportions of the relevant population.

Corruption can be defined in different ways. However, the most common definition is that it is the abuse of public power to promote private benefits. Thus, a public employee who abuses his/her public position to derive benefits for oneself or friends, relatives or political associates is engaging in an act of corruption. Not all cases of corruption involve the payment of bribes.

A n important question is whether corruption can be measured directly. A moment of thought indicates that such an attempt is unlikely to be successful. It is not even clear what one would wish to measure. Should one attempt to measure acts of corruption? Or amount of bribes paid? Or number of persons involved? Or number of transactions contaminated by corruption? It is not clear which but, in any case, none of these attempts at measuring corruption would be successful. For this reason, not surprisingly, there is no direct measurement of corruption available for any country.

While no direct measurement of corruption exists, following a trend that is becoming more and more common in economics and in other fields such as political science and sociology, in recent years, data have become available that attempt to measure not corruption per se but people’s perceptions of the prevalence of corruption.
In this approach, presumably informed observers are asked to rank countries, often on a score of 1 (most corrupt) to 10 (least corrupt). It is not always clear whether the samples are random and large enough to provide statistically acceptable results. It is also not clear to which extent the data are fully comparable across countries and over time. However, there are now at least six institutions, including Transparency International and the World Bank, that have been generating data on the perception of corruption. In spite of their shortcomings, the data are being used with increasing frequency by economists in their cross-country statistical studies. It is important to add that the users often ignore the weakness of the data and may, at times, draw perhaps too strong conclusions from them. At the same time, it is important to point out that there is a high correlation among the various indexes of corruption provided by the various institutions. This gives some assurance that they are broadly on target.

Various factors contribute to corruption. See Tanzi (1998) for more details. Some of these factors have a direct impact; others only an indirect one. Among the factors which have a direct impact we should include (a) regulations and authorizations; (b) complex tax systems; (c) government spending decisions; (d) public provision of goods and services at below market prices; (e) situations in which public employees have discretionary power over economic decisions; and (f) need to finance political parties. Among the indirect causes must be included (a) the quality of the bureaucracy; (b) the level of public wages; (c) institutional controls, both internal and external; (d) the severity of the penalty system; (e) the transparency of rules, laws, and processes; and (f) the example provided by the leadership of the country.

The factors listed above are probably the most important that in various ways determine the extent of corruption in a country. In the next section we discuss in some detail the relationship between the structure of public revenue and public expenditure and governance in general and corruption in particular.
Governance and Taxation

Good governance calls for taxes that are based on clearly written laws and do not require frequent contacts between tax payers and tax administrators, which are more likely to lead to acts of corruption by tax administrators. Corruption is likely to be a major problem to tax and customs administrations in the following situations (Tanzi, 1998):

- The laws have many exemptions and special treatments.
- The laws are difficult to understand and are subject to different interpretations so that taxpayers need assistance in complying with them.
- Frequent contacts between taxpayers and tax administrators are required to determine tax liabilities and pay taxes.
- Tax administrators are paid low wages.
- Acts of corruption on the part of tax administrators are ignored, not easily discovered, or, when discovered, are not penalized or penalized only mildly.
- Administrative procedures (e.g., the selection of taxpayers or audits) lack transparency and are not closely monitored within the tax or customs administration.
- Tax administrators have discretion over important decisions, such as those related to the provision of tax incentives, the determination of tax liabilities, the selection of audits, and litigations.
- More broadly, the state (the principal) exercises weak control over the agents that carries out its functions.

In case of political corruption, those who represent the state (president, prime minister, ministers) or their close relatives and cronies may use the tax and customs administrations to pursue rent seeking and corrupt practices. They can even write the laws to their own advantage.
In some countries (e.g., Peru and Uganda), the tax administration became so riddled with corruption that the government decided to close it down and replace it with a new and more independent one. Several countries have had very corrupt customs administrations. This has led in some cases to the jailing of the director of customs and in others to the replacement of the domestic customs organizations with foreign companies providing preshipment inspection services.

Reports from several countries indicate an unusually large number of applicants for poorly paid jobs in tax or customs administration, suggesting that the applicants are aware of the opportunities for extra incomes that these jobs can create.

**Governance and Public Spending**

Corruption can affect public expenditure in different ways. The categories of public expenditure most affected by corruption are discussed below. In all these areas, lack of transparency and of effective institutional controls are the main factors leading to poor governance.

Public investment projects have frequently lent themselves to acts of high-level corruption or rent seeking. Because of the discretion that some high-level public officials have over decisions regarding public investment projects, this type of public spending can become distorted, both in size and in composition, by corruption and rent seeking. Public projects have, at times, been carried out specifically to provide some individuals or political groups with opportunities to receive “commissions” from the project implementers, or to benefit particular areas or individuals. This has reduced the efficiency of such expenditures and has resulted in projects that would not have otherwise been justified on the basis of objective criteria of investment selection such as cost-benefit analysis.
Procurement, i.e., the purchase of goods and services, is another area that is often affected by poor governance. To lessen the possibility of corruption, some countries have developed complex and costly procedures which may have reduced corruption at the cost of sharp increases in the prices of some goods and delays in the corresponding government activities.

Extrabudgetary accounts for given types of expenditure or revenue are common in many countries. Some of them are set up for legitimate purposes (pension funds, road funds, etc.). Others may be set up to reduce the political and administrative controls that are likely to accompany budgetary spending. In some countries, the money received from foreign aid or from the sale of natural resources such as oil and other minerals is channeled into special accounts which are typically less transparent and less closely controlled than budgetary funds. Some of this money may find its way into illegitimate uses or pockets.

“Ghost” workers, dead pensioners, etc., are often used by unscrupulous individuals to collect unearned payments, in the absence of adequate human resource databases and poor expenditure controls.

Goods and services provided at below-market prices in most countries—foreign exchange, credit, electricity, water, public housing, some basic commodities, access to educational and health facilities, access to public land, and so on—have provided fertile ground for abuses and corruption by individuals who benefit enormously from access to such goods and services.

At times, because of limited supply and large demand, rationing or queuing becomes unavoidable. Excess demand is created and decisions have to be made to apportion the limited supply. These decisions are often made by public employees. Those who want these goods (the users) are often willing to pay bribes to get access (or greater access) to what the government is providing. It is thus not surprising that cases of corruption have been reported in all the areas mentioned above. Often, poor institutional capacity hinders the control of abuses.
Other Discretionary Decisions

Besides the areas mentioned above, public officials in many countries may be granted discretion over important decisions; in these cases, corruption, including high-level or political corruption, can reach significant proportions. The most important of these discretionary decisions are as follows:

- Provision of tax incentives against income taxes, value-added taxes, and foreign trade taxes, which may be worth millions of dollars in reduced future liabilities to those who benefit from the exemptions.
- Decisions regarding the particular use of private land (zoning laws), which determine its market value. A piece of land that can be used only for agriculture will have low market value, while land on which high-rise buildings can be built becomes very expensive.
- Decisions regarding the use of government-owned land (e.g., for logging). Major cases of corruption related to permissions granted to cut trees in publicly owned forests or to exploit public lands for their mineral wealth have been reported in several countries.
- Decisions authorizing major foreign investments, often in conjunction with domestic interests, which provide the investors with monopoly power or access to valuable natural resources.
- Decisions related to the sale of public-sector assets, including the right to extract natural resources.
- Decisions on the privatization of state-owned enterprises and on the conditions attached to that process, such as the degree of regulation of the industry.
- Decisions providing monopoly power to particular export, import, or domestic activities. “Crony capitalism” has often been linked to such decisions.

Decisions such as those described above are often worth a lot to individuals or enterprises. Some of these will naturally
attempt to get favorable decisions, in some cases by paying bribes and in other cases by simply exploiting close personal relations with public officials. The bribes may be paid to low-paid public officials whose “temptation price” may be far less than the value of the potential benefit to the bribers.

Some Quantitative Results

Corruption and poor governance may affect economic performance through their impact on tax revenue, public spending, and fiscal deficit. In particular, a study to investigate empirically the impact of corruption on tax structure shows that:

- High-level corruption reduces tax revenue.
- Corruption reduces most the revenue from social security tax, then sales tax revenues; it reduces personal income taxes least.
- A one-point increase in the corruption index reduces tax revenue collected by 2.7 percent of GDP.
- Corruption increases tax evasion. The sample showed a negative relationship between corruption and the productivity of the value-added tax (VAT) per unit of nominal rate.

Using some of the indices of corruption now available, various researchers have tested several hypotheses bearing on the relationship between corruption and growth. These results, summarized below, show that governance matters a lot in the allocation and management of public resources.

Corruption and investment

Most economists accept that a positive connection exists between investment and growth. Therefore, if corruption affects investment, it must also affect growth. Corruption may affect investment
in different ways. It may affect the amount of total investment, the amount of foreign direct investment, the size of public investment, and, of course, the quality of investment decisions.

In several papers, Paolo Mauro of the IMF has shown that corruption can have a significant negative impact on the ratio of total investment to GDP (Mauro 1997). Regressing the investment ratio in relation to the corruption index, GDP per capita in 1960, secondary education in 1960, and population growth, he showed that a reduction in corruption could significantly increase the investment/GDP ratio. On the other hand, a drop in the investment/GDP ratio as a result of corruption was shown to have an important effect on growth. Mauro estimated that a reduction in corruption equivalent to two points in the corruption index would raise the annual growth rate by about 0.5 percent through its positive effect on the investment/GDP ratio. In addition, as discussed later, corruption is likely to affect adversely the quality of investment.

Corruption and foreign direct investment. In a paper focusing on foreign direct investment (FDI), Shang Jin Wei (1997a) showed that while a one-percentage-point increase in the marginal tax rate on foreign investment reduces FDI by about 3.3 percent, an increase in the corruption index by a single point reduces the inflow of FDI by about 11 percent. Thus, an increase in the corruption index from, say, the Singapore level to the Mexican level, would reduce FDI almost as much as a one-fourth increase in the marginal tax rate.

In a related work, Wei (1997b) also showed that the unpredictability of corruption (as measured by the dispersion of individual ratings of corruption) has a further negative impact on FDI. A higher level of dispersion makes corruption behave like an unpredictable and random tax. Wei concluded that “the effect of uncertainty on FDI is negative, statistically significant and... large. An increase in uncertainty from the level of Singapore to that of Mexico... is equivalent to raising the tax rate on multinational firms by 32 percentage points.”
Corruption and public investment. Tanzi and Davoodi (1998) have argued that corruption is likely to increase public investment because public investment can be easily manipulated by powerful political or bureaucratic personalities, and often gives rise to the payment of higher “commissions” by those who carry out the project. Regressing public investment as a share of GDP against the corruption index, real per capita GDP, and the share of government revenue in GDP, Tanzi and Davoodi showed the corruption index to be highly significant (at the 1 percent level). The more corruption there is, the more public investment there will be. (See also Ades and Di Tella [1997].)

The reduction in the total investment ratio and the FDI ratio can be assumed to have a clear negative impact on growth. However, an increase in the share of public investment in GDP has a more ambiguous impact on growth. More evidence is needed to reach a definite conclusion.

Corruption and operation and maintenance expenditure. Despite great difficulties in getting good data, Tanzi and Davoodi have provided evidence that, other things being equal, high corruption is associated with: (i) low operation and maintenance expenditure; and (ii) poor quality of infrastructure.

In terms of statistical significance, the impact of corruption is strongest on the quality of roads, power outages, and railway diesels in use. Most of these relationships survive when real per capita GDP is added to the equation as an independent variable. Thus, the costs of corruption should also be measured in terms of the deterioration in the quality of the existing infrastructure. These costs can be very high in terms of their impact on growth.

Ades and Di Tella (1997) have also tried to estimate the impact of industrial policies (identified with procurement preferences for “national champions” and unequal fiscal treatment of different enterprises). They found corruption to be higher in countries pursuing an active industrial policy.
To sum up, corruption reduces total investment, distorts its composition, and reduces the quality of a country’s infrastructure. The combined impact of these changes on economic growth is bound to be negative and substantial.

Corruption and the composition of public spending. In addition to the above, corruption may have other effects on expenditure, which may be important for growth. Mauro’s research has shown that more corrupt countries spend less for education and health. This result has been confirmed by Gupta, Davoodi, and Alonso-Terme (1998). Because these categories of expenditures are generally assumed to promote growth, corruption in this regard can also have a negative effect on growth.

Finally, both Mauro (1997) and Tanzi and Davoodi (1997) have shown that in countries with high corruption, the GDP share of tax revenue collected tends to be lower because some of the tax revenue is diverted to the pockets of tax administrators. Thus, the true burden of taxation on the taxpayers is not reduced. An overly high level of taxation may lead to a suboptimal level of public spending and, perhaps, to higher fiscal deficits.

**Policy Conclusions**

Governance problems may arise in connection with many principal-agent relationships. In any one of the relationships shown in the figure below problems of poor governance can emerge. These problems exist in any society but tend to be more severe in some countries and under certain conditions. What can be done?

One strategy is to pursue a zero-tolerance approach to corruption without changing the role of the state. Such an approach would rely on:

- ethics offices;
- anticorruption commissions;
- tighter controls on public officials;
Figure 1.1
Principal-Agent Problems in Policymaking

Ideal Government

Actual Government

Individual Ministers

Principal Secretaries, Heads of Institutions

Heads of Departments

Heads of Divisions

Individual Civil Servants

Taxes  Spending  Other
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- higher penalties for those who are caught in acts of corruption;
- higher wages for public-sector employees;
- reduction in the right to privacy of government employees and those who deal with them (for example, by requiring employees to report on the value of their assets);
- anticorruption efforts undertaken at the international level, such as those sponsored by the OECD, the ADB, the World Bank, and other regional or international organizations, or at the national level by active civil society and a free press.

This approach would undoubtedly help in improving governance but, unless accompanied by efforts to modify and reduce the role of the state in the economy, it may not go far enough. To make significant progress against corruption and poor governance, it is also important to modify the role of the state by reducing its reliance on regulations, authorizations, quasi-fiscal activities, and other activities and tools that lend themselves to abuse by public officials. It is also important to make the state’s actions more transparent.

In the context of the architecture of the international financial system, the IMF in 1998 developed a Code of Good Practices on Fiscal Transparency aimed at increasing transparency in fiscal policy. The Code contained several principles that could be followed by countries to increase fiscal transparency. The application of these principles would make fiscal policy more transparent and in the process reduce the scope for poor governance. Among the principles are the following:

- The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.
- There should be a clear legal and administrative framework for fiscal management.
• The public should be provided with full information on the past, current, and projected activity of government.
• A public commitment should be made regarding the timely publication of fiscal information.
• Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.
• Budget data should be classified and presented in a way that facilitates policy analysis and promotes accountability.
• Procedures for the execution and monitoring of approved expenditures should be clearly specified.
• The integrity of fiscal information should be subject to public and independent scrutiny.

In conclusion, actions to improve governance and to fight corruption need to be taken on several fronts. Both the demand for acts of corruption and the supply of such acts would need to be reduced.

References


Chapter 2

Government Policies and the Budget Process

Francesco Forte

Introduction

The first section of this paper (related to the theme of governance) deals with the need for a monocratic budgetary process by the executive, for the proper allocation and management of budgetary resources. The second section (related to the theme of financial management) deals with the basics of public expenditure in relation to: (i) aggregate fiscal discipline, (ii) allocative efficiency, and (iii) operational efficiency. The paper then proceeds to discussing, in turn, the requirement of transparency and financial accountability; the role of a top-level independent national auditing office; the role of the central government as supplier of priorities; and the issue of how the executive branch of government should keep its budgetary commitments, through realistic forecasts, prudential policies, and determination to carry out its fundamental choices. The paper concludes with an evaluation of budget implementation in terms of: the execution of natural strategies; the implementation of the basic allocational choices; and the performance of government bodies.1

1 The focus of the paper is on emerging countries, where sustaining a high-growth path together with domestic and foreign monetary stability requires an economic policy in which fiscal governance is paramount, and the perspective is necessarily global. I draw on my personal experience as cabinet member and Minister of Finance in the 1980s and as Chairman of the Italian Senate Finance Committee in the first years of the 1990s, as well as my research on developing countries and on the adjustment problems faced by European countries in meeting the deficit and debt criteria of the Maastricht Treaty and the subsequent requisites of the Stability Pact.
A Monocratic Budget Process

The executive branch of government is at the core of the fiscal governance issue. It is, however, in a somewhat lopsided situation, particularly in the effectiveness of its policy decision making. On the one hand, international financial institutions and the financial markets and investors hold it responsible for general fiscal governance; on the other hand, in a democratic country, it is not the sole fiscal and budgetary power. The legislative body normally approves the national budget, and unless there are severe constitutional constraints legislative amendments may challenge the fiscal discipline imposed by the executive.\(^2\) Furthermore, the budgets of local governments and of quasi-autonomous public entities and public corporations may contain deficits and debts that are not easily detected and controlled by the executive. These “off-budget”\(^3\) public institutions represent a big problem for fiscal governance by the executive.\(^4\)

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2 In Italy the constitutional constraint on fiscal deficits exerted by article 81 of the Italian postwar Constitution is too vague and badly controlled to be effective. See Forte (1999). Articles 110 and 115 in the postwar German Constitution (Grund Gesetz) require expenditures in the federal budget other than those for investment to be balanced by final revenues. According to article 113 of the same Constitution, parliamentary amendments increasing expenditures or reducing revenues immediately or at any time in the future must be approved by the Federal Minister of Finance. In the French Constitution of 1958, article 40 disallows parliamentary amendments that reduce revenues or increase expenditures even if these effects are offset by new taxes. In the US, the Gramm-Rudman-Hollings Act approved by the Congress and the President in 1985 subjected the federal budget to the constraint of a gradual deficit reduction, to reach balance in 1991. The new procedure was not effective at first (Leloup, Graham, and Barwick 1987). However, the US federal budget for 1999 shows a surplus.

3 The budget referred to here is obviously that of the central government narrowly defined.

4 Article 112 of the German Constitution requires all off-budget expenditures to be approved by the Federal Minister.
Some of these institutions are natural components of a well-organized pluralistic system of government that conforms to the requirements of a modern market economy, open to the global markets. Thus, even if a robust executive with a powerful head is needed to steer the country in today’s global economy, local governments with their autonomous budgets are necessary for an orderly and efficient economy and civil society in an age of urban growth.

But many other off-budget public or quasi-public institutions with a noncommercial or commercial orientation have a much more dubious qualification. They often seem to be hybrid entities, acting as quasi-government institutions vis-à-vis the market, to enjoy the privileges of public entities, and as quasi-market institutions vis-à-vis the government, to claim autonomy and exemptions from its fiscal discipline. Generally, off-budget entities that may be considered public enterprises must be clearly distinguished from the (often innumerable) noncommercial public entities in health, welfare, culture, education, recreation, research, and other areas, which must be considered nonprofit public institutions, and the regulatory agencies, whose budgets should be consolidated with the budget of the government that owns or controls them. The national budget, obtained by consolidating the central and local government budgets will give the executive a full picture of the scope of its budgetary tasks.

Off-budget public enterprises in the industrial, trade, or financial sector, whether supervised by central or local government, should be organized as private corporations without privileged access to the banking system and the financial market. Where possible, they should be privatized, to subject

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5 For the fiscal issues raised by the “blurring of the public and private sectors” by these entities, see Heller (1997).

6 These are actually the rules prescribed for public enterprises in the Maastricht Treaty, to avoid distorting competition and to control excessive public debt in the European Union.
them to market discipline and the demands of fiscal prudence. But until they are privatized, their capital expenditures should be included with the investment expenditures of the government to which they belong, and their debt should be accounted for as a contingent liability in that government’s accounts in the year in which these arise. If public service justifies the continued operation of a losing public enterprise, say, the state railways or a municipal bus service, that enterprise should receive a yearly grant from the government which should be considered in balancing its current account.

The financial autonomy of off-budget noncommercial entities should be severely limited. Their current and capital expenditures, on the one hand, and their revenues and transfers from government, on the other, should balance, and they should have no access to credit from the banks or the financial market.

Local governments should not only be obliged to balance their current account as off-budget public enterprises. To give the executive full control of the public debt and its management, local governments should finance their capital investments only with their own revenues, capital transfers from the central government, or loans from a specialized credit institu-

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7 In some cases the government might simply retain a small (e.g., less than 5 percent) “golden share.”
8 Frequently the losses of off-budget entities are temporarily financed with borrowings from creditors and banks.
9 The European Union has tried to confine government transfers for noninvestment purposes to exceptional public service enterprises. But the applicability of this rule to state railways and municipal transportation services has yet to be enforced.
10 Maastricht rules, in this respect, merely state that no public institution should have privileged access to credit. In Italy health institutions do not have access to credit from credit institutions and the financial markets. However, the fact that suppliers can discount their credits at banks has led to hidden debts for these health institutions which the central government feels obliged to take upon itself from time to time, to avoid interruption in health services.
tion of the central government that requires revenue guarantees.\textsuperscript{11}

Many public services may be provided by private enterprises under a regulatory authority. All public investments that, in the judgment of the executive, can be run with market resources should be privatized to save scarce public resources for high-priority investments that are inherently public. Water supply and sewerage systems, telecommunications, transport, postal services, environmental services, and related investments may be handed over to the market economy,\textsuperscript{12} perhaps with land for the investment. Private investors, for their part, can supply school buildings, hospitals, justice and law-enforcement facilities, and other public-service buildings, in exchange for rents and leases from the government. In Britain, all the services in the municipality of Coventry have been leased to private business.

To own less in order to control more effectively seems to be a very important general principle for government in an era of growth in information, technology, and global finance. Until now, however, we in Italy (and also in Germany) have thought differently, such that big state corporations have often dictated to the government, rather than the other way around.

\section*{Aggregate Fiscal Discipline, Allocative Efficiency, and Operational Efficiency}

Drawing on international experience and particularly the recent successful fiscal adjustment in Italy,\textsuperscript{13} I suggest two main institutional devices, which should interact: (i) the discussion

\begin{footnotesize}
\begin{enumerate}
\item This system works quite well in Italy, through the Cassa Depositi e Prestiti (Loans and Deposits Fund), a specialized financial corporation wholly owned by the Treasury which was established in the previous century.
\item Such extensive privatization has been carried out particularly in the UK. See HM Treasury (1997), Sawkins and McMaster (1997), and World Bank (1997).
\item See, among others, Tarshys (1986), Schick (1986), and OECD (1987).
\end{enumerate}
\end{footnotesize}
and approval by the executive and by the legislature of a financial and economic plan for the next three or four years, some months before the budget discussion; and (ii) budget preparation by the executive, on the basis of the foregoing plan.

The financial and economic plan should be binding with respect to the budgetary allocations for first year, and indicative for subsequent years except for the deficit figure. It should be prepared and updated yearly by the treasury and budget minister (or the finance minister), under the strict supervision of the head of government (the president of the republic or the premier) assisted by the council of economic advisers (or similar body). The plan should be discussed in the cabinet but in a presidential system does not require ministerial approval. However, it is important that the various branches of the government agree on the figures it contains, to provide the budget with a rational basis. Its main feature is its binding limit on the deficit and net indebtedness, in relation to GDP, in the central government and national budgets for the next three (or four) years. The national budget, according to the standard definition, consolidates the budgets of the central government, off-budget noncommercial institutions, and local governments.

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14 Each year, another year is added to replace the past year. This kind of preliminary budgetary document, introduced in Italy by Law n. 362 (1988) and made more effective in the '90s, has allowed the Cabinet to cut drastically the high deficit in the central government and national budgets, such that the country entered the Monetary Union in 1997 with only a 2.7 percent deficit (in relation to GDP) in the national budget. The Italian triennial, known as the "Documento di Programmazione Economica e Finanziaria," is approved by the Cabinet in June and by the Parliament in September, and the vote is binding for the first of its three years. The budget and the financial law approved by the Cabinet in September and presented to the Parliament in October are based on this document. Thus, the deficit and indebtedness figures for the succeeding financial year (or the next calendar year), cannot be modified by the Parliament which has already approved them. For more on this budgetary document, see Da Empoli, De Ioanna, Vegas (1988 and new ed.)

15 As in the Philippines or Indonesia.
In budget preparation, as noted, the treasury minister should have sole responsibility to the executive (monocratic budgeting). The treasury minister should also be responsible to the legislature for the central government and national budgets, on behalf of the executive. The treasury minister may accept legislative amendments, after consulting with the minister responsible for the relevant expenditures or revenues and in the most important cases with the head of government. In case of amendments reallocating resources among the branches of government, to which the treasury minister does not object in principle, the head of government will have the final decision in consultation with the cabinet.

The logic and content of this two-stage procedure can be explained as follows. The financial and economic plan consists of macroeconomic and fiscal figures as well as strategic guidelines for legislation and policy measures needed to attain the quantitative targets in the medium to long term. Therefore, new legislative proposals from the cabinet to the legislature to achieve the quantitative targets of the plan should accompany the proposed budget law. The preliminary approval of the contents of the plan by the legislature constrains its amending power in the subsequent discussion of the budget, but does not legally constrain it to approve the related legislation, for which the plan only sets guidelines. The parliamentary majority supporting the cabinet should, however, be politically committed to approve the legislation, and within the time prescribed in the plan.

The head of government, through the financial and economic plan, thus commits the cabinet to a medium- to long-term budgetary strategy supported by structural reforms.

The macroeconomic figures in the plan include expected real GDP growth, inflation rates, main balance-of-payment figures such as ratio to GDP, foreign debt as a percentage of

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16 In Germany, France, UK, and US, a monocratic budget procedure is clearly applied within four different types of constitutional structures.
exports, rates of individual and aggregate consumption, savings and investment as percentages of GDP, level of employment, and rate of unemployment.

The fiscal figures in the plan should be stated in money terms, in constant prices, and as percentages of GDP and over the previous year’s figures. The figures should include: aggregate current and capital expenditures; tax and nontax (transfers and other receipts) revenues; the resulting deficit or surplus in the current account, the capital account, and the aggregate balance; and total public debt, distinguishing between domestic and foreign debt and expressing the latter as a percentage of exports. The primary budget, with its balance between expenditures other than interest on debt and all revenues, is distinguished from the secondary budget, which includes debt service. The financial and economic plan is also the means by which the executive obtains agreement among the various branches of government on the main budgetary allocations in the central government and national budgets, particularly for off-budget noncommercial institutions and public enterprises and for local governments. To allow an assessment of their broad effect on the market, public expenditures in the primary budget should be classified into purchases of goods and services, wages, and transfers to families, to the economy, and abroad (if any).

A two-stage consolidation of public sector operations appears useful, to make operational choices transparent. In the first stage, the central government budget should be formed by consolidating the budgets of all off-budget noncommercial

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17 This amount should include commercial debt without general government guarantees, commercial debt with general government guarantees, and public debt.

18 Obviously this figure includes only the public foreign debt. Full national debt liabilities must also include government guarantees on commercial foreign debt. The aggregate foreign debt figure, including commercial foreign debt, should be among the macroeconomic data in the financial and economic plan.
institutions and public enterprises, and adding the aggregate and the resulting deficits and liabilities to the central government budget. All local government budgets should also be consolidated in a “local government” budget at this stage. The national budget is then obtained by consolidating the budgets for the central and local governments. Clearly, among its allocative choices, the executive must decide on the amount of transfers to off-budget noncommercial institutions and public enterprises and to local governments, in relation to their needs and overall budget constraints. It must also decide on the appropriate legislative or other interventions on the expenditure and on the revenue side to meet targets.

To allow the cabinet to discuss the main allocative choices for the central and local government and national budgets, expenditures—current and capital—should be classified according to main functions, and revenues according to main categories (direct taxes, domestic indirect taxes, indirect taxes on international affairs, social security contributions, transfers, other revenues). The expenditure and revenue figures should be given in both nominal and real terms, and as percentages of GDP. Real rates of increase or decrease in expenditures (by functions) and revenues (by categories) over previous years and forecasts for the medium term should also be given.

The standard classification by functions on the expenditure side crosses that of the government ministries and may be too general. Four or five subclasses of the main functions or

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19 The World Bank in its World Development Report classifies central government revenues into taxes on income, profit, and capital gains (i.e., direct taxes); social security contributions; domestic taxes on goods and services (i.e., domestic indirect taxes); taxes on international trade and transactions (i.e., indirect taxes on international affairs); other taxes; and nontax revenues.

20 According to the World Development Report of the World Bank: defense, education, health, housing and amenities, social security and welfare, economic services, and others.
any of these functions should be given to provide a less global picture and allow better allocative choices.\textsuperscript{21}

The head of government and the treasury (or finance) minister, as we have seen, have a leading role in the preparation and discussion of the financial and economic plan by the cabinet. This discussion, in turn, gives them the full support of the various branches of the government in having the plan approved by the legislature. Thus, the treasury minister should be able to manage the approval of the central government budget, the consolidated central government sector budget, and the national budget and the accompanying financial legislation in the parliamentary debate, within the framework of the financial and economic plan. As noted repeatedly, the head of government, assisted by the treasury minister, must have monocratic power in budget preparation, which cannot be sustained economically and operationally if the allocation of resources is not subjected to fiscal discipline through a medium-term program. Thus, a combination of financial and economic planning and monocratic budgeting seems necessary from the point of view of both fiscal discipline and resource allocation.\textsuperscript{22} Operational efficiency in

\textsuperscript{21} The World Bank, in its World Development Report, for instance, classifies expenditure on education (including both public and private education) into primary, secondary, and tertiary. To these, one should add vocational education and preschool education.

\textsuperscript{22} Italy’s experience in this area provides “negative” evidence of the validity of combining a financial and economic plan with monocratic budgeting. Indeed, in the absence of monocratic budgeting, the fiscal discipline needed to meet Maastricht criteria has been achieved partly by increasing the tax burden and reducing the public expenditure on investments, while particularly generous old-age pension schemes have allowed these current expenditures to soar in relation to GDP. On the other hand, the Italian financial and economic plan does not allocate expenditures by function for either the central government budget or the national budget, nor does it include a sector budget for major off-budget noncommercial institutions and public enterprises. Thus, the huge deficits of the state railways and of the old-age social security institutions escape the attention that they deserve from the point of view of “keeping the basics right.” On the question of the quality of fiscal adjustment and fiscal deficits, see Selowsky (1999).
both budget legislation and budget execution will benefit from this combination of approaches.\textsuperscript{23}

**Budget Transparency and Fiscal Accountability**

A policy of fiscal discipline inherently tends to distort budgetary outcomes through “opportunistic accounting” to reduce the official deficit and debts of the central government, to shift deficits and debts off-budget, and to move from true budgetary obligations to nonbudgetary commitments.\textsuperscript{24} In a sense, deficits and debts are similar to the dust on the floor of an apartment which the cleaners may merely sweep under the rugs and the furniture, rather than work hard to remove. Thus, cuts in transfers to welfare institutions from the central government budget may lead these institutions to accumulate debts with beneficiaries or suppliers (for instance, suppliers of pharmaceuticals and food to hospitals) who, as in Italy, may discount their credits with banks.

Obviously, if the accounting is transparent and the obligations are correctly accounted for, the consolidation of the budget for noncommercial institutions with the central government budget will show that the dust has only gone under the carpet and is still in the room. But the consolidation might be done improperly. Sometimes, cash budgets are consolidated with the central government budget, rather than budgets showing the obligations of nongovernmental public institutions. On the other hand, even when consolidating central and local government sector budgets in terms of obligations, debts may be

\textsuperscript{23} In a presidential republic, monocratic budgeting depends on the president’s budgetary power while the financial and economic plan depends on cooperation between his office and the treasury.

\textsuperscript{24} For a discussion of “opportunistic accounting” or “creative accounting” as practiced in European countries to facilitate compliance with Maastricht deficit and debt rules, see Forte (1997).
concealed through legal devices. A typical fix consists in accounting as obligations on the expenditure side the amounts actually credited, i.e. credits payable—a spurious concept of credits which is close to the cash concept. By opportunistic accounting rules, credits payable may be made greatly different from matured obligations. To narrow the credits for expenditures to credits payable norms accompanying the budgetary law may limit the spending capacity of each government entity to a given percentage of its total appropriations of a past period. By this rule, a host of pending obligations may be postponed to the future, without giving rise to present “credits” on the expenditure side of the budget.

Sometimes this practice may reduce the impact of the cash flow from the national budget on monetary circulation. The question, however, is whether these temporary adjustments represent true savings for the budget or only a temporary relief, which merely shifts problems to the future, aggravating future liabilities. In principle, even if these obligations are not included in the budget and hence in the deficit of the year of maturity, they should be included in the new indebtedness for that year, thus adding to the total public debt amount for that year. But another opportunistic accounting practice is that of including in public debt only the public debts issued on the markets plus central and local government debts payable. Generally speaking, to be transparent and fiscally accountable, a budget should conform to prudential accounting principles.

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25 This procedure has been extensively applied in Italy to meet Maastricht parameters on deficit and debt.
26 In some circumstances, this kind of maneuver has been useful in Italy to combat inflation. But the damage to the functioning of the public economy and to the market economy of delayed payments of budgetary obligations may be substantial.
27 Excluding the debts of off-budget noncommercial institutions and the deficits of off-budget public enterprises.
28 I have dealt with these issues in a paper presented to the “EU Accession and Sovereign Debt Management” workshop and subsequently published in European Commission and World Bank, European Union Accession: The Challenge for Public Liability Management in Central Europe, 1998.
By this I mean a sort of asymmetric methodology in which, in

case of doubt, one adopts an “expansive” forecast on the ex-

penditure side and a more restrictive one on the revenue side,

thus biasing forecast errors towards overestimating expendi-

ture and underestimating revenue. 29

Following this prudential methodology, the expendi-

ture side should include all the obligations in the year in which

they are incurred, even if not payable that year. This should be
done both for real expenditures and for transfers. In the first

first case one must adopt the criterion of the time when the good

or service pertaining to that obligation was actually supplied. 30

In the second case, the criterion is the year in which the trans-

fer is due. 31

Often, purchases of assets of other entities—public or

quasi-public, domestic or international, particularly of public

financial institutions—are written below the line in government

budgets, assuming that they are financing items which do not

create a net expenditure. But prudential accounting implies that

if these assets do not yield any revenue to the government, they

should be considered as transfers to be entered above the line. 32

According to prudential accounting, the revenues to be entered

on the revenue side of the government budget for a given year

should be those whose obligations were generated that year

29 On this point, see also Schiavo-Campo and Tommasi, 1999.

30 This principle and most of the others mentioned above have been adopted

by the member countries of the European Union, under ESA 95 (in Eurostat


31 See the previous note. Payments for new pensions or for wage increases

of public employees or for public works might be postponed not because

of cash constraints but because of the need to determine the amounts

actually due. But if the persons to whom the new pensions are due have

the status of pensioners; if the employees to whom the wage increases are

due have rendered their services; and if the public works have been

executed, under prudential accounting the obligations pertaining to these

events must be entered in the budget, even if the payments are not yet

due in full.

32 On this principle, see Blower and Cheasty (1991).
and have the real possibility of being encashed in the not-too-distant future (not necessarily in the same year). The entry should correspond only to the percentage of the official credit that may be encashed, or discounted for the postponement of the payment if it is legally to be made in installments.\textsuperscript{33}

Obviously, the above prudential accounting is intended to achieve effective fiscal discipline. However, aside from the need that the obligation-based budget be approved by the legislature, a cash budget may prove useful for monetary policy objectives, particularly in a period of inflation.

Cash budgets for the various governments and government sectors may also give a quick picture of their impact on aggregate demand and on monetary flow. Periodic reports to the executive by the treasury on budgetary cash flows and deficits may therefore improve fiscal governance.\textsuperscript{34} However, to avoid confusion, under prudential accounting these documents should carefully distinguish above-the-line operations from below-the-line operations. On the revenue side, tax revenues, transfers, receipts from sales of services and goods other than public assets are entered above the line, and receipts from the sale of public real and financial assets are entered below the line. On the expenditure side, payments for current and capital expenditures, including the purchase of assets of public or quasi-public entities that are not expected to be revenue producing, are entered above the line, while disbursements for past obligations and revenue-producing asset purchases are entered below the line. The balance is the amount of cash that the treasury needs to generate through new public debt. Transparency in the area of public debt requires that governments finance themselves only by issuing bonds and other certificates on the market.\textsuperscript{35}

\textsuperscript{33} ESA 95 is less clear on this important issue.
\textsuperscript{34} In Italy, the basic budgetary reform, through Law n. 468, 1978, requires the Treasury to present a periodic cash budget to the Parliament for information purposes. On the relevance of cash deficits to fiscal management, see Balassone and Franco (1996).
\textsuperscript{35} This is one of the main rules of the Maastricht Treaty for fiscal discipline.
Accountability for the budget, and therefore effective governance by the head of government of the national budget and particularly of its own budget, generally implies a “put” rather than a “call” option, in the terminology of derivatives. In other words, the cabinet must “ask” others to conform to the prescribed behaviors and not “be asked” and constrained by others to intervene in their favor when they need money.

Thus, public debt should preferably not be short-term debt. Contingent liabilities should be minimized, as they constitute a “hidden risk to fiscal stability” (Polackova 1999) and, anyway, should be accounted for in an official annex to the central government budget. According to the German Constitution, contingent liabilities must be authorized by law insofar as they might give rise to future debt. Good governance requires the executive to be very careful in providing guarantees to debts of other entities. Such guarantees might avoid more expensive interventions such as loans or straight transfers to these entities but nonetheless could create an uncontrolled hidden burden for the central government.

**National Auditing Office**

It is a gigantic task to gather information from the various branches of the central government, off-budget noncommercial institutions and public entities, and local governments, prepare the financial and economic plan and the central government and national budgets, monitor their implementation, and prepare the financial statements. Computerization may greatly ease the task but cannot solve it without top-level coordination. Experience shows that to accomplish this task a specialized central auditing office is needed. This office may

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36 See article 115 of the Grund Gesetz.

be directly under the chief executive\textsuperscript{38} or under the treasury minister and reporting to the chief executive.\textsuperscript{39} In any case, it must be organized as an autonomous agency with officials scattered among the various branches of the central government and its main off-budget commercial and noncommercial entities, to assist and supervise their internal auditors.

A primary task of the central auditing office is to provide a standardized system of accounts for gathering homogeneous data for the preparation of the sector budgets for the central and local governments. Normally public institutions entering these two consolidated sector budgets differ in their systems of accounts. Some of the differences are unnecessary and should be eliminated by imposing standardized accounting rules.\textsuperscript{40} However, such a reform may take time to be approved and implemented, particularly because it requires a learning process and changes in the information processing networks. On the other hand, some differences in accounting rules are unavoidable, because the budgets of public enterprises should follow the accounting rules of private corporations,\textsuperscript{41} while government budgets at the various levels and the budgets of noncommercial government agencies and institutions should follow the general criteria adopted for governmental institutions. Prudential accounting differs for the two kinds of budgets, particularly in such areas as the purchase of assets and contingent liabilities. Thus, to avoid gathering heterogeneous data, the central auditing office should prepare standard forms to reconcile the accounting criteria for the various government branches, agencies, institutions, and public-service enterprises.

\textsuperscript{38} The president of the republic in a system where he is also the head of the government, as in the US.

\textsuperscript{39} In the US federal system, this task is performed by the Office of Management and Budget.

\textsuperscript{40} As those of the UN, to be adapted to the specific situations of the emerging countries. See also Eurostat (1996) and IMP (1996).

\textsuperscript{41} See, for instance, International Accounting Standard Committee (1997)
The basis of auditing should not be limited to mere collection of ex-ante and ex-post financial data of expenditures and revenues. It seems very important also to collect economic and resource information. Among the latter, it is quite important to know the amount and type of personnel employed in the various institutions and offices and the extent of their activity, expressed in terms of standard indicators (for instance, the average, maximum, and minimum number of students per teacher in a given type of school in the various districts, or the time lag until a patient is visited by the public health service). Among the economic data, prices paid (such as the unit cost of each kilometer of roads built according to given standards) are very important. Comparisons of price actually paid and standard market prices are useful in pinpointing corruption and irresponsible behaviors.

**Central Government as a Supplier of Public Priorities**

Public budgets have an inertial tendency to increase every year in real terms. The problem of avoiding this inertial growth and of focusing the central and local government sector budgets on the right activities is thus the first priority of the executive for achieving allocative efficiency and public consensus. For a sustainable balance between the public sector and the market economy, collective needs might at times be satisfied with a lower aggregate level of public expenditure, implying a lower tax level and reduced pressure of public debt on the interest rates. And when real GDP growth is significant, lowering the ratio of public expenditure to GDP, even without reducing the aggregate level of public expenditure in real terms, may be a wise choice.

But to strike a right balance between functions, the executive must also be able to react to inertial tendencies of public

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42 See on this theme the basic paper of Polivka and Stryker (1983).
expenditures in some government sectors to show a differential increase at the expense of others. Zero-base budgeting has been suggested in response to this differential tendency to grow in the various sectors of public spending. This seems to be an unnecessarily drastic change in budgetary practices, however, which risks failure for lack of operational consensus among the various bureaucracies concerned. Within any broad class of public expenditure, shifts among subclasses may improve quality (e.g., shifts from secondary to vocational education). On the other hand, geographic allocation, too, should be systematically considered. Normally, the executive produces only functional classifications of public expenditures among the various branches of the public administration at the central and local level. Rarely does the executive produce and propose to the legislature, in budgets, the geographical distribution of expenditures by functions. However, misallocations may arise from the fact that some regions are undersupplied while others, for mere historical reasons, or other reasons, are oversupplied or do not need any increase.

But how should allocational priorities at the cabinet level be assessed? The major preliminary choices are “political decisions” for which the head of government must take responsibility before the legislature. The aggregate rate of growth of public expenditure is one such choice. Another broad “political” decision relates to the priorities among the four main public functions: law and order, public goods for production, civil and social welfare.\(^43\) I would suggest a shift of emphasis in favor of the supply of goods for production over those for social welfare. In a structural perspective, “production” of public goods may have a much higher profitability in terms both of economic growth and employment, and may be also more responsive to the demands of equity and social welfare.

\(^{43}\) Some of these classes cross the functional classification of public goods. Vocational education typically belongs to the category of “goods for production” while other kinds of educational expenditures belong to civil and social welfare.
Many allocative choices cannot be decided on the basis of broad political judgment but need detailed field research into the demand and supply of public goods which are complemented by private supplies, as in the case of education, health services, or water supply. Basic needs should be assessed globally: those currently satisfied by governments; by nonprofit institutions; by the market; those that remain systematically unsatisfied; and hidden needs that sometimes (as in the area of civil needs and of welfare for the less favored) have a higher priority.

To get consensus on its allocative choices, the chief executive should promote hearings in the legislature on the various important needs, in the various areas of the country. The legislature, to this end, should also hear organizations representing the various interests: associations of entrepreneurs and independent workers, workers’ unions, cultural and social associations, and local government institutions and representatives. When fiscal discipline requires containment of expenses, choosing among priorities may be hard. Exploring the degree of consensus on them in the society is therefore particularly important, to avoid surprises later on.

But meeting public service priorities does not necessarily imply more financial resources. Unsatisfied demand for public goods many times arises from lack of quality in public services. In turn, bad quality may arise from excessive regulation, lack of clarity in the division of competencies among the various authorities, administrative duplication between the central government and the regional and local governments, time-consuming bureaucratic behaviors, and corruption. Some remedies consist in reducing the amount of regulations, simplifying procedures, obliging government administrators to be transparent in their choices and to end the various practices within defined time spans, after which the authorizations required are automatically given. Incentives should be given to induce the bureaucracies to adopt more efficient behaviors.
Binding Commitments in Budgetary Decisions of the Executive

Not all budgetary decisions of the executive should be conceived as binding. It is better to stick firmly to a selected list of basic commitments than to try to be inflexible on the entire budgetary spectrum.

Within the broad fiscal constraint set in the financial and economic plan, legislative amendments may improve the quality of allocative choices and in any case they facilitate their acceptance in the country. Some flexibility in the legislative debate on the budgets presented by the executive should also be allowed, particularly for the allocation of expenditures among the various functions and the relative weights of the various tax burdens, provided that the broad “political” priorities agreed upon in the financial and economic plan are respected.

The executive should make realistic binding commitments relative to the “fundamentals.” The targets to which the executive is strongly committed may appear unattainable over time, even with corrective measures, for four main reasons. One, the general economic picture, on which the fiscal choices were based, was wrongly assessed or has changed because of unexpected events. Two, expenditure and revenue trends based on the given general economic picture may have been assessed inaccurately. Three, the effects of legal and administrative measures devised to restrain public expenditures and to increase tax revenues may have been overvalued. Four, the legal and administrative measures needed to reach the given targets may not have been fully implemented.

The executive is often understandably sanguine about general economic trends: official pessimism could unduly depress the financial markets. However, unrealistic official valuations of the domestic economic trend and lack of careful consideration of the international perspectives, after a while, are proven false and this reduces the reliability of the executive for its own commitments as well. Having to revise revenues...
downward and some expenditures upward may call for unpleasant corrective measures. As stressed earlier, to avoid this problem expenditures should be forecast expansively and revenues conservatively. Generally, all forecasts of the domestic and international economy should be prudent. Public macroeconomic variables should be related to the variables of the market economy, within prudential limits. The elasticity of tax revenues with respect to the economic variables should be assessed in an asymmetric way: underestimating slightly the elasticity of revenues to economic improvement while doing the opposite for their elasticity to the worsening of economic conditions.

Fiscal adjustment targets may be missed because the rules introduced in the budget legislation to limit expenditures and to raise revenues may be too optimistic. Drawing on my European experience, for instance, deficits of public-service enterprises may be larger than expected because the new constraints imposed on them are inefficient and improvements in tax collection may prove illusory. One should be careful in assessing the probable effects of these measures in real practice.

Ex-post corrections are much better than noncompliance with binding commitments. However, because they are undertaken as urgent measures, they may lack structural quality. And—again I draw on my European experience—they communicate to the citizenry and to the markets a sense of frustration about the reliability of the government’s fiscal policy and the usefulness of the sacrifices required. Thus, it seems advisable to leave a certain amount of flexibility in the budget, with some reserves on the revenues and expenditures side, so that if unforeseen deterioration in the accounts does take place, new corrective measures can be avoided.
Evaluation of Budget Implementation and Concluding Remarks

The implementation of the budgetary choices of the executive will be judged on the basis of the degree of success of the strategy and the performance in the various sectors of activity at the macro and micro levels. Two types of control institutions are required and generally adopted in the best budgetary legislation: internal auditors guided by the central auditing office, and an external control institution (as in the Court of Accounts in many European countries) which monitors the central government and its main institutions and reports to the legislature.

In a private corporation, internal control is done continuously by the budget office. External control is done by professional auditors who certify the accounts, but above all by the market, through the stock exchanges. Here, actual profits and growth prospects are the indicators of the success of the strategy adopted and of the efficiency and effectiveness of its implementation. Governments do not have such specific control. The legislature and public opinion cannot take the place of the stock markets. But domestic and international financial markets judge governments, too. As with private corporations, what matters for government budgets are:

- The timely implementation of the medium- to long-term structural strategies adopted by the executive;
- The results in terms of the macroeconomic and fiscal parameters; and
- The indicators of quality from the point of view of the efficiency, effectiveness, and equity of fiscal action.

It is beyond the scope of this paper to examine the methodological aspects of budgetary control. Let me end, therefore, with a quote from a 1998 lecture by World Bank Chief Economist Joseph Stiglitz on “Economics in Government”: Making government processes more open, transparent and democratic,
with more participation and more effort at consensus formation, is likely to result not only in a process that is fairer, but one with outcomes that are more likely to be in accord with the general interest.

References


Chapter 3

Public Financial Management: Getting the Basics Right

Arigapudi Premchand

Introduction

Public financial management in its broadest sense\(^1\) links a community's aspirations with its resources, and the present with the future. It therefore lies at the very heart of the operations and the fiscal policy of government.

During the last five decades, financial management at all levels of government and in bodies that are supervised by government has undergone a major change. The historical role of financial management in monarchies was described as serving or saving the king. Then financial management became an important tool for the advancement of social ends and for the formulation and implementation of fiscal policies. There were many attempts to update financial management systems— their overall design, operational techniques, and procedures. Complementary changes were sought in the institutions and organizations that were entrusted with the task of public financial management. To be sure, these changes were not uniformly implemented in countries and public organizations, nor did the changes, where made, always represent a coherent strategy.

\(^1\) In the broad-based sense, financial management includes financial planning, budget formulation and implementation, payments to and from public bodies, accounting, financial reporting and internal evaluation. More narrowly, financial management is interpreted as limited to recording, accounting, financial reporting, internal audit, and evaluation. This paper adopts the broader definition of the term.
Rather, changes came in a piecemeal fashion, in response to changing requirements. In some cases, the impetus came from within, as a result of a considerable accumulation of problems and potential risks for the pursuit of appropriate fiscal policies. In most developing countries, however, the impetus came from a general awareness of the shortcomings of inherited colonial systems and an acute consciousness of the efforts being made in industrial countries.

Notwithstanding efforts to strengthen the existing systems of management and related attempts at installing modern financial management systems, a survey of the existing situation in several countries—industrial and developing, as well as those in the Asian region—reveals a quiet crisis in the making in the performance of financial management systems. There is a pervasive feeling that financial management systems have not succeeded in moderating the growth of expenditures or in responding effectively to changing needs, and that public resources continue to go to waste. More significantly, it is felt that there is an enormous gulf between the rhetoric and delivery of services, that client needs are not properly recognized, that systems lag in anticipating crises and in formulating action plans aimed at containing and resolving the crises, and that most operations lend themselves to widespread fraud not so much because of the cupidity of selected groups of people, but because of poorly designed programs. Meanwhile, the language used to evaluate government budget plans has also changed. Earlier metaphors were drawn from the military terminology (attack, counterattack, etc.). Now terms are those used in fiction (illusion, fantasy, etc.). The end result is loss of credibility of public bodies, which are seen as engaged in extensive window dressing to cover their own inadequacies. There has been further erosion in the public trust of public bodies in the context of the recognition that most problems have their origins not so much in systemic inadequacies as in circumvention and manipulation of the systems to meet the needs of the iron triangle of politicians, bureaucrats, and selected groups of beneficiaries.
These issues have been recognized since the early 1990s and are being addressed in industrial countries. The pursuit of a new public management philosophy has also found supporters in the developing world. There has been a good deal of debate on the relevance of this philosophy, and its implementation, where attempted, remains incomplete or, in some cases, even counterproductive. The components of this new philosophy and the new demands for transparency and accountability have so far had only a marginal impact on financial management as practiced in many countries. There is a growing sense that governments are so thoroughly mired in problems that they cannot rise above those problems and recognize them for what they are. This has, in turn, contributed to the perception that governments have lost the capacity for self-determination. Legislatures point to government failures; governments, in turn, point to the international financial institutions or to global financial movements, while the citizens allege that the enormous and growing bureaucracies are more keen to promote their own interests. Action, when taken, is based more on passion than on logic, or on someone else’s experience, or on prescriptions written without a look at the patient.

It is argued in this chapter that, to be effective, financial management should address the structural issues. The systems would then have developed capacities to be transparent, to be accountable, and, more specifically, to be more effective in managing the country’s finances, which is their principal task. But addressing the structural issues does not mean formulating a revolutionary, all-inclusive strategy, but the more realistic task of formulating a feasible framework for improvement.

In considering the realities of government financial management in Asia and the Pacific, it is important to keep in sight the following features.

Asian countries offer immense diversity. There are big countries and small-island economies; land-locked economies and open economies; countries with a distinct market orientation...
and others that are in selective transition from central planning to market-based approaches. There are countries that have been submitting annual budgets for more than a century, while there are also countries that submitted their first budget barely two decades ago. There are countries that have been making assiduous efforts to modernize their financial management systems, while there are countries that have remained immune to change. There are several countries that have made enormous investment in the application of electronic technology to government operations and there are others where the processes continue to be manually operated. There are countries that have systems based on the British model, while there are some that follow the US system of financial management, and there are countries that continue to follow the Soviet practices associated with the bygone era of centralized management. In addition, there are countries that are modeled on the Dutch, French, and Portuguese colonial systems. This rich diversity notwithstanding, there are common features and problems, as discussed below, which may, however, be present in varying degrees in different countries. Comments made here would therefore apply differently to different countries.

The principles of financial management—effective stewardship of public resources and efficient provision of services—are common to all countries. But the institutions set up for the purpose, and the systems and procedures specified, differ between countries contributing to divergent practices. Some practices may be more efficient than others but that consideration alone does not determine the course taken. This paper is concerned with the practices and issues that arise at the operational level.

Notwithstanding the differences in heritage, institutions, and approaches among the countries of the region, the ideological factors that hitherto dominated government policies have yielded to more pragmatic considerations. In most countries, the portfolio of government expenditures has been changing with transfers becoming a dominant feature. Increas-
ingly, central or federal governments are more concerned with the formulation of policies, while implementation is taking place at the regional/ state/ local levels, or through autonomous bodies, or through state-owned enterprises. Selectively, some programs are also being implemented through nongovernmental organizations. Furthermore, greater reliance is being placed on contracting out services. These approaches have brought about a separation of funding from the delivery of services. In the circumstances, financial management at the central levels tends to be more concerned with the formulation of policies and monitoring of performance by the implementation agencies that may be in or outside the government framework. The implications of this separation remain to be fully comprehended and the financial management systems adjusted to reflect the changing portfolio of expenditure.

**Realities**

The perception that financial management systems are ineffective and expensive has its roots in the operating problems of the systems. In considering the adequacy of the existing systems and their capacity to respond to changing requirements, these problems need to be given proper weight. Accordingly, these issues are discussed below with reference to the pertinent stages of the financial management system.

**Policy formulation**

The transformation of the community’s aspirations into feasible policies with well-recognized financial implications is at the very heart of financial management. Issues not addressed during policy formulation tend to grow in magnitude during implementation and may frequently contribute to major reversals in the pursuit of policies or major slippages that may lead to contrary results. Moreover, policy measures aim at building
confidence in the community and in the financial markets, and to that extent policy formulation should be seen as transparent and empirical, too. Notwithstanding the obvious importance of this phase, governments encounter numerous issues, which are described below.

In most countries, the inertial rate of growth of public expenditures tends to be higher than the rate of growth of revenues. In this context, and as the Plowden Committee (1961, UK) noted, the central problem of expenditure management is “how to bring the growth of public expenditure under control and how to contain it within such limits as the government may think desirable.” Although the question was raised nearly four decades ago, it continues to elude firm and proactive policies from governments.

Government expenditures need not always be reduced. Indeed, there are frequent opportunities for governments to get involved with the task of stimulating the economy. In this regard, there is generally a long lag in providing a policy response; often, results occur when there is no longer any need for them. The lack of a positive strategy has contributed to too many and underused infrastructure projects in some places, and to the creation of assets with doubtful value, in others. Further, the pursuit of the golden rule (of borrowing only for investment) has not always yielded the expected results in that projects funded with borrowed funds have tended to be far less productive than expected.

The above aspects are expected to be taken into account through the formulation of a multi-year expenditure strategy covering all categories of outlays. In practice, however, such medium-term outlooks are available for investment projects only. The future financial implications of current and continuing policies are also not available in several countries. An inevitable consequence of this is the adoption of ad hoc and “stop-and-go” approaches.

Without a medium-term strategy to anticipate the effects of current trends, responses by governments tended to be
less than needed. As reported by the IMF and the World Bank, most developing countries, instead of providing leadership by sending appropriate signals, often panicked and resorted to measures such as underfunding, the build-up of payment arrears, cosmetic rather than substantive economic measures, and deferral of nonexisting projects. These failures illustrate that the systems of management lacked data on expenditure profiles and dynamics, which, if available and used wisely, could have contributed to the perception that there was a firm hand guiding the government business.

Financial management in government has the task of promoting cost-consciousness or economy in the use of resources. These approaches could be induced either by the market or, where such an opportunity is not available, through the promulgation of rules, and limits on spending and borrowing. In most governments, however, policymaking shows the pursuit of a two-track approach—one relating to revenues and another dealing with expenditure. The latter is often pursued independently such that the spending agencies do not sufficiently internalize the resource constraint.

Moreover, the cash-based financial management systems of most governments render difficult the estimation of the full costs of government operations. By extension, there are no organized data on the informal or hidden debt of government, contributing, in turn, to distortions in policymaking.

The existing processes of policymaking have also contributed to the perception that in the allocation of resources greater weight tends to be given to those who thump the table harder or lobby more effectively. There is a view that much of annual decision making is influenced by the military-industrial complex, the construction complex, the social-service complex, and donors. Lack of transparency has exacerbated this perception.

Governments everywhere recognize the need for economy and efficiency, yet most policy decisions militate against these principles. Several programs are allocated
resources with reference to “norms” and yardsticks, which make them in effect, supply-driven and unrelated to resource availability. Moreover, some policies are subject to judicial interpretation and governments are at the receiving end with little alternative but to implement them. This is the case in most Commonwealth countries. The absence of built-in incentives to economize in the use of resources and vulnerability to external decision-making centers have made financial management difficult.

Policymaking in most governments tends to be concerned with future needs. Such preoccupation with the future prevents them from looking into the previous policies and the effectiveness with which they were implemented. As a result, those previously approved programs acquire some legitimacy through sheer existence, even if they have not been successful in fulfilling their objectives.

**Budget formulation**

This stage represents the formal first step in annual budgeting, and is intended to finalize the allocation of resources before submission to the legislature for review and final approval. Here, again, a number of shortcomings of the systems have become evident in recent years. These include the following.

As noted above, the resource constraint is not, in most cases, conveyed to the spending agencies with the result that the bottom-up compilation of estimates contributes to levels of outlays that are far in excess of available resources. Inevitably, in the circumstances, the central agencies engage not so much in a review of the merits of competing programs as in adjustments at the fringes. This permits the programs to enter into the budget or to continue, thus contributing to a steady growth in expenditures.

Budget estimates are often subject to different types of window dressing, depending on the context and the strategic purpose. Revenues and current expenditures tend to be under-
estimated and capital or development expenditures are over-stated so that they serve as a basis for securing higher levels of donor commitments. The doctoring of estimates, however, leads to unrealistic expectations and when the truth is revealed, it contributes to erosion in the credibility of governments.

The review of budget estimates differs widely among countries in the region. Following the tradition, there are many countries that tend to look into the minutiae, such as, the objects of expenditure. As a part of this tradition, considerable emphasis is laid on the control of staff in the belief that once the numbers of employees are limited, the rate of growth of expenditure could be moderated. In reality, however, the bulk of the expenditure is now in the form of transfers to other agencies rather than on direct personnel. Elsewhere, in recognition of the futility of controlling personnel, emphasis is laid on the determination of “running costs” for programs. These allocations are considered in some countries as firm ceilings and the spending agencies are given the freedom to adjust outlays on the components of running costs. The annual increases are provided in conformity with the estimated rate of growth of the economy. These experiences reflect the gradual shift in the anchor of expenditure control. In most cases, however, a firm anchor is conspicuous by its absence.

Budget timetables also differ considerably between countries. Budgets in the British-type systems are usually short, while countries that are modeled on the US system have the longest timetables, in that it takes about sixteen months before the start of the fiscal year for the budget to be prepared. In the British system, supplementary budgets are also traditionally submitted thrice during the year. This practice, together with a type of budget review focusing on adjustment at the fringes, makes the annual budget a putative one, and the spending agencies frequently entertain the notion that what was lost in the initial round can always be recovered in the later stages. In the US-based systems, the long lead time contributes to unrealistic budget estimates.
In China, the fiscal year starts without an approved budget. The budget is approved in April, at the end of the first quarter. Meanwhile, the outlays for the first quarter are restricted to the levels of the previous year. In other countries in the region (e.g., Indonesia, Saudi Arabia), development budgets do not lapse at the end of the year. Thus, several types of outlays are carried over from the previous year. This feature complicates the estimation of the impact of fiscal policy.

More significantly, in several countries the approved budget ceases to have operational importance. What is implemented is a cash-limited budget: expenditures are limited to the actual government revenues. This feature alone has contributed to a loss of credibility of the original budget.

Organizationally, the existence of extrabudgetary accounts, or the separate compilation of current and development budgets, has helped create multiple centers of decision making, and lack of coordination among them. In some countries, the focus in annual budget making is not on the main budget but on the special accounts where allocations tend to vary significantly from one year to another. In some countries, the separation of the plan budget has introduced avoidable rigidity into the system, not to mention an incomplete view.

The annual search for reductions in expenditures has consolidated the traditional ritual of seeking reductions in the consumption of utilities and the use of staff cars and related equipment. In the absence of efforts to streamline programs, these efforts have not been successful and the “slack” in many programs continues.

Budget structures

The financial transactions of governments are expected to be classified so as to make the legislators and the public alike gain a perspective on the objectives that are sought to be achieved through the budget. In addition, the classification should be so arranged as to facilitate internal management of programs as
well as the compilation of accounts. In practice, however, the experience in the Asian countries reveals a widely differing picture. In some countries, the classifications have been improved to the point that the compilation of national income accounts has been rendered easy. Elsewhere, however, there is a continuing reliance on the traditional line items. In at least one country, the effort of the government to introduce a program-based classification was rejected by the legislature because the new classification needed to be clarified. By and large, however, the following issues are recognized.

Most classifications emphasize inputs, and it is difficult to have a perspective on the likely output and outcome. In some cases, performance budgets (limited in one country to development outlays) are prepared on a supplementary basis to provide information to the public. These budgets, however, are yet to attain a prominent role in the allocation of resources. Of course, when “performance” is misspecified and/or effective monitoring difficult or nonexistent, these budgets should not play a role in resource allocation.

In some cases, the line-item classification is so traditional that separate exercises, remote both in time and space from the main budgetary process, are undertaken and data provided.

In several cases, the program or output categories are too broad to permit an understanding of the objectives. In current budgets, extensive line-item details are provided, while project outlays tend to be bulky and lacking in detail. In a few cases, categories such as “policy formulation” and “miscellaneous” tend to be dominant and the result is that they obscure more than what they reveal.

Very few countries in the region rigorously apply the principles specified for the separation of current and capital outlays. There are several equivalents, such as “investment budget,” “construction budget,” “development budget,” and “below-the-line transactions” and the practices differ widely in this regard. More significantly, items are frequently transferred from one section to another, contributing to
discontinuities. No country in the region (except for Australia and New Zealand, which have been experimenting with forms of accrual accounting) maintains depreciation or provides for capital charge.

The success of fiscal policy depends on the congruence achieved between budgetary intent and outcome. In a number of countries, particularly those that are patterned on British Commonwealth practices, the outcome tends to be different with excess expenditures and higher fiscal deficits. In some countries, the budget outcome tends to be the same as indicated in the estimates. Not all these are to be taken at face value, however, as there is also a build-up in the hidden debt. In addition, several uneconomic practices, as enumerated below, make implementation cumbersome and in some cases counterproductive.

It is expected that the amounts and the related budget authority for expenditure be released to the spending agencies in a time-sliced fashion. The traditional practice of issuing warrants and exchequer releases was intended to cover this aspect. Most countries do not have an organized cash release system that takes into account the seasonality of outlays. Rather, the control process proceeds on the formula of “one size fits all.” In some countries, paperwork relating to these releases has become extensive and contributes to rent seeking.

Freedom to switch outlays from one category to another is rather restricted. Such restrictions, which were devised when the economy was normal and even placid, were intended to protect legislative rights. In practice, however, the day-to-day dynamics and changing price levels make the flexible use of resources an imperative.

Many governments have yet to install cash management systems, which, while facilitating the smooth implementation of the budget, would pave the way for coordinated domestic management. The practice of limiting outlays to collected revenues has exacerbated this problem. In effect, there is a massive underfunding of the programs and projects provided for
in the budget. This, in turn, contributes to widespread discontent and growth of distrust in the government.

Spending agencies are expected to devote their efforts to procuring economies in expenditure and efficiency in operations, among other things. While the practices referred to above have undoubtedly contributed to a process of “muddling through,” it is doubtful whether efficiency has been enhanced. Moreover, the lack of incentives to economize and the practice of basing future allocations on the previous years’ actual expenditures effectively prevent the spending agencies from pursuing this agenda.

In a number of countries, there is an enormous rush of expenditure (reflecting in part the lack of cash management systems) toward the end of the fiscal year, so that funds do not lapse. Inevitably, this gives rise to unnecessary and unproductive expenditures.

In regard to projects, the cost escalation during implementation is so severe that the eventual cost could be four times higher than the original estimate. To some extent, this is attributable to underfunding. In most cases, however, the causes are poor-quality initial budget estimates, lack of adjustment for inflation trends, and mid-course changes in the design of the project, not to mention the long time lag between the preparation of the initial estimates and provision of formal funding for them.

In regard to contracted-out services, contractors tend to follow their own schedules with no regard for the resources of the government. This adds to the strains of government and illustrates the case for evolving effective controls for service contracts.

**Payments system**

The system of payments refers to the operational procedures for receiving monies from the public and for making payments to them. Traditionally, this task was undertaken by treasuries, but the gradual growth of the banking system and its spread
to the remote rural areas have facilitated the task of payments. Notwithstanding this facility, in at least one country the treasury is organized to deal with all payments (to and by the government) without any contact with the banking system and is thus involved in managing the flow of currency. The following problems are also experienced.

Centralization of government payments in some countries contributes to excessive paperwork and frequent delays. Governments make payments using a variety of labor-intensive procedures. These include book adjustments, issue of checks, and payment authority. Payroll and pension payments remain to be computerized.

Electronic payment systems still have to be introduced in governments.

These practices show how expensive government operations are.

**Government accounting and financial reporting**

Government accounts have the dual purpose of meeting internal management requirements while providing the public with a window on government operations. In both these aspects, the experience shows that several systemic, technological, and manpower problems are experienced.

Most accounting systems in Asian countries are cash-based. Thus, they do not permit an assessment of the cost of programs or an understanding of the real and contingent liabilities. Inasmuch as very little cost data are available, accounting has not found, in practice, the prominent place that was envisaged for it.

Accounting structures have changed little in recent years and continue in all their complexity. This, in turn, has contributed to long delays in the preparation of the monthly and annual accounts.

The annual accounts are usually furnished late, delaying, in turn, the audit and legislative review. Further, most
accounting information is provided in such broad categories that the range of their illumination is limited.

As the accounting organization, which is usually distant, has not been successful in providing up-to-date data, spending agencies have taken to installing management information systems to meet their requirements. A part from redundant work, two sets of data are produced; one on the basis of authority issued and another based on actual payment.

In some countries, massive investments in mainframe technology have been made. In the absence of rationalization of the accounting structure, this has contributed, at best, only to the mechanical processing of what was hitherto done manually.

Some governments are seeking to introduce accrual-based accounting and financial reporting systems (preparation of balance sheet, etc.) to conform broadly to generally accepted accounting principles. But some innovations, such as responsibility accounting, suggest that what have been practically discarded by the commercial sector is being undertaken by the public bodies after a long lag.

Accounting, in most cases, is being done by people who have no professional training in the subject, but who have acquired rudimentary skills while working on the job. Although the effort itself is commendable, the issue arises whether there could be material change if accounting were to be done by professionals.

In several countries, foreign-aid accounting continues to be an area that needs improvement in coverage and timeliness.

**Internal financial management**

As governments have grown in size, so have the operations of spending agencies. It was expected that the centralized control that was hitherto administered by the finance ministries would be relaxed, and that spending agencies would be endowed with financial powers commensurate with their tasks and responsibilities. Moreover, there would be financial responsibility only
when there was an integration of administrative and financial aspects. There are limits to which financial consciousness can be inculcated from outside. Although, as Keynes remarked, the treasury has a prominent role in keeping the “wickedness” of spending agencies under control, the issue is one of limits and the tenor of control exercised by the finance ministry. The experience of several countries in the region shows the broad problem areas delineated below.

Ministries of finance have grown in size over the years and have taken up many tasks that are debatable. Further, with each economic crisis, they have tended to centralize even more, thus negating the purpose of previous decentralization. This also suggests that the ministries of finance may not have paid sufficient attention to their own core tasks. Experience also shows that the finance ministries have not proven to be ideal exemplars as they have routinely spent more than budgeted.

The spending agencies, responsible as they are for implementing policies and providing services (street-level bureaucracy), have not been able to manage their affairs and take risks because the system does not promote that behavior.

Audit

The financial management cycle in public bodies reaches its penultimate stage when their accounts are audited and are further reviewed by the legislature. The contribution of audit in the countries of the region reflects the uneven growth of this institution. In a few countries, audit agencies have been working for over a century. In a few others, audit agencies were set up only during the 1970s. Both types have, however, yet to be effective instruments contributing to improved financial management. This phenomenon has its roots in the following factors.

Many audit agencies are legally prevented from reviewing “policies.” Most of them cannot follow the trail of money, as they do not have the right to look into the books of contractors, autonomous agencies, and local governments. Many of
them have yet to start doing performance audits. Substantial areas such as public debt and exchange reserve management remain outside the scope of audit.

The effectiveness of audit agencies depends, on the one hand, on the timely rendition of accounts and, on the other, on legislative schedules. Caught between the two, audit agencies have not been successful in bringing up the issues on time.

Most audit agencies continue to be engaged in financial audit, following the approaches adopted years ago. Although the International Organization of Audit Institutions has recommended peer review, this remains to be undertaken in most countries.

**Legislative control**

The body that has the final oversight responsibility for the management of the people’s money is the elected legislature. Despite this fundamental responsibility, the widely varying experience in Asian countries does not inspire confidence. Some countries have had legislative oversight for several decades. In other countries, the legislature does not have the power to make individual appropriations. In still others, the legislature does not have complete access to the budget documents. The following factors may also have contributed to the erosion of the role of the legislature.

In several countries, there has been a massive shift of decision making from legislatures to the executive. These include decisions on external borrowing, provision of guarantees, and the use of foreign exchange reserves. In some cases where the legislatures have approval powers, governments have routinely circumvented these. Arrangements made with international financial institutions have, for the most part, been secret and have not needed legislative approval.

Even in countries that have endowed their legislatures with extensive powers, many agency budgets are approved
Evolution

Public financial management systems have undergone continuous conceptual development. An introspective look into the last five decades shows at least seven waves of development, each one leaving its distinct imprint on the growth of the system.
Immediately after the Second World War, there was a general recognition that the traditional approach of preparing and implementing a budget in terms of objects of expenditures (or input categories) would no longer be adequate to meet the growing tasks of government and the curiosities of the public and the legislature. The question then was what is the community getting for all the outlay of governments at all levels. This contributed to the formulation of performance budgeting systems. Notwithstanding the inherent attraction of the alternative system, governments and officialdom were slow to move from the traditional system to the new one. Even before performance budgeting developed roots in government, there was a view that, notwithstanding the best of implementation practices, this system would have little impact on the growth of public expenditure. Governments needed an approach that would persuade the public that efforts were being made to contain expenditures. To this end, an approach that emphasized the need for explicit medium-range financial planning (as very few problems get solved within a fiscal year) was promoted. It had a program structure that shifted the traditional emphasis from inputs to objectives and accomplishments, envisaged the application of information technology, and, more significantly, sought the allocation of resources on the basis of analytical quantitative criteria such as the family of techniques of cost-benefit analysis.

The application of this approach was limited mostly to industrial countries including the Soviet Union, which sought to apply it to defense operations. The spread of this approach to developing countries was extremely limited (a couple of Asian countries attempted a variant of this approach) as there was a view that some of the features of this system, which came to be known as PPBS, were already available and were being applied in the formulation of development plans.

Meanwhile, the growth of public expenditures continued unabated, and there emerged a growing chasm between the available resources and the expenditures needed to fulfill existing commitments and established needs. There was
recognition that the systems of financial management exacer-
bated the deficit problem as the fiscal slippages contributed to
higher budget deficits. The response to this problem was that
budgeting and the overall system of financial management
should explicitly internalize the resource constraint and the mac-
roeconomic linkages. This emphasis on financial management
systems as instruments for securing macroeconomic stability
led to extensive changes in the operational spheres of financial
management. Success was, however, limited. This, in turn,
spawned an intensive search for other systems and techniques
that could be used by governments in their fight to stem the
inexorable growth in public expenditures. These efforts, which
are now more than a decade old, have evolved, for purposes
of our discussion, in three stages.

The first of these stages was aimed at securing fiscal
consolidation (a euphemism for the restructuring of govern-
ment agencies and their civil services), privatization of state
enterprises, and reform of entitlement programs in the devel-
oped western countries. Although these aspects may be viewed
as policy measures, they left their own indelible imprint on the
systems of financial management. The terms “lean and mean”
and “getting more for less” became a part of the operational
lexicon of financial management systems. The second stage
drew inspiration from the practices of the corporate world,
which, in turn, emphasized the provision of managerial au-
tonomy, the specification of results and binding resource ceil-
ings, and client orientation. The third stage arose from the
emphasis on improved governance through transparency, ac-
countability, and a code of civil conduct based on recognized
ethical practices. These different stages are illustrated below.  

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2 For an elaboration, see the chapter entitled “Expenditure Management

3 In the analytical framework formulated by Kuhn, each paradigm seeks
to replace the former. In the case of financial management, however, all
paradigms, except the traditional line-item approach, coexist and have
become multiple dimensions of the same function.
## Changing Paradigms in Public Financial Management

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<th>Control through budget line-items</th>
<th>Control of minutiae</th>
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<td>Budgeting through an aggregation process</td>
<td>Emphasis on accounting and payment controls</td>
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<td>Prior approval from the Ministry of Finance in most cases</td>
<td>General emphasis on inputs</td>
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<th>Performance budgeting paradigm</th>
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<td>Specification of results</td>
<td>Activity of program-oriented classification</td>
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<td>Emphasis on cost controls</td>
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<th>Planning paradigm</th>
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<td>Exploration of alternatives and application of quantitative techniques of analysis</td>
<td>Longer-term horizon</td>
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<td>Program classification</td>
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<th>Macroeconomic policy paradigm</th>
<th>Containment of budget deficits</th>
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<td>Moderation of expenditure rate of growth</td>
<td>Efforts to ensure that budget outcome is congruent with intent</td>
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<tr>
<th>Fiscal consolidation paradigm</th>
<th>Restructuring of government operations with emphasis on contracting out to private sector and nonprofit organizations</th>
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<td>Reorganization of the civil service</td>
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<th>Corporate practice paradigm</th>
<th>Creation of task-oriented agencies</th>
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<tr>
<td>Determination of global budgetary ceilings</td>
<td>Specification of results</td>
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<td>Provision of managerial autonomy</td>
<td>Performance contract</td>
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<td>Client orientation</td>
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<th>Governance paradigm</th>
<th>Transparency of government transactions</th>
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<td>Accountability</td>
<td>Ethical practices</td>
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The second and third stages described above also constitute the main planks of what is now known as the New Public Management. This philosophy (hereafter referred to as NPM) lacks a standard definition, with the result that many writers enumerate the contents in different ways. To a very large extent, NPM is influenced by management practices in the corporate world, and also by the public-choice school of economics. NPM is concerned with all aspects of government as a whole and, as such, some financial management elements have also come to find place in this approach. The main elements of NPM and the corresponding elements of public financial management are illustrated below.

<table>
<thead>
<tr>
<th>Major Themes of NPM</th>
<th>Financial Management Improvements</th>
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<tr>
<td>Policy improvement</td>
<td>Medium-term rolling expenditure planning</td>
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<td>Organizational restructuring</td>
<td>Establishment of task-oriented agencies</td>
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<td>Improved internal control systems</td>
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<td>Appointment of chief financial officers</td>
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<td>Establishment of treasury divisions</td>
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<td>Market testing</td>
<td>Renewed emphasis on competitive tendering and bidding</td>
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<td>Seller/buyer nexus</td>
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<td>Transparency</td>
<td>Improved budget classification</td>
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<td>Data on costs and performance</td>
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<td>Frequent publication of financial statements</td>
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<td></td>
<td>Financial management initiative for reorganizing internal information systems</td>
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<td></td>
<td>Frequent publication of data through electronic media</td>
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<tr>
<td>Accountability</td>
<td>Performance contract</td>
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<td></td>
<td>Specified oversight bodies</td>
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<tr>
<td>Application of electronic technology</td>
<td>Integrated financial management systems covering financial planning, budgeting, accounting, and reporting</td>
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Problems inherent in the new management approaches

The new approaches illustrated in the two tables have a number of problem areas:

Public interest versus public pressure. A significant point of departure from the traditional approaches is the emphasis placed on much-needed customer orientation and the need to be responsive to changing patterns of demand. In the corporate world, the consumer pays in full for the services rendered. In the public sector, it is more than likely that the service is either free or, more frequently, subsidized. Where there is a publicly funded service, there will be public pressures to change or to seek higher budgetary allocations. Where many of the features of the services provided are legislated, increased pressures and associated lobbying will be brought to bear on the legislature. Where, however, the design of services is within the jurisdiction of the program manager, the pressures take more subtle forms that may not always lead to improved delivery of services or to macroeconomic stability. The distinction between interest and pressure, or, more specifically, the borderline where interest transforms itself into pressure, and the way in which such pressure may be addressed, has not been given due recognition.

Legislative regime versus social control. Increasingly, as a part of the new approaches, there has also been a demand for social control of governmental finances and greater participation in the policy processes. Implicit in this approach is the underlying assumption that the legislative processes and procedures have not been entirely successful in enabling participatory management and that, in any event, the management of public money is too important to be left to legislators belonging to various political parties. But social control could also mean serious erosion of the credibility of the existing legislative institutions, and could contribute to greater public pressures
and the formation of public movements designed to stop or secure greater allocation of funds. Social control could also contribute to a good deal of defensive policymaking that could prove to be counterproductive. The full implications of these aspects are explored in a later chapter on accountability.

Bureaucracy versus management. The new approaches imply a total indictment of the existing patterns of work, which are considered hidebound, rule-oriented, and generally uneconomic. Managerial approaches, on the other hand, are expected to be task-oriented and flexible. This very flexibility, however, becomes an issue of accountability. To what extent is the legislature willing to provide that flexibility within the overall framework of accountability? Is it ready to trust the decision of a public servant? The answers to these issues are becoming increasingly problematic, as legislatures keep on adding more and more legislation and administrative rules which can potentially hamper managerial flexibility in government.

Organizational aspects: Process versus technology. The need for the progressive application of electronic technology to government operations is no longer a matter of debate. The only issues are how and when. Meanwhile, the experience of several countries shows that, in the absence of efforts to streamline the process as a first step, information technology could become a fifth wheel to the coach. The way in which the process of government financial management has to be adapted to make the application of technology effective remains an area that awaits a blueprint. (See chapter 4 for an elaboration of these issues.)

Integrated versus segmented. How should the new forms of management be introduced—in one swoop or through a pilot program which could be considered for extension to the whole government after sufficient experience has been gained? Some prefer the former, while others prefer the latter evolutionary approach. The answer depends
largely on administrative capacity, which is typically very limited in developing countries.

Entity versus ministry. The focus of the application of the new management approaches is the “entity.” An entity in the corporate sector can often be different in form, purposes, and content from an entity in the public sector. In fact, entities in the public sector tend to be highly uneven in organizational structures and budgetary allocations. In such circumstances, the preparation of independent financial statements, as is envisaged in the introduction of accrual accounting at the entity level, could be less useful. For the purposes of policy formulation and implementation, the department represents the hub of operations. Focus on entities could contribute to undesirable and unnecessary fragmentation.

**Problems that persist even after full implementation**

As noted earlier, many of the new approaches still have to be fully implemented, and as such the assumption of full implementation may demand a leap of faith. For analytical convenience, however, let us assume that the systems have been implemented as envisaged and that they have become operational. It is likely that problems will persist in management, accountability, and transparency because of the changing portfolio of expenditure. In most countries, the share of government expenditures on directly provided services is shrinking. In the United States, this is about 4 percent, and even when the wage component of defense outlays is added it just reaches 8 percent. Increasingly, central or federal governments are becoming cash distribution centers, while actual services are delivered by autonomous agencies, state or provincial governments, contractors from the corporate sector, and nongovernmental organizations. As third-party payments have emerged as a major category, the distance between government and the client has
become even more remote. At the street level, services are being delivered on a third-party basis with the transaction completed between the buyer and the seller, or the provider and the receiver. This phenomenon has implications for management in government.

From a management point of view, the policy feedback becomes difficult as services are provided on a contractual basis. Indeed, many argue that a policy deficit is emerging. The approach also contributes to a growing dependence on contractors by government. As it is, one of the weakest points in government financial management is the ability to manage contracts to reap the advantages of bulk purchases. Given this weakness, placing greater reliance on contractual services could only exacerbate the problem. The appointment of chief financial officers or comptrollers is unlikely to be helpful in a context where the design of services is specified in legislation and where the services are provided by contractors. The problem becomes even more acute in a context where little is known about the internal controls of the contractor or the cost controls in government. The chief financial officers may seek to integrate systems and may secure full compliance of specified systems, but this would be like maintaining a hollow shell.

From the accountability point of view, the creation of task-oriented agencies with power to borrow on their own may weaken actual accountability. The agencies may be expected to compile annual reports on accountability and on finances, but these provide too infrequent opportunities to exercise the requisite oversight. In fact, it is quite likely that many of these agencies may also be outside the ambit of the supreme audit institutions.

Even within the normally accepted framework, several areas have remained unaffected by the new emphasis on accountability. For example, public debt charges remain outside the normal procedures of annual appropriation and, in several cases including industrial countries, remain to be audited by the supreme audit institutions. Outlays on defense continue to
be opaque and not always fully accountable. Thus, when autonomous agencies have their own forms of simplified accountability, and when sizeable outlays of the annual budget continue to be managed by governments without requiring the annual legislative approval, or are not even audited, assertions about enhanced accountability lack credibility. (See chapter 6 for a fuller discussion of public financial accountability.)

As for transparency, the revised budget classifications, which are output-oriented, do not appear to be radically different from the previous ones, particularly in a context where major parts of departmental expenditures continue to be devoted to categories such as “policy advice.” This usage becomes even more debatable when the same policies are continued year after year with little change, if any. Also, the annual financial statements issued by organizations are more oriented to the needs of investors and stockbrokers than the general public.

Neglected high-risk areas

The design of the new management approaches does not include sufficient clarity or detail, among others, in the following four areas:

- uncertainty management;
- contract management;
- relationship between central and spending agencies; and
- inadequacies and discontent in public financial management.

Uncertainty. The most important problem with a profound impact on all the financial operations of government is the way in which uncertainty is addressed. Most budget estimates leave very little margin to the financial manager. At the same time, there are some categories of expenditure that are demand-driven and that contribute to a budget outcome that is different from the estimated. Faced with uncertainty, many
central agencies end up reserving various tasks for further scrutiny or to be taken up only after specific approval has been received. Within the agencies, managers are caught up in serving the clientele, while at the same time conforming to the estimates and to the associated budget discipline. In the absence of procedures and techniques specifically aimed at dealing with uncertainty, repetitive budgeting and associated dilatory procedures tend to be adopted. If these are to be avoided, it is important to specifically address uncertainty and to introduce contingency planning techniques.

Contract management. As noted above, this is one of the weakest areas in government financial management. Repeated assertions about the advantages of competitive tendering and contracting are unlikely to prove helpful, unless they are backed by improved procedures for the compilation of costs within the government that can then be used as benchmarks for monitoring the activities of contractors.

Many of the present ills of government contractors are associated with three factors:

- lack of a firm design at the outset, and frequent improvisations after the start of the project;
- long delays in the acquisition of sites; and
- cost-plus basis for the award of contracts.

The net result is that the actual cost turns out to be considerably higher than initially estimated. What type of improved controls, including forward planning, would be appropriate? Are there alternatives to cost-plus arrangements, and how can they be utilized for the benefit of governments?

Relationship between central and spending agencies. Although the new approaches place considerable emphasis on decentralization, the latter is considered more in terms of the structural relationship between central and local governments rather than in terms of the specification of responsibilities of
central agencies and spending agencies. The attempt to delineate internal controls (the reports prepared by the Cadbury Committee, the committee of sponsoring organizations of the Treadway commission, and the Canadian Institute of Chartered Accountants have dealt with these aspects in detail) has led planners to envisage the establishment of a control environment where risks and control objectives are identified and evaluated and there are information and communication, control, and monitoring and corrective mechanisms. The envisioned control framework is somewhat static rather than part of the dynamic partnership between the central and spending agencies in a government. The framework is based on the premise that each entity has functional financial freedom—a premise that is highly debatable in the context of government functioning.

The reforms undertaken so far or envisaged in the medium term have not paid much attention to the thorny issue of this delicate relationship between the central and spending agencies. The public or the community is generally unaware of this issue, which is viewed more as an internal issue of the bureaucracy. But this has a pervasive impact on all phases of financial management. The reforms envisage the responsibility of the central agencies as more in the realm of macroeconomic management, and the day-to-day micromanagement of programs and projects as within the jurisdiction of spending agencies. The expectation is that once the budget ceilings have been determined by the central agencies, the spending agencies will have the freedom to carry on with their tasks. Reality is, however, different. Global ceilings are predicated on certain assumptions. Once these assumptions change, the whole process may have to be revisited, not once, but as frequently as changes in the economic situation demand. Attention therefore needs to be paid to the specifications of the macro and micro tasks and the green, yellow, and red zone controls.

Inadequacies and discontent. As a result of changing paradigms, there has been an increase in the objectives to be
served by the financial management system. The success of the new systems depends on their capacity to meet all the objectives. This adequacy test is illustrated in the table below. This table shows that some of the systems such as performance budgeting, are ineffective in terms of fulfilling the requirements of macroeconomic stability. A combination of various systems or their selected features would be needed as a minimum threshold. Such a combination is not yet available. By extension, it may be noted that not all objectives may be pursued at the same time, and at any given stage, some may have to be given greater importance than others. Such systems have a limited major focus and as such are not in a position to address the diverse objectives. The selection of objectives is conditioned by needs as well as the capacity to achieve them.

Several factors shown in the table below impede the implementation of fiscal policy. Many of these factors, which cover revenues, expenditures, lending and borrowing, and selling and buying operations, create perverse incentives that tend to affect the overall tenor of the financial management system.
Adequacy of Budget Financial Management Systems

<table>
<thead>
<tr>
<th>Types of Systems</th>
<th>Macro-economic Stability</th>
<th>Effective Budgeting</th>
<th>Financial Discipline</th>
<th>Efficiency Gains</th>
<th>Program and Project Management</th>
<th>Financial Disclosure</th>
<th>Transparency</th>
<th>Accountability</th>
<th>Client Orientation</th>
<th>Political Acceptability</th>
<th>Citizen Participation</th>
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<tbody>
<tr>
<td>Line-Item Budgets</td>
<td>General emphasis on inputs; in its most recent form, is used in the United States to secure cuts in legislatively approved programs and projects</td>
<td>Can be used in its own way, to match outlays with resources</td>
<td>Little capability</td>
<td>Little capability</td>
<td>Sheds very little light on policies</td>
<td>Shows only the broad objection which money is spent</td>
<td>Provides a narrow based accounting of money raised and spent</td>
<td>Very little</td>
<td>In its simplicity and long tradition, it found a large measure of political acceptability</td>
<td>Very little</td>
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<tr>
<td>Performance Budgeting</td>
<td>Had very little orientation to the macro-economic policies; in fact, scrupulous adherence to specified performance standards could contribute to steadily increasing expenditure.</td>
<td>Like traditional systems, this too can be used to secure budget balance.</td>
<td>As above</td>
<td>Properly utilized, this should contribute to efficiency gains and to more effective cost controls.</td>
<td>Most useful in ensuring proper management.</td>
<td>Sheds more light on performance.</td>
<td>Facilitates greater transparency.</td>
<td>Provides enhanced accountability.</td>
<td>Performance takes into account the needs of clients.</td>
<td>By enabling a causal link between resources raised and services provided, it has a built-in political acceptability.</td>
<td>The system did not provide for this feature but can be augmented to include this feature.</td>
</tr>
<tr>
<td>Types of Systems</td>
<td>Macro-economic Stability</td>
<td>Effective Budgeting</td>
<td>Financial Discipline</td>
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<tr>
<td>Planning, Program-</td>
<td>Placed greater emphasis on allocative efficiency and application of quantitative techniques of analysis; not much attention to stability</td>
<td>Placed greater emphasis on medium-term context and on getting the right balance of money, manpower, and materials</td>
<td>As above</td>
<td>The gains were to be procured through the application of quantitative technical analysis</td>
<td>Most useful in ensuring operation management</td>
<td>No emphasis on this aspect</td>
<td>No particular emphasis on this aspect</td>
<td>Accountability was more in the right selection of policies, programs and projects</td>
<td>Not much</td>
<td>Provided empirical support to proposed policies</td>
<td>Very little</td>
</tr>
<tr>
<td>Budgeting</td>
<td>Systems</td>
<td></td>
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Public Financial Management: Getting the Basics Right
<table>
<thead>
<tr>
<th>Types of Systems</th>
<th>Macro-economic Stability</th>
<th>Program and Project Management</th>
<th>Financial Discipline</th>
<th>Efficiency Gains</th>
<th>Financial Disclosure</th>
<th>Transparency</th>
<th>Accountability</th>
<th>Client Orientation</th>
<th>Political Acceptability</th>
<th>Citizen Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero-based Budgeting; Fundamental Review; Target-Based Budgeting; Evaluation</td>
<td>Aimed at securing a moderation in the rate of growth of expenditure and an improved allocation of resources</td>
<td>As above</td>
<td>The system offered a means to eliminate uneconomic programs and projects</td>
<td>No major emphasis on this aspect</td>
<td>Very little emphasis</td>
<td>No particular emphasis. These are used mostly internally in the preparation of the executive budget</td>
<td>No such emphasis</td>
<td>One of the criteria of evaluation is the extent to which programs have succeeded or failed in responding to client needs</td>
<td>It indicated the determination of the government to drop the uneconomic program; politically, it meant a loss of support from some quarters and gaining support from those who want to be seen as an efficient government</td>
<td>Very little</td>
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<tr>
<td>Output Budgeting</td>
<td>No emphasis on this aspect</td>
<td>Sought to build a nexus between allocation and outputs but not between aggregate resources and outlays</td>
<td>As above</td>
<td>The quantitative expression also implied the efficiency levels to be achieved</td>
<td>Very helpful in securing program and project achievement</td>
<td>Sheds light on the physical aspects of government services</td>
<td>In addition to financial data, information is given on the non-financial aspects</td>
<td>Accountability for results is provided for explicitly</td>
<td>The output orientation is expected to include this dimension too</td>
<td>Lends support to the view that political acceptability is enhanced when new dimensions of accountability are added</td>
</tr>
<tr>
<td>Accrual-Based Budget Systems</td>
<td>Very little emphasis on this aspect</td>
<td>Provides an effective link between assets, liabilities and net worth</td>
<td>As above</td>
<td>No specific attention</td>
<td>Program managers are expected to have a heightened awareness of costs and resource utilization</td>
<td>Shows the effective use of resources</td>
<td>Shows the financial condition of government</td>
<td>Provides yet another dimension of accountability</td>
<td>Very little</td>
<td>Enhances governance</td>
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<tr>
<td>Corporate Practice of Management-Oriented Budgets</td>
<td>Little attention to this aspect</td>
<td>The links between resources and outputs, as well as responsibilities are specified</td>
<td>As above</td>
<td>The manager would be obliged to deliver services within specified cost estimates</td>
<td>Allows greater flexibility to program and project managers in resource use</td>
<td>Period provision of information is envisaged</td>
<td>Provides greater transparency through the publication of contractual agreements</td>
<td>Managers are expected to be accountable to specific channels</td>
<td>Managers are expected to be market oriented and thus be responsive to client needs</td>
<td>It brings new relationship between political levels and managers</td>
</tr>
</tbody>
</table>
In recent years, transparency and accountability have become, to use Weber’s term, “domain assumptions.” But the preceding analysis shows that, while transparency and accountability are essential and steps are needed to establish a minimum threshold, these approaches by themselves do not provide answers to the several issues described so far.

### Fiscal Instruments and Application Issues

<table>
<thead>
<tr>
<th>Policy Instruments</th>
<th>Factors Impeding Their Effectiveness/Flexibility</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Taxes</strong></td>
<td>Earmarking, Exemptions, Evasion, Long collection lags, Write-off amounts due, Deferral of repayments, Conversion of amounts due into grant/equity, Retention of receipts by agencies</td>
</tr>
<tr>
<td><strong>Nontax revenues</strong></td>
<td>Evasion, Long collection lags, Write-off amounts due, Deferral of repayments, Conversion of amounts due into grant/equity, Retention of receipts by agencies</td>
</tr>
<tr>
<td><strong>Foreign aid</strong></td>
<td>Tied borrowing, Donor-specified procedures, Receipt of aid outside the budget process of the host government, Extrabudgetary accounts, Lags in reimbursements</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td>Unpaid bills, Informal IOUs, Leasing rather than purchasing, Underestimation of costs, Earmarking and extrabudgetary accounts, Use of quasi-fiscal accounts, Expenditure offsets</td>
</tr>
<tr>
<td><strong>Expenditures</strong></td>
<td>Unbundling approaches to avoid funding ceilings, Ghost employees, Change of effective dates, Carryovers, Netting Misappropriation, Misclassification</td>
</tr>
<tr>
<td><strong>Commercial Buying</strong></td>
<td>Leasing, Unbundling approaches to avoid ceilings, Underestimation of costs, Failures in quality of goods bought</td>
</tr>
<tr>
<td><strong>Commercial Selling</strong></td>
<td>Subsidized sales, Noncollection of dues, Asset deterioration due to delayed sales</td>
</tr>
<tr>
<td><strong>Financial Borrowing</strong></td>
<td>Borrowing in kind from suppliers, Issue of guarantees to autonomous organizations, Informal IOUs</td>
</tr>
<tr>
<td><strong>Financial Lending</strong></td>
<td>Delinquent accounts, Subsidized rates of interest and long grace periods, Provision of advances with no terms, Deferral of repayment and rescheduling, Write-off of interest and principal</td>
</tr>
</tbody>
</table>
The Basics: Four-Pillar Approach to Financial Management

It is obvious that efforts need to be made to address the problem areas described earlier. Such an attempt may also be labeled as an effort to get the basics right. But the determination of “basics” itself is a formidable task for two reasons. First, what is basic is itself a moving goalpost. Not too long ago, it was considered that the submission of annual accounts itself was the last step in the chain of accountability. Now, however, accountability refers to the performance promised and actually achieved. Similarly, client orientation was not one of the significant dimensions of financial management. Now, it is practically the core concern of public bodies. As such, the formulation of basics at this stage should take into account the expanded version of some of the components of financial management. Second, the consideration of the contours of basics may be influenced by the experience of other countries, in particular the Western democracies. But the basics have to reflect, in the final analysis, the capacity of the government, the needs, and the areas where immediate improvements are needed.

Broadly speaking, four pillars of financial management can be identified. These are: (i) macroeconomic stability; (ii) increased efficiency in government operations, (iii) supporting technical infrastructure; and (iv) an effective accountability framework.

Macroeconomic stability

The pursuit of macroeconomic stability is now the dominant concern of governments and financial management systems in public bodies have the primary purpose of serving the needs of policies aimed at securing that goal. This, in turn, requires that the machinery of financial management should have the following elements (the objective here is to promote improved policy planning and the formulation of an annual management
strategy that guides the various stages of operations of financial management):

- Identification and assessment of the future financial implications of current policies.
- Explicit recognition of the resource constraint. The annual budget exercise is intended to facilitate the internalization of this factor. As such, every step of the process should facilitate a collective consideration of needs and resources. Once resources are allocated, they should be viewed as a binding constraint.
- Maintenance of an extensive database on the expenditure profile of all agencies. Efforts must also be made to maintain cost data where services funded by public agencies are provided by private and non-governmental sectors.

In the light of the above, public bodies should aim at formulating medium-term fiscal strategies that set the parameters for the financial management machinery. As an integral part of this approach, it may be useful to specify limits for some operations, e.g., borrowing.

No strategy is self-fulfilling. If it lacks the capacity to reflect changing needs, then it becomes counterproductive. To be responsive to volatility, financial planning may include reserves or may specify other options.

Achievement of efficiency

The way to restore confidence in government, which should be one of the primary aims of financial management, is to specify the efforts being made to attain efficiency. To this end, any strategy aimed at improving financial management should have the following:

- Measurement and publicizing of the costs of important activities. The factors and areas contributing to
expenditure increases should be identified and addressed.

- Pursuit of alternative strategies for the delivery of services when costs tend to increase.
- Elimination of most labor-intensive operations in public bodies (e.g., the payment system) and their replacement by electronic technology. Some of these operations can be contracted out.
- Removal of existing perverse incentives in the system.
- Publicizing of efficiency endeavors made by agencies so that other agencies and the community may emulate them in their own spheres.

Technical infrastructure

To strengthen the work in the first two phases, many organizational improvements need to be made, including the following:

- Establishment of an information system which makes relevant operational data available to all policymakers and program managers, thus facilitating their task of monitoring.
- Focus on core tasks by central agencies responsible for financial management. These tasks include policies, costs, and the specification of desired performance levels.
- Managerial autonomy for spending agencies in the use of allotted resources. They should be encouraged to take risks.
- Selective conversion of accounting systems to an accrual basis particularly in those agencies that have large inventories or those that charge for their services.
- Inclusion of depreciation and capital charge in the systems. In what manner and how fast depends on the circumstances of each country. Full funding of pension liabilities depends on the type of the system.
• Pooling or centralization of common payments such as payroll, pensions and public debt charges. Electronic operations would speed up the compilation of accounts and reduce fraud.
• Reduction of layers of oversight.
• Identification of the factors—systemic, technological, and human—contribute to underachievement in countries where the elements of financial management described here already exist but are not functioning effectively.

Accountability

This phase requires the provision of the necessary instruments for securing accountability as well as a specific body with oversight responsibility. It is quite likely, however, as indicated earlier, that even where such a body exists, it may not be performing its tasks effectively, or performing them to suit a political agenda. The framework of accountability should therefore provide for avenues that would enable bridges to be built directly between governments and the society. The society has to be provided with the requisite information, so that, it may, if it chooses, exercise a form of social control over and above legislative control. For this purpose, financial management systems should aim to provide the following:

• Specific costs and expected performance, as an integrated part of the overall framework of accountability. It is recognized that performance specification must inevitably be selective. In such cases, costs would serve the purpose.
• Avenues for the people to secure information on historical series such as government accounts, but more importantly, on policy decisions made during the year.
• Oversight bodies where none now exist.
• Adequate efforts to disseminate information in various forms.
Moving Forward

The efforts involved in the above stages differ between countries in view of the diversity of their problems. In formulating strategies, which is primarily the task of member countries as they are the best judge of their situation, the emphasis, in the immediate short term, is likely to be on scratching where it itches.

It is also necessary to make arrangements for the transition. The switchover where the changes are substantial may take a long time and may prove expensive in the short term, and the rewards may not be immediately evident. Further, overcoming the barriers of tradition is far from easy. Apart from sustained political commitment, this requires concerted action on several fronts, all of which are in the realm of the governments of member countries. The role of international financial institutions is primarily to provide the requisite stimulus and unbiased information on international experience, and to function as catalysts and not as advocates of preselected agenda.

It should be noted that the four-pillar agenda described above does not have a label. It is an eclectic combination of efforts needed to secure specified benefits. As Deng Xiao-ping said, the color of the cat is not important, so long as it catches mice. Labels are often distracting. What matters most is whether the proposed approach yields the desired results.
Chapter 4

Information and Communication Technology for Public Finance

Clay Wescott and Salvatore Schiavo-Campo

Introduction

It is impossible to provide a good overview of the context of public finance management without some reference to the informatics revolution. The monumental change wrought in every field by the new information and communication technology is still only in its initial phase. The subject of ICT is too vast to be adequately discussed in this chapter. But a few general considerations should be raised here.¹

First, ICT is a tool, immensely powerful yet essentially no different from a photocopier or a car, in the sense that user needs and requirements must come first and dictate whether and how the ICT tool should be used. For certain functions, pencil and paper, or a telephone, or a face-to-face meeting, or a visit to the library is far more effective than computers or the Internet. This obvious point must be stressed because there are frequent instances when governments, consultants, or donor agencies encourage computerizing anything in sight. Indeed, many would argue that IT innovation is now largely supply-

¹ This paper draws in part from Asian Development Bank, Managing Government Expenditure, 1999, chapter 1. Grateful acknowledgement is also given for permission to draw from a presentation prepared by the Deloitte & Touche Consulting Group, Singapore, for a March 1999 workshop sponsored by the Asia-Pacific Development Information Program, UNDP.
and marketing-driven rather than dictated by the needs and requirements of the users. Thus, it is essential to assess realistically and compare the costs of a given ITC change with the actual benefits expected from it.

Second, the ICT “techie” and the “public financial manager” should not work in isolation from one another. As noted, improvements in effectiveness stem largely from better rules and procedures in the sector concerned. To apply advanced ICT to obsolete or inefficient rules and processes means in effect to computerize inefficiency. Doing the wrong thing faster is not progress. On the other hand, the absence of relevant ITC knowledge risks either costly mistakes or missed opportunities for dramatic service improvements.

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

Fourth, faster and integrated public financial management information systems carry correspondingly greater potential risks for the integrity of the data, and can even jeopardize the financial management system in its entirety if developed carelessly and without sufficient checks, controls, security, and virus protection. Indeed, the first advice to a government moving from a manual public accounting and recording system to a computerized one should be to keep the manual ledgers going alongside the new system until the new system is working well, and is secure and free of risk.

Fifth, it is often argued that ICT reduces the corruption. In fact, computer technology eliminates almost all opportunities for corruption for those who do not understand fully the new technology, but opens up new corruption vistas for those who understand the new systems well enough to manipulate them.

To sum up, organizations adopting more advanced ICT should: (i) always fit the new technology to user requirements
and the real objectives of the activity; (ii) see to it that the new technology goes hand in hand with improved rules and processes; (iii) protect data and systems integrity; and (iv) aim at an integrated strategy and avoid a piecemeal approach (which can fit specific needs but adds up to a ramshackle and even dangerous system). Note, however, that an integrated approach requires compatibility and coordination, but not necessarily a single system.

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

During the 1960s, the public sector led many private enterprises in the use of computers in support of basic administrative functions, including management information systems, payroll processing, and accounting applications. Since then, the private sector has taken the lead in IT uses of electronic service delivery systems that give direct access to information and services, and integrated resource management.

The figure below shows the various IT systems used in the private sector. These systems are important tools in the four major business sectors: manufacturing, telecommunications/utilities, financial, and consumer business. In manufacturing, the most commonly used IT systems are online sales catalog,
electronic purchasing, Web-based order entry, auto replenishment, supply chain integration, enterprise resource planning (ERP), and electronic data interchange. In the telecommunications/utilities sector, the following IT systems are used: bill presentment and payment, electronic messaging, corporate Web site, ERP, and customer dynamics. The financial sector uses the following IT systems: banking applications, corporate Web site, Web-enabled transactions, workflow and imaging, electronic funds transfer, and customer dynamics. The consumer business sector uses a combination of these systems in the production and delivery of its services.
To illustrate how IT systems interact with the major players in a business, a high-level view of a typical supply chain is shown in below.

The fast-expanding use of the Internet is helping some companies implement fully integrated value changes to create partnerships with suppliers and customers, together with whom they can find ways of cutting costs, improving quality, expanding markets, and sharing the benefits. This is changing the old idea of a free-standing business. Internet-enabled companies are bringing suppliers and customers much deeper into their business practices and systems, and need a similar understanding of those of their partners’. This in turn is forcing greater openness and transparency among all partners than in the past. Customized services, products, and pricing are becoming more the rule than the exception. Increasingly, business processes not considered core are contracted out to more efficient providers.
Just-in-time inventory systems are becoming common. An unprecedented amount of collaboration is possible, where management skills are up to the task.

**IT in the Public Sector**

Public-sector institutions have not yet fully grasped the benefits of the IT revolution. The challenge of the information revolution has yet to be tapped by many governments to modernize practices and procedures. This is evident in most activities of the government in delivering basic services to the people: problems in inter- and intra-agency record sharing; paper trail required for approval processing; paper form filing done over the counter; difficult access to public information; difficulty for citizens in giving feedback to public officials and getting timely responses; cumbersome document archiving; delays in getting public census results, etc.

The “paper-chase” legacy is still alive and well in most public sectors. The telephone is used primarily to prompt action, and paper is still king. Several copies of a single document are usually required, even within a single department. The in-box and out-box system still prevails. These practices use too many resources to shuffle and screen paper.

The reasons for slower adoption of IT by public-sector institutions are:

- higher costs due to the scale of public organizations;
- existing legacy systems in place;
- security concerns;
- confidentiality of information;
- existing regulations and laws;
- lack of understanding and skills; and
- the silo system.

Many public-sector institutions in developing countries have difficulty shifting from the traditional and “economical”
ways of doing things to the modern use of computers, the Internet, Web sites, and other IT systems because of budgetary constraints. These constraints can arise not only from the normal costs of hardware, software, and systems integration but also from country-specific factors. In Fiji, for example, a 64K Internet circuit from the publicly owned telephone company costs US$10,000 per month, nine times the cost in Jamaica. Other factors besides cost hamper the use of IT in government. In addition to existing legacy systems in place, security concerns, and confidentiality of information, existing laws and regulations impede the modernization of existing government information systems. South Africa, which needs to remove the legal framework that entrenched racial discrimination before it can proceed with IT development, presents an archetypal example.3

IT capability has always been associated with depth of understanding and skills, and most developing countries do not usually have access to sufficient training. Those that have the needed skills often cannot be retained for long on standard government salaries and benefits. These concerns have been yet another set of factors hampering enthusiasm for the adoption of IT systems. To this end, an initiative developed and funded by the United Nations Development Programme (UNDP) has started assisting the countries in the region by providing training and other technical solutions for IT needs.4

An important step toward IT development is the development of a culture of information management to ensure that information systems fit the task for which they are adopted. The figure below shows the change imperative for governments to embrace IT.

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3 This is discussed fully in Khan and Swanborough, Information Management, IT and Government, IDPM, 1999.
4 See http://www.apdip.net.
Despite the constraints, the use of IT in the public sectors of some countries is increasing. For example, electronic commerce is seen as a feasible solution to: linking government agencies, suppliers, citizens, and employees via the Internet; promoting communication and information sharing; enabling self-service for more efficient use of resources; automating and streamlining payment and disbursement; and generating new enterprises. Workflow systems are used to improve efficiency and enterprise-wide systems are implemented to support operational and infrastructure processes.

**Global Trends**

IT opportunities for the public sector consist of the Internet, electronic commerce, workflow, enterprise systems, contracting out, and knowledge management.
The Internet

Public-sector use of the Internet will almost triple in the next two years. As shown in the figure above, developed countries now use the Internet for an estimated 20 percent of public transactions; in the next two years, and this is projected to climb to 59 percent. Meanwhile, the use of the Internet for marketing purposes is already more than 50 percent, and will reach about 65 percent in the next two years. This means that the use of the Internet for public transactions has just begun, and is projected to escalate within the next two years as more public-sector institutions seek to improve their IT systems.

Aside from the Internet, other emerging technologies are beginning to be used by public-sector institutions, to achieve higher productivity and information access. Among these are: voice recognition, automated call centers, object-oriented technology, groupware, workflow management, image/document management, hand-held computers, multimedia, and Intranet.

Several factors are propelling the Internet to the forefront of popular demand. These factors are the following:

- increasing computer literacy and usage;
- falling communication costs;
- easy-to-use and "hot" interface multimedia web browsers;
- demand for "mass personalization" and instant gratification;
- telecommuting; and
- the globalized economy.

The Internet did not cause these trends, but it is a catalyst that is bringing them together, accelerating their progress, and making the result greater than the sum of its parts.
The figures below show examples of Internet use in the public sector, and promoting self-help among citizens.
Electronic commerce

Electronic commerce is a general term applied to the buying and selling of goods and services, and the transfer of funds, through digital communications. It can include buying and selling over the worldwide Web and the Internet, smart cards, digital cash, and all other ways of doing business over any digital network. It also uses technologies such as electronic mail, electronic data interchange, electronic funds transfer, electronic catalog, directory systems, file transfer, fax, video conferencing, and workflow.
Typical examples of electronic commerce are shown below.
Workflow

Workflow is a general term applied to the ability to move images, files, documents, etc., from workstation to workstation, using specific business rules for review, authorization, data entry, data editing, and task assignment. Business processes that are accomplished by moving paper can now be managed electronically—from the very beginning to final disposition. The delays normally associated with hard-copy documents and manual processing can be minimized with workflow systems.

A workflow system is fundamentally different from a traditional system. As shown in figure below, a workflow system focuses on what to do and how to do it, and is event-driven, process-oriented, and modeled after human workflow. In contrast, a traditional system focuses on features and functionality, is organized by function, is “vertically” oriented, and serves a specific application need.
The major components of a workflow are procedures, tasks, events, and workers. A procedure is a series of interrelated tasks required to complete an instance of work. An event is an occurrence that triggers the start of a procedure or task. A task is a discrete element of work that can be assigned to an individual worker. It can be defined in terms of the information required to complete it, the application used, the workers who can perform the task, and the timeframe and priority that should be assigned to it.

Some promising IT applications in the public sector are the following:

- integrated financial management (budget, accounts, treasury);
- tax management;
- claims processing and management;
- bid and proposal routing and tracking;
- engineering change notice distribution;
- handling of customer service and complaints;
- college enrollment;
- grant and scholarship award, approval, and processing; and
- human resource recruitment and hiring.

**Enterprise resource planning**

Enterprise resource planning (ERP) is an integrated business system that ties all of the various functions of an enterprise (finance, human resource management, etc.) into a cohesive system on a common database. ERP systems are integrated with the Internet (e-mail, messaging), electronic commerce, and workflow. ERP presents opportunities to the public sector in the areas of financial management, which includes treasury/cash management; human resource management, which includes payroll, record management, and benefits administration; and facilities/resource management, which includes procurement, forecasting, and material management. Although
these were initially proprietary, client/server systems, the latest versions are increasingly Internet-based, allowing information to be accessed by anyone who needs it, and reducing training and other costs.

**Contracting Out**

Like the private sector, some governments are also using IT to facilitate the contracting out of service provision. Contracting for services can have the advantage of increasing efficiency and effectiveness through increased competition, and getting around public-sector work rules which are oriented more toward control and accountability rather than customer service. IT can help governments monitor and measure performance under such contracts. On the other hand, contracting may entail greater specification, more complex negotiation, and higher litigation, negotiation, and bargaining costs than does the use of internal resources. Thus, the decision to contract out a given service needs to be made carefully.  

**Knowledge Management**

Governments need to improve their knowledge of development trends and policy outcomes. Global and regional changes in trade and aid flows, labor migration, technology, climate, and investment can have fast and profound changes on countries in an interconnected world. Governments need to monitor these changes in order to determine appropriate responses. In particular, governments need to measure the social impact of economic trends and policy responses, to ensure that the conditions of disadvantaged groups are not made worse.

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5 For a full discussion, see Schiavo-Campo and Tommasi, Managing Government Expenditure, Chapter 15: Strengthening Performance in the Public Expenditure Management.
IT can help in many ways, including gathering information on global trends through the Internet, conducting virtual conferences that bring together experts in different locations, and using IT systems to better organize and analyze national economic and survey data. Governments can use the same systems to facilitate the timely dissemination of these data, so that investors and other stakeholders have accurate information on the risks and opportunities.

Conclusions

The benefits of IT systems to the public sector are:

- **better service delivery to the public**
  - new payment channels,
  - additional avenue for public feedback,
  - self-help access to information and service, and
  - 24-hour, 7-days-a-week delivery of services;

- **lower cost and increased efficiency**
  - up-front checking of completeness/ accuracy of information,
  - simplified government procurement processes;
  - reduced data re-entry into systems.
  - automated workflow,
  - paperless office, and
  - document archiving and storage.

- **increased workgroup productivity**
  - inter- and intra-department/ agency / ministry collaboration,
  - progress and task-turnaround monitoring, and
  - business process reengineering.

Some current observations regarding IT use in the public sector are:
• Only a small proportion of the public now have their own computers or access to the Internet. However, the numbers are growing.
• Citizens and employees may lack the computer skills needed to fully appreciate IT.
• Some countries may need to develop first of all the basic infrastructure to support IT use.

Making IT Happen

There are some important points to make about the sustainability of IT projects. An information technology project:
• is not only about information technology, and is not just a project. It is a strategic initiative which should be driven by senior government executives, and designed to deliver tangible benefits.
• is not about cost savings. Rather, it is an investment for the benefit of the public.
• is not factored according to time and budget. It is guided by a strategic plan to enhance value.
• is not easy or risk-free. It is complex, difficult, even painful, and will require change.

Change processes must be managed and led from the top. If well done, the change can help governments attain some of the same benefits that private companies are already achieving. They can deliver public services more effectively and efficiently and thereby gain greater support from their citizens.
Introduction

Improvements in the budgetary system are largely a function of institutional change, in the contemporary sense of the basic rules that govern the behavior of organizations and individuals.¹ The distinction between “institution” and “organization”—and the interplay between the two—is key to understanding the challenge of improving the management of public expenditure in developing countries. Budgeting organizations can be improved—sometimes even created ab nihilo—but economic, social and political behavior will not change unless the rules and procedures change as well. For example, simply merging a Ministry of Finance with a Ministry of Planning will not, by itself, do much to integrate current and capital budgeting more thoroughly. However, the reverse is also true: rule modification is unlikely to produce results in an operationally meaningful timeframe unless organizational improvements proceed apace. Thus, to follow the same example, an improvement of the budgetary rules for coordination and integration of current and

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¹ See Schiavo-Campo, 1994, for a summary of the main issues. Section A of this chapter is based on parts of that publication.
capital budgets can be frustrated if the organization of the Ministry of Planning is not improved as well. Clearly, then, improving public expenditure management requires both institutional (regulatory and procedural) reform and organizational development.

In the light of the above considerations, this chapter first presents some general strategic considerations; then outlines the key priorities and sequencing of reform in each of the various aspects of public expenditure management discussed in this volume. Our standard warnings should be repeated once more: (i) budgetary improvements should be assessed not only in terms of the benefits expected, but also of the probable cost and of likely sustainability; (ii) “best practice” is a dangerous term, when it is misinterpreted as importing budgetary models developed elsewhere and without hard-nosed consideration of local realities—particularly administrative capacity, data availability, and the informal rules that determine much of the behavior of local officials and their private sector counterparts in the specific country.

**Strategic Considerations**

**General reform choices**

Aside from the extremes of a “quick and clean” reform strategy (optimal but entirely unrealistic) is optimal and a “slow and dirty” strategy (the worst possible approach), the practical strategic choice revolves around the intermediate options of a “slow and clean” reform strategy or a “quick and dirty” strategy. As a general presumption, the former is preferable be-

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2 This may be considered by some as an obvious choice, given that there is no credible alternative to some sort of step-by-step process. In actual practice, however, the attempts at “shock therapy” are all too frequent and have caused considerable problems.
cause it is more likely to be sustainable. Short-term efficiency of public financial resources must be balanced against the need to improve financial accountability in the long-term. This balancing act between flexibility and excessive discretion is probably the most difficult dimension of improving public expenditure management. The extremes are easy to define and to reject. Thus, reform that eliminates ex-ante financial controls altogether in the name of managerial flexibility, without paying any attention to accountability regimes, is a recipe for widespread corruption. At the other end, protecting the integrity of public resources by introducing a list of micromanagement controls is bound to reduce efficiency sharply. The right middle ground between these two extremes is difficult to find and must be country-, sector-, and time-specific.

The “torto-hare” approach to institutional change

Strategic attention should focus on identifying areas where it is feasible to move very fast (with only a slight cost in terms of “cleanliness” or deviations from the optimal long-term path), and areas where it is essential to build slowly and carefully the solid institutional foundation required for sustainable reform.

Thus, to the question of what the “optimal” pace of reform is, the reform-maximizing answer is “it depends”—unsatisfying and demanding as such an answer may be. This answer is especially valid in the fluid and opaque circumstances of the current transition. To use the metaphor of road traffic, optimal driving speed depends on traffic conditions—subject to an overall speed limit and to the need to keep moving. “Torto-hare” was the slogan (tarta-lepre in Italian, combining tortoise [tartaruga] and hare [lepre]) coined by the Italian highway authority in the 1960s to describe the optimal driver behavior: drive fast or slow depending on the circumstances. To complete the metaphor, the worst approach to driving in heavy and
erratic traffic and poor visibility is to go on cruise control, whether at high or at low speed.

In this perspective, there is an aura of unreality to the debate between “big bang” and “gradualism”. The underlying premise of the big-bang approach is that, in the absence of simultaneous rapid policy reforms in complementary areas, partial reform measures will have no effect. The underlying premise of the gradualist approach is that there is only so much change and upheaval a society can stand at any one time, and the attempt to do too much may end up in a failure to accomplish anything. The difficulty is that stretching these valid premises to their logical extremes leads to caricature and untenable prescriptions. Thus, the “fundamentalist” interpretation of the big bang is tantamount to advocating reform of everything at once. Aside from being utterly unrealistic, especially for developing countries, such a prescription could also cause extreme damage in a plural society riven by ethnic conflict. At the other extreme, the “fundamentalist” interpretation of gradualism becomes a prescription for total immobility. Hence, the actual operational choice is never between these two extremes, but between the specific policy areas where a “big bang” is possible, and those where gradualism is more effective. The obvious alternative to ideological approaches is analysis, on a case-to-case basis, of the benefits, costs, opportunities, and risk of specific budgetary reforms in a specific country. A budgetary reform should be pushed very fast wherever and whenever the circumstances warrant, but may need to be postponed in other areas or occasionally slowed down to allow accountability to catch up, absorptive capacity to grow, or public tolerance to be rebuilt. Such an obvious point would not deserve to mention if it were not so often disregarded in practice.

3 A macroeconomic example of such a mistake would be an attempt to reduce the fiscal deficit by improving the tax effort without concomitantly strengthening expenditure control mechanisms. A microeconomic example would be the liberalization of public enterprise pricing without the complementary measures to place the enterprise on a commercial footing.
Some corollaries

The futility of “paper reforms”

A first corollary of the above considerations is that public budgeting improvements are hollow in the absence of effective monitoring and enforcement mechanisms. Organizational and human capacity is essential to administer and enforce the new framework. Administering, monitoring, and enforcing mechanisms take time, resources and genuine commitment at several levels to become operational. Yet, two very different tendencies often converge in practice to sidestep these requirements. The first tendency is the temptation of politicians and foreign donors alike to declare a problem solved and move on to the next item on the agenda. Thus, the introduction of a new budgetary nomenclature can be considered as an isolated output without any attention to the other elements needed to improve the budget process. The other tendency is the ingrained habit of control-minded elites in the Ministry of Finance to try to effect behavioral change by decree. There is overwhelming evidence that such change, if any, is purely transitory.

Adopt, adapt, or create?

A second corollary concerns the question of whether it is possible to “import” foreign budgetary and/or accounting practices. The answer to the question is often phrased in dichotomous yes or no terms. The term “best practice” is itself an example, in its implication that a given practice is “best” in all circumstances. However, as is generally true in other instances of transfer of technology, once again the better answer is: “it depends”. Formal rules can be imported fairly easily, informal ones much less so. It follows that importing foreign institutional practices is a practical proposition only when these practices have a high component of formal rules. This is the case, for example, the more “technical” areas of public
expenditure management. However, even the most “technical” procedures require an open-minded assessment that country conditions are amenable to the efficient introduction of the new procedures.

By contrast, when the nature of the institution entails a high component of informal rules, as in “social” and “governance” areas or personnel incentives, the institution will normally need to be homegrown or, if imported, will require substantial adaptation and changes over time. In such cases, process and form (“ownership”, “dissemination”, “consensus-building”, etc.) are as important as the eventual results. Indeed, it is sometimes true that (pace Frederic Molnar) “the play’s the thing”: the process is the reform.

Design of assistance for PEM improvement

The risks of giving the “wrong” advice (which, as noted, includes “good” advice that is not suited to local realities) are heightened by the reality of “path dependence”, i.e., that institutional reforms enacted today have inescapable but unpredictable long-term implications—particularly in the more fluid context of developing countries and transition economies. The penalty for mistakes, of course, falls almost exclusively on the people of the developing countries themselves. Thus, the moral hazard inherent in all forms of intervention from the outside—however benevolent the intention—is especially severe in the area of institutional change. Those who urge to “just do it” take on a particularly heavy moral burden.

These considerations should not be taken as counseling inaction or benign neglect—inaction, too, carries its own brand of moral hazard—but to stress the importance of identifying the risks and minimizing them to the extent possible. The risks can be generally minimized by flexible mechanisms of assistance adjusted periodically, with attention to financial accountability and governance implications, and by a focus on local capacity building. More concretely, the risks of interven-
tion can be reduced by interaction with a variety of local inter-
locutors and optimum use of local expertise. (An example of
successful intervention is the ADB loan of US$250 million to the
Indian state of Gujarat for public sector reform—see box below).

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<tr>
<th>A D B Loan of $250 million for the Gujarat Public Sector Resource Management Program</th>
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<tr>
<td><strong>Project Objectives</strong></td>
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<td>• The program supports the Government of Gujarat in improving public finances and augmenting domestic resource mobilization, improving the allocation and efficiency of the public sector, and reducing the role of the Government of Gujarat in commercial activities while promoting market-oriented policies to enhance private sector participation in the infrastructure sectors.</td>
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<tr>
<td><strong>Project Scope</strong></td>
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<td>• The program focuses on (i) strengthening state public finances and their prudent management; (ii) divesting and restructuring state-owned enterprises (SOEs) to allow the private sector to take the lead in commercial activities while reducing the burden that SOEs put on the budget and the economy at large; and (iii) strengthening the policy, regulatory, legal and institutional frameworks for private sector participation in critical infrastructure sectors (power, ports, and roads) and evolving an enabling environment.</td>
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<tr>
<td><strong>Highlights of the Program</strong></td>
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<td>• Reduction of overall fiscal deficit to sustainable levels.</td>
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Operational approaches

The search for operational approaches to improving public expenditure management in developing countries rests on the above strategic considerations, as well as on four premises. First, the information problem is massive. Second, specific entry points must be identified. On the one hand, it is evident that simultaneous budget system reform across the board is not realistic; on the other hand, total inaction on the institutional front is a recipe for progressive deterioration of functions. Somewhere between those two extremes, intermediate possibilities for constructive action must be found. Third, path dependence is a reality. Institutional mistakes tend to become evident only years down the line, when they have become irreversible and the advisers or consultants are long gone, with potentially severe consequences for accountable governance and effective public resource allocation and use. Fourth, countries must, after all, work with what they have. The human resource endowment, the inertia of bureaucratic habits, the predictable resistance and backlash of the losers from change, etc.—all these factors can be altered, combated, utilized, perhaps even deliberately neglected, but cannot be ignored by those who would assist the institutional transformation. These four premises underpin two interrelated approaches to constructive intervention: (i) strength-
ening intrasystem linkages; and (ii) fostering the creation of “efficient nuclei”.

**Strengthening internal linkages: The essence of “capacity building”**

In many developing countries, and in most transition economies, the absence of systematic lines of interagency communication and the lack of incentives to share information (which is often viewed as a personal asset) result in fragmented policy formulation and atomized decision making. This presents a major problem for the implementation of reforms. The challenge is how to improve communications and reduce the cost of information within the public sector.

It is difficult to decide whether to strengthen one particular agency of government or another; the outcome of bureaucratic “turf” disputes is utterly uncertain, and the risks of losing an organizational bet are potentially severe. The guiding operational criterion of technical assistance for sustainable PEM improvement should therefore be to strengthen the linkages between the components of the overall budget formulation and execution system, not only among central ministries, but between them and subnational entities. Not enough is known to pick winners and losers—and today’s winners may well be tomorrow’s losers anyway. Strengthening the institutional and communication linkages within the system: (i) does not prejudice or preempt the appropriate transition path for the system as a whole; (ii) entails a direct reduction in transaction costs; and (iii) is most likely to have positive implications for transparency and accountable financial management (except in countries with extreme and systemic governance problems). Even when supporting the reinforcement of one or another specific budgetary procedure, it is essential to encourage positive interaction with other government agencies. Such encouragement must not be limited to rhetoric, but should entail incorporating in the assistance specific incentives for greater
information exchange, training and cooperation. This point leads to the second approach suggested here.

Efficient nuclei

Action to strengthen linkages and communication channels facilitates but does not in itself generate the spread of new rules and efficient organizational practices. There must also exist dynamic agents of change that can generate the positive “messages” to be transmitted throughout the system by the improved communication channels. These agents, these “efficient nuclei”, must be deliberately created to perform a few key selected public functions.

A guiding criterion for selecting these key functions (and this is where the interrelation with the previous approach emerges) is their contribution to maximizing the linkages within the public sector. By analogy with Albert Hirschman’s “unbalanced growth” approach of 30 years ago, efficient nuclei should be created largely on the basis of their potential for spreading new institutions and organizational practices throughout the public financial management system.

Beyond the general criterion of linkage maximization, an efficient nucleus should meet the following practical standards:

• Be small;
• Be fiercely meritocratic, in the initial selection and in the evaluation of staff performance;
• Have flexible and simple procedures;
• Provide adequate compensation for staff (this may require fixed-term contracts without fringe benefits, to permit adequate salaries without compromising eventual decisions on a fiscally sustainable civil service structure and compensation);

4 Furthermore, interdonor cooperation is important to prevent tunnel-vision actions by individual donors.
Reform Priorities for Public Financial Management

- Have adequate material and financial resources;
- Use local talent, with external advisers only when demonstrably necessary;
- Be a transitional arrangement, with a clear sunset clause and advance specification of the procedures for reassignment of its staff throughout the relevant government agencies;
- Operate not only to perform specific tasks but also a teaching-by-doing function, in cooperation with other agencies.

An illustration can be given in the area of public investment. Realistic and affordable public investment programming based on economic project evaluation and real-cost financing, is key to efficient and effective allocation of bid resources. However, improving “core ministry” capacity (e.g., in a Ministry of Planning, or of Finance) accomplishes little without sufficient capacity at the sector level to screen out unsound ideas and formulate good projects. It will take a long transition for the sector ministries to build up their own capacity in this respect. In the interim, a mechanism is needed to assure results and speed up the transition as well. By the efficient-nucleus approach, such a mechanism could consist of creating a “visiting team” unit in the core ministry that is charged with public investment responsibility. The unit would comprise a small number of highly qualified, newly trained local analysts and an experienced external adviser, all with excellent communication skills in addition to economic competence. The unit would provide ad hoc assistance to sector ministries, at the right points in the budget cycle, by sending a visiting team “in residence” for a brief period of time. This would combine their technical knowledge with the sectoral familiarity of the ministries’ staff. The team would visit each sector ministry in turn, and interact with its staff to produce better-quality decisions as well as some “teaching by doing”. The relationship would be one of cooperation and mutual
assistance—because decisions on actual approval of projects for funding would be entrusted to an entirely different core entity. Such a relationship would therefore encourage informal exchanges of information and advice as and when needed. When, helped by this mechanism (and, of course, their own specific training programs), sector ministries have acquired sufficient project preparation capacity, the visiting team unit would disband, and its personnel would be reassigned to take care of PIP matters within the core ministry or to lead the work in sector ministries.

Reform Priorities and Sequencing of Reforms

The convenience to the reader of having a self-contained PEM reform and sequencing agenda justifies this duplication.

The budget and its preparation

Budget coverage

Priority actions should consist of laying the foundations required for any sound budgeting and policy formulation system, which include:

- A reasonably comprehensive coverage of the budget;
- Assessment, disclosure, and review of all policy decisions that have an immediate or future fiscal impact, such as contingent liabilities, lending, tax expenditures, and quasi-fiscal expenditures;
- An expenditure classification system that fits the needs of both policy analysis and management, and covers all government expenditures.

These actions should be carried out jointly with the priority actions listed below to improve budget preparation,
execution, and accounting procedures. They are a prerequisite for further improvements in the budget system.

Among these further improvements, the following can be considered:

- Developing instruments for better assessment of liabilities, contingent liabilities, and policy commitments. These instruments can include a modified accrual accounting system or multi-year expenditure programming.
- Developing special management arrangements for some expenditure programs (e.g., user charges, service delivery agencies) that can improve their operational efficiency without reducing the comprehensiveness of the budget or weakening expenditure control and accountability to the legislature.
- Setting up a classification of expenditure by activity and program, to allow defining the right performance indicators at an appropriate level.

Budget systems and expenditure

The main considerations here relate to the absolute need to take into account the lessons of experience and the specific country circumstances. Introducing sophisticated and demanding performance budgeting systems (and particularly their culmination in detailed output budgeting) has been shown by the experience of the last 50 years to be badly counterproductive when local capacity and “ownership” are not conducive to their introduction. In developing countries, this oversight has led to wasted resources and, in some cases, loss of fiscal discipline. The reform lessons are that: (i) line-item budgeting and expenditure control must be firmly established before moving beyond; and (ii) complex reforms in a limited-capacity environment succeed only in disempowering the limited local capacity itself and reinforcing dependence on external advisory. It should be recalled, however, that there are various ways to strengthen
the performance orientation of the budget system short of introducing formal variants of performance budgeting.

Budget preparation

As noted, weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Improving budget preparation is not sufficient to address all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires (in addition to the scrutiny of all decisions with a fiscal impact) improvements in the following:

- Financial constraints must be built into the start of the budget formulation process, deriving from the preparation of a macroeconomic framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.
- Policy coordination mechanisms that fit the country context are needed, with particular attention to the policy-budget link.
- It is necessary to develop appropriate policy coordination mechanisms that fit the institutional, constitutional, and political context. Participation of civil society through consultation mechanisms should be sought.
- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority to design these
programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.

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

Moving to a multi-year perspective

Every country should prepare its budget within a medium-term macroeconomic framework, covering three to five years, to be able to assess fiscal sustainability. The degree of sophistication of projections depends on technical capacities within the country, and could be progressively improved by the development of econometric models. However, the development of these tools should not be a prerequisite for preparing a macroeconomic framework. The macroeconomic framework should be supplemented by projections of aggregate expenditures by function and broad economic category, to assess its realism and to identify policy requirements and constraints in achieving the fiscal objectives.

To improve budget preparation, the first priority is to set sectoral spending limits and announce them early in the budget preparation calendar. Also, close coordination in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from funds, etc.) is required, whatever the government organizational arrangements. In countries where responsibilities for the capital budget are separated from responsibilities for the current budget, the priority measure is to require joint reviews of the two components of the budget at each stage of budget preparation and at each administrative level.
Budget preparation should systematically adopt into a multi-year perspective. This requires:

- At least, preparing aggregate expenditures estimates by function and broad economic category, and estimating and reviewing the forward costs of programs when preparing the budget;
- At a further stage, preparing multi-year expenditure programs, within a macroeconomic framework, linked with the budget preparation, and including only programs/projects for which financing is certain (multi-year programs should focus only on ongoing policies, and new policies should be decided only during the preparation of the annual budget);
- As a final stage, preparing a formal medium-term expenditure framework with the same coverage and in the same degree of detail as the budget. To achieve this objective effectively a progressive approach can be considered. As a first step, aid-dependent countries should prepare a strong PIP and detail the forward costs of investment projects financed by external sources. Other countries could focus on the more costly items, e.g. entitlements, large investment projects/programs, or major specific sectors. It is also possible to gain experience by preparing a full sector expenditure program for one of two key sectors. These partial programs, as noted, must be supported by projections of aggregate expenditures, by function and broad economic category.

Organizational issues and the budget approval process

The legislature is the appropriate locus of overall financial accountability:

- The obvious first step is to give adequate means to the legislature to review policies and the budget;
The budget should be presented to the legislature on time, to allow its proper scrutiny and budgetary debates to be completed before the start of the fiscal year;

A ggregate revenue, expenditures, and fiscal targets should be reviewed together.

To contain pressures to increase expenditures, limits may have to be set on the powers of the legislature to amend the budget (e.g., any amendment that increases expenditures or decreases revenues should be accompanied by a counterbalancing measure to maintain the initial deficit target). The legal framework should stipulate that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or its supplementary acts.

**Budget execution**

Budget execution generally needs to be improved along two lines: enhancing expenditure control, and creating the conditions for increased efficiency in public spending. An adequate balance between these two different requirements should be found. In addition, certain priorities for improving cash management can be suggested.

**First stage: Ensuring basic expenditure control**

In a number of countries, the first stage should be both to reinforce expenditure control and to ensure better conformity in budget execution with budget policies. In this respect, special attention needs to be paid to the following:

- Timely release of funds;
- Cash planning in conformity with budget authorization and taking into account ongoing commitments (of course, a sound budget is a prerequisite to begin with).
• Effective controls at each stage of expenditure (whatever the organization of controls, internal to the spending ministry or ex ante/external);
• Adequate monitoring at each stage of the expenditure cycle (commitment, verification, and payment);
• Clearly defined procedures for registering transactions (notably for commitments);
• Adequate cash management;
• Transparent procedures for procurement.

Second stage: Improving the efficiency of the system

For more efficient public spending, the following actions are generally needed:
• Flexible rules for virement and regulated carry-over provision, especially for capital expenditure;
• Progressive decentralization of controls (in parallel with a reinforcement of procedures for auditing and reporting); and eventually;
• Development of market testing and consideration of possibilities for contracting out.

Cash management and the Treasury function

In most countries priority actions should concern the following areas:
• The centralization of cash balances should be ensured (together with a centralization of the monitoring of transactions). In countries where the payments system has broken down, this may call for implementing a centralized Treasury system from scratch. In other countries, banking arrangements and procedures for transferring funds should be reviewed to better control cash and avoid idle balances. Factors to be taken into account include: (i) constraints due to the localization of local agencies and the infrastruc-
ture of the country; and (ii) the possibilities offered by modern information technologies.

- Sound cash planning should be established, together with other measures such as improving revenue forecasts and commitment accounting.
- Debt management, especially the timely tracking of borrowings and repayments, should be strengthened.

Once the centralization of cash flows is ensured, incentives for managing and forecasting cash flows more efficiently could be considered, but in practice this concerns only a limited number of developing countries.

Management control, audit and evaluation

The several elements that can contribute to the integrity, efficiency and effectiveness of government organizations and programs, must be instituted by government. They do not come into existence because one wishes them to. Some of the key considerations involved in developing effective management controls, auditing and program evaluation are as follows.

A government that is convinced of the need to build or strengthen its control and analysis capabilities needs to define a strategy for accomplishing these goals and establish responsibility for doing so. In most countries, there are two institutions that should play critical roles in this process, the Ministry of Finance and the Supreme Audit Institution. Ideally, the strategy should be the outgrowth of consultation and cooperation between these two institutions. Implementation of the strategy, involving the actions that must be taken by the line ministries, should be the responsibility of the ministers and senior civil servants in the line ministries, under the leadership of the MOF and external oversight by the SAI.

It is not possible to develop all the needed institutions and procedures at one time. In almost all countries, and especially in developing and transition states, the highest priority
should be placed on assuring the reliability of the financial systems and the integrity and security of the controls over transactions. This translates into placing first emphasis on building reliable management control structures and effective internal audit units in the ministries and on assuring the effectiveness of the SAI as the external auditor. Only when these are in reasonably satisfactory condition is it worthwhile to focus on the efficiency and effectiveness of operations.

Countries need not depend exclusively on their own knowledge and experience in developing effective management controls, auditing and program evaluation. Technical assistance is available in all these areas from multilateral institutions, donor nations and professional organizations. SAIs and MOFs in developed countries are often willing to provide technical advice and assistance to their counterparts in developing and transition countries because of their professional commitment to sound financial management in all countries.

The technical infrastructure

Accounting and reporting

In a majority of developing countries, it is necessary first to focus on the following:

- In countries that monitor only payments, a commitment register and an ancillary book for outstanding payments should be implemented. More generally, a comprehensive budgetary accounting system and register expenditure should be implemented at each stage of the expenditure cycle. Budget execution reports must show expenditures at each stage of the expenditure cycle.
- Develop a debt accrual accounting system should be developed if none exists, and comprehensive reports on debt should be prepared.
• Operations of extrabudgetary funds (if any), should be consolidated, and all government entities should be made to follow the same classification in their reporting.
• Contingent liabilities should be recorded and statements of these liabilities must be prepared and published.
• Publication of financial statements.

Further steps should include:
• Implementing modified accrual accounting to provide a comprehensive framework for reporting on liabilities, and systematic registration of contingent liabilities;
• Implementing asset registers, at least for the categories of assets that need to be carefully monitored.

When (and only when) the previous actions have been implemented, and are on a solid basis, can a move toward full accrual accounting and the accompanying financial reporting be considered. Taking into account the heavy implementation requirements, accrual accounting could be implemented gradually, beginning with agencies with a more urgent need to assess full costs.

Public investment programming and aid management

The broad goals of public investment programming are to: (i) raise investment efficiency by improving project quality; (ii) bring investment allocation in line with country policies and priorities; (iii) assure consistency between investment

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5 Because almost all developing countries still need to complete the improvements listed above, full accrual accounting is a realistic option only for developed countries, although many of these have not even begun to introduce it.
Because aid is fungible, if the government would implement a particular project in any case, aid earmarked for it releases governmental resources to finance a "marginal" project of which the donor knows nothing. The aid in effect finances the latter project, and the earmarking is an illusion. Hence, if the quality of governance or of public management is seriously deficient, donor control over the investment program as a whole may be the only way for aid moneys to have a positive development impact. (A far stronger impact, however, would result from assistance or insistence to improve governance in the first place.) In most developing countries, instead, donor financing for a project which the government does not consider a priority can distort resource allocation and create other adverse incentive problems and moral hazards which more than offset the direct positive impact of the assistance itself. Hence, strong coordination and direction by the recipient country's government are essential to the development impact of the assistance. The implications of aid fungibility for the investment program under different assumptions have been examined long ago (see Schiavo-Campo and Singer, 1970) and have been recently rediscovered.
these procedures, involvement of high-level policy makers (and, for very large projects, the Cabinet) must be built in at a very early stage.

- Also essential is the capability for economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable, and selectivity is needed. Only projects of significant size should be analyzed in detail, with smaller projects “bundled” and the bundle evaluated only for its general correspondence with sectoral policies and common sense.

- Third, an agile procurement process that minimizes the opportunities for corruption, and effective physical monitoring of project implementation and completion are a must. Strengthening the audit function and obtaining systematic feedback from local entities can be extremely useful.

For the other three objectives of public investment programming:

- It is important to have a procedure for early decision of whether the investment allocation corresponds to aggregate and sectoral policies, and the ensuing preliminary definition of the sectoral expenditure envelopes.

- Also, through good aid management and coordination among donors, regulations are needed for assessment of the probability of financing for various projects, and strong regulation should be in place to assure that only projects with certain financing are included in the investment program.

- Finally, a realistic procedure and minimum capacity for estimating the total cost of investment projects and their recurrent costs is a must. This is always
preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process. Conversely, the experience gained through these forward estimates can be invaluable for the eventual move to a comprehensive multi-year expenditure approach.

Performance orientation and contracting out

Injecting new formal performance-related elements into the budget process requires extreme care, both because better performance orientation is critical for improving public expenditure management and because there are many wrong ways of pushing it and only a few ways of doing it right. The lessons of international experience for the reform process in this area are thus essentially the following:

- Never confuse the objective of better performance orientation with any one of the specific instruments for achieving it. There are many ways to foster performance, short of making formal changes in the budgeting system;
- If the public expenditure management system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. (Symmetrically, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.)
- Consider carefully the probable impact on individuals’ behavior, especially in multi-ethnic societies or very small economies.
- Understand clearly the different uses and limitations of input, output, outcome and process indicators, and tailor the use of each to the specific sector and issue in question. Whenever possible, avoid using any single indicator to assess performance.
• Assure robust monitoring of performance, with swift and predictable consequences.

• Build-in provisions for the systematic assessment of performance of the performance system itself. It is inherent in the logic of the system that it, too, must be subject to a reality test, and to periodic proof that its concrete benefits have outweighed the cost.

• Beyond these caveats, it is important to continuously look for any possibility to expand the "service awareness" of government administration; raise the rewards for good performance (not necessarily monetary) and the sanctions for unsatisfactory performance; and keep under constant review the possibility of introducing the various tools for measuring and monitoring performance. In all these tasks, systematic feedback from the service users and the public at large is invaluable, and so is an informed and aggressive free media.

• The process of introducing performance indicators can consist of first picking one or two government departments that provide services directly to the public; introduce simple performance measures at an acceptable cost (including transactions cost); monitor closely the functioning and impact of the measures; debug the measures and adjust as needed; gradually expand the application of performance measures to other governmental areas as and when appropriate; and stop when reaching the point of diminishing returns. The performance indicators can be used right away in the dialogue during the budget preparation, but direct and mechanical links to budgetary appropriations should be postponed to a later stage.
A Concluding Word

The approach of this book has been resolutely pragmatic, providing a menu of options rather than single “best-practice” models, and highlighting the need to consider carefully the specific country context. However, pragmatism degenerates into ad-hockery and shortsightedness if it isn’t guided by coherent and universal principles. Among these, the following are fundamental and applicable everywhere:

- Strengthening the “four pillars” of governance (accountability, transparency, predictability, and participation).
- Reinforcing their foundation in civil society, through such means as efficient and responsible fiscal decentralization, and encouragement of citizens’ “voice”.
- Using improvements in public expenditure management partly to reduce opportunities for corruption, both home-grown and imported.
- Following the beacon provided by the PEM objectives—fiscal discipline, strategic resource allocation, good operational management and due process.
- Stretching the horizon of budgeting beyond the immediate future—through a concrete multi-year approach, when feasible, but at a minimum at the level of systematic reflection and dialogue.

In addition to these universal principles, we suggest from experience four practical rules for assessing the merits of recommendations to improve expenditure management in the specific country context:

- Put first things first. “Getting the basics right” is a must for the process of spending the people’s money, especially in poor countries where the people can least afford costly experiments. Other areas of economics and technology may offer realistic opportunities for “leapfrogging” over the immediate
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problems into a more advanced state of affairs. In
public expenditure management, such opportuni-
ties are very limited, the costs of mistakes are very
high, and these are rarely borne by the advocates of
the experiment. In the words of the Press Commu-
nique of the Conference on Fiscal Policy and Reform
(February 2-4, 1999, Apia, Samoa): “…fundamental
elements of budgeting preparation; implementation;
and monitoring that permit effective control, pro-
mote transparency, foster accountability, and ensure
legitimacy need to be firmly in place before highly
sophisticated concepts of budget management…
[are] introduced.”

• Don’t make the same mistakes. Mistakes are inevitable;
but repeating the mistakes of others can be avoided,
by a realistic assessment of the concrete experience
of a variety of other countries with the same mecha-
nism or process.

• Put the right driver in the driver’s seat. Any measure
to improve public expenditure management in de-
veloping countries must raise the country’s own ca-
pacity to manage its public expenditure. An
“improvement” in public expenditure management
designed and implemented primarily by expatriate
specialists is no improvement at all, quite the con-
trary. Nor can improvements last if they are imposed
top-down by the central agency with little involve-
ment or implementation capacity of the sector
ministries.

• Finally, be open-minded but questioning. The history
of development assistance is littered with the bones
of imported institutional failures. If the recommen-
dation is sound, it will withstand critical challenges;
if it is not, only critical challenge will reveal that fact.
Introduction

Going through any public-sector reform process is difficult given the various contending forces which push and pull at the public sector. Yet, fiscal and budget reforms are essential because the quality of public financial management determines, to a large extent, the country’s macroeconomic stability and the quality of its governance. There is no question about this, especially since the quality of program delivery by government is now considered as one of the determinants of growth.

It is indeed important for countries undergoing reforms to learn from the successes and failures of others. The literature on reforms undertaken in other countries provides lessons to those who are still in the process of formulating a reform agenda. But one should always keep in mind the importance of a contextual perspective, the diversity of country problems, and the responsibility of the countries themselves, which are best placed to do so, to decide where to place their emphasis.

The manner of reform implementation and sequencing of the reforms are key issues. In the Philippines, the different oversight agencies in government are at different stages of their own reform agenda. However, these “reform silos” point to common objectives, that is, enhancing aggregate fiscal discipline, ensuring strategic allocation of resources, and encouraging better operating efficiency in agencies. There is an ongoing effort in the Philippines to coordinate these objectives for a
holistic and more strategic approach which would build on the synergies and capitalize on the reinforcing effect of the different components of public management reform. Budgeting is being linked to the development planning exercise. Budgeting, cash management, accounting and auditing functions both at the oversight and agency levels are now being integrated. We consider interdepartmental coordination very important as a way to build support, and avoid inconsistencies and bottlenecks in the implementation process.

Where Are We Going?

The Department of Budget and Management of the Philippines (DBM) has embarked on an ambitious and mutually reinforcing package of public-sector reforms that includes the strengthening of public expenditure management systems and the restructuring or reengineering of the core government.

Because of the interdependence and reinforcing effect of these two reforms and the extent of studied dysfunctions in the structure of government and weaknesses in the budgeting system, the government decided to integrate the implementation processes of these two reforms so as to facilitate their implementation. But more importantly, the Asian financial crisis and the election into power of a new administration offer the window of opportunity for the implementation of these politically sensitive reforms.

For the medium term, the DBM is changing the way it formulates and allocates the budget through the installation of a Medium-Term Expenditure Framework (MTEF), the strengthening of performance monitoring, and the gradual simplification of budgeting rules to enable government managers to manage their resources to attain better performance. This effort is being supported by an institutional development grant from the World Bank. The components of this project include the installation of an MTEF, which is a three-year rolling ex-
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A expenditure framework that will allow the tracking of funding requirements of ongoing agency programs and projects for the next three years. This framework will link annual budgeting decisions to medium-term spending constraints indicated by the macroeconomic framework and the resulting fiscal plan. Thus, it will ensure that future financial implications of new spending and savings decisions in any given year’s budget are consistent with medium-term fiscal policy targets. Moreover, with the specification of multi-year sectoral ceilings which will be approved by multi-sectoral Planning Committees and serve as the basis for the annual budget ceilings of agencies, the framework will pave the way for the restructuring of the budget toward the priority programs of the administration and introduce greater transparency in budget formulation. Unlike in past years, resources under this framework will be projected conservatively.

Another component of the expenditure management improvement project is increasing accountability for performance. This involves the development of effective and acceptable indicators of performance for line agencies. Performance measurement will improve public-sector performance through better accountability mechanisms and systems that give feedback to the budget process. Specifically, we hope that performance measurement will rationalize the accountability of public officers and employees; promote allocative and operating efficiency; and promote client orientation, as the performance culture becomes pervasive.

Together with this last component is the gradual delegation to agencies of some of the present high-level controls over agency spending, in return for increased control over the medium-term profile of total budget spending and increased information on the magnitude and quality of agency expenditures. Here, we take special notice of the sequencing issue. Sequencing for each of the components of the improvement program is being given utmost consideration.

Started in October 1997, this expenditure management improvement effort counts as part of its accomplishments the
initial integration of the planning and budgeting exercises for the year 2000 budget, and the conceptualization of a performance management system for the national government.

Central to the public-sector reform of the Philippine government is the Reengineering of the Bureaucracy for Better Governance Program. This program offers a new paradigm of governance that will determine the scope, level, quality, and focus of government intervention in society. It will rationalize the distribution of functions between the government and the private sector, between the national and local governments and among government agencies in the context of the government’s thrusts toward globalization, liberalization, and decentralization. This reform effort was triggered by the existing observed dysfunctions in the bureaucracy and the seeming lack of philosophical foundation of governance.

At the request of President Estrada, a bill has been filed in Congress that will grant to the President full authority to reorganize the executive branch. Pending the enactment of the bill, the DBM has been encouraging agencies to review their programs and projects to be able to refocus them toward new priorities of government. A few departments and agencies such as the Bureau of the Treasury, Department of Health, and Department of Social Welfare and Development have initiated department reorganization processes.

How Do We Get There?

Public-sector management reform is in the Ten-Point Agenda of the Estrada presidency. Hence, from day one of the administration, we have been setting in place the proper environment for the reform. First, the DBM has been working toward getting the support from the important stakeholders: Congress, the private sector, and the national agencies. We have drafted a Budget Accord in recognition of the important role of the Congress in supporting budgeting and expenditure manage-
ment innovations. Intended to be passed as a joint resolution by both houses of Congress, the Accord aims to promote better coordination with Congress in the different phases of budget implementation. The Accord will set in place the fiscal targets of the MTEF including the policies and parameters for program implementation and reporting mechanisms that will be adhered to by both the Executive and Congress for the medium term.

A Budget Dialogue Group was also formed consisting of the private-sector business, basic and NGO, secretaries of key departments, and heads of leagues of provinces, cities, and municipalities. The creation of this group is envisaged to generate support for the medium-term reforms and the identification of needed budget systems reforms. Support for the reforms from the oversight and implementing agencies is also being solicited through various budget dialogue forums, and interagency and committee arrangements. This effort will be strengthened as the capacity building and change-management component of the expenditure management improvement project takes off. We believe that strengthening financial management capacities in the implementing agencies and not only at the oversight level will be the key toward the internalization of fiscal discipline, technical efficiency, and performance focus in government.

Second, because providing resource predictability is needed to reap the benefits of an MTEF, starting this year release procedures are being streamlined. We have instituted the “what-you-see-is-what-you-get” (WYSIWYG) policy. Under this policy all appropriations for ongoing and specific agency programs for which funds were appropriated by Congress are deemed released at the beginning of the year with the General Appropriations Act (GAA) serving as the spending authority. Thus for 1999, the first year of this new arrangement’s implementation, some 80 percent of the budget was deemed released at the start of the year and agencies were able to obligate for the implementation of agency programs and projects. This was made possible with the abolition of Congressional “pork barrel” funds in the agency budgets.
We are moving away from the highly disruptive imposition of across-the-board expenditure cuts and reserve impositions. We intend to deal with changes in the fiscal scenario through the well-measured release of lump-sum budgetary funds and the undertaking of a mid-year assessment of financial and physical accomplishments of agencies.

Third, settling expenditure arrears, which resulted from the squeezing of expenditures as a result of the Asian economic crisis, is also one of the immediate priorities of the government for this year. Some P60 billion or 40 percent more than in the previous year, was set aside from the 1999 disbursement program to enable the early settlement of arrears. A direct payment system to external creditors has been installed through the government banks, and the list of creditors paid is posted on the DBM Web site for increased transparency and streamlining of release procedures.

The Philippine government is committed to maintaining macroeconomic stability and fiscal consolidation as a fundamental component of sustained growth. However, to nurture early economic recovery, it is disposed to incur a higher fiscal deficit from the original target of P17.9 billion to P68.4 billion in 1999, compared with the 1998 deficit of P50 billion. It is our intention to progressively reduce the budget deficit and attain a balanced budget by the year 2002.

The DBM, together with the Department of Finance and the Commission on Audit, is also strengthening the financial management systems in government both at the oversight and agency levels. The effort involves several components:

- simplification and refinement of accounting systems to yield additional information useful for budget management;
- review of financial management capacities at the agency level to address weaknesses which may have resulted from decentralization and the retention of manual systems;
• development of an integrated financial management information system (IFMIS) to promote data sharing and streamline the external reporting system in government; and finally
• strengthening of the procurement and bidding procedures in government.

At the DBM, the initial phase of the development of an IFMIS has begun with the development of a Budget Execution and Tracking (BEAT) system. Initially, the system will allow the tracking of releases to agencies and the monitoring of actual expenditures from agencies. DBM will be working to improve agency financial management systems by enhancing the agency module of the BEAT system. This will set the platform for the devolution of financial management to the agencies. A strong interagency effort should therefore be emphasized for the success of reform in this area. There is an ongoing effort with the World Bank to assess and strengthen the financial management systems of agencies through systems reengineering and capacity building.

With regards to procurement reform, we are closely coordinating with the Commission on Audit toward the installation of an electronic bid board which will greatly enhance the transparency and reduce the cost of bidding processes for supplies and equipment. The government now spends some P16 billion yearly for the purchase of supplies and materials, including medicines and textbooks, and another P7–P10 billion for furniture and equipment including IT equipment.

To enable the DBM to better serve its client-agencies, the public, and the donor community, we have sought authority from the President to reorganize the Department. We propose to set up one-stop shops in our operating bureaus which will allow the integration of the results of performance monitoring, financial analysis, and organizational review to provide feedback for decisions concerning the approval and release of funds. We are also setting up a bureau specifically to handle
all matters related to foreign-assisted projects (FAPs) in order to strengthen the DBM’s interface in the review and approval of projects in the Investment Coordinating Committee and to facilitate budgetary actions related to FAPs. We are streamlining our release procedures to lessen the number of documents and signatures required for the release of funds.

Conclusion

In conclusion, the four-pillar approach suggested by A. Premchand in chapter 3 is a matter of particular relevance to our country. In fact, most of the components of this approach are being addressed in the reforms being instituted in the Philippines. The Philippines has still a long way to go to improve public-sector management. The task ahead of us is formidable. We have no illusion that problems will not be encountered along the way. But with the assistance of the private sector and the agency stakeholders, as well as the donor countries and institutions like the ADB, the World Bank, IMF, AusAID, and CIDA, we are confident that we can carry out the reforms necessary to meet the challenges of the new millennium.
Introduction

What is accountability? What is it that the community is interested in? Answers to these questions have never been easy. Not a great deal has been said about the components of accountability or the means through which it may be achieved, although routine incantation of the need for accountability has become a notable feature of national and international debate. In some quarters, it is being offered as an instant aspirin that help minimize fiscal problems. There is, however, a need to go beyond slogans and discussion of general propositions, into the details, and to delineate the contours, contents, and potential fault lines of accountability in general and, more particularly, financial accountability. In addition to the two important issues raised above, it is imperative that answers be provided to a variety of questions that arise in this context. How did accountability evolve? Why the current emphasis on financial accountability? What are the features and instruments of financial accountability? Are the instruments adequate for the purpose? If they are underachieving, what are the contributory factors? What constructive agenda may be followed hereafter?

The need to provide answers to the above and a multitude of related questions has assumed greater importance in the context of the impact of four factors. First, two decades of fiscal turbulence have contributed to a substantial erosion of the credibility of governmental fiscal machinery, and to a
growing distrust of governments. Second, the gradual spread of globalism has put policymakers in many countries in a reactive, rather than a proactive, mold; external developments that do not always lend themselves to precise identification would appear to have a greater role, indeed a dominating one, on fiscal policies. Information asymmetries have made the already formidable tasks of policymakers even more complex and intractable. In the absence of crucial information, the risks faced by the policymakers have increased significantly. Third, the change in the nature of government and its gradual withdrawal from production activities has made it take an active role in regulation, which adds to the complexity of financial accountability. Fourth, there has been a major change in the composition of expenditures of central and federal governments. Apart from the sizeable outlays on the servicing of public debt, expenditures at the central-government level are increasingly devoted to transfers to the private sector, entitlement payments, and transfers to regional and local governments. This has contributed to a separation of funding from the actual provision of services and has affected the pattern of financial accountability.

This paper is devoted to a consideration of the above issues. Such a consideration requires a comprehensive perspective on the evolution of accountability. Only in the light of that perspective can financial accountability be distinguished from general accountability.

In order to provide a comprehensive background that would facilitate an appraisal of the current issues, the evolution and practice of the idea of accountability is discussed first. This is followed by a discussion of the anatomy of financial accountability and its inherent aspect of underachievement of goals. The paper concludes with a constructive agenda for the future.

It will be argued in this paper that, notwithstanding the fact that the idea of accountability is inherent in the actions of an institution and its employees, the means of achieving it have varied over the years and have moved from a simple to complex, if frequently expensive, machinery. Despite the com-
plexity, however, the capacity to achieve full accountability has been and continues to be inadequate, partly because of the design of accountability itself and partly because of the widening range of objectives and associated expectations attached to accountability. It is further argued that if accountability is to be achieved in full, including its constructive aspects, then it must be designed with care. The objectives of accountability, it is argued here, should go beyond the naming and shaming of officials, or the pursuit of sleaze, to a search for durable improvements in economic management to reduce the incidence of institutional recidivism. The future of accountability consists in covering the macro aspects of economic and financial sustainability, as well as the micro aspects of service delivery, including specific attention to public/private partnerships. It should envisage a three-tier structure of accountability: that of officials (both political and regular civil employees), that of intragovernmental relationships, and that between governments and their respective legislatures. Further, it is argued that the existence of numerous institutions and established procedures for financial accountability does not necessarily contribute to the realization of the goal of full accountability, and that the fulfillment of financial accountability does not necessarily mean improved fiscal status for a country. Improvements in the existing systems, which are undoubtedly needed, should be envisaged with due regard to cost-effectiveness and possible paradoxical results.

**Evolution and Practice of the Idea of Accountability**

Accountability has been viewed since time immemorial as a channel for ascertaining the use of power by an individual or an organization that has been entrusted with the task of performing prescribed tasks. The means through which accountability has been achieved, however, has varied over the years.
The concerns of financial accountability, whether in a kingdom, which was the more common form of government, or that of a democracy in the pre-Christian era, was the same, viz., the preservation of the wealth of the king or the society. Writing nearly three hundred years before the beginning of the Christian era, Kautilya, in what is easily recognized as the first manual on bureaucracy, observed that human nature was disposed to acquire public money for private gain. He wrote: “Just as it is impossible not to taste honey or poison that one may find at the tip of one’s tongue, so it is impossible for one dealing with government funds not to taste, at least a little bit, of the king’s wealth.” He added: “Just as it is impossible to know when a fish moving in water is drinking it, so it is impossible to find out when government servants in charge of undertakings misappropriate money.” 1 In recognition of this human proclivity, Kautilya went on to formulate a series of checks and balances in the administrative system. He wrote that “in all cases (where) an official has caused loss of revenue to the state...his property shall be confiscated.” 2 A similar set of practices was observed in contemporary China. 3

In the Athenian state, the hallmark was “its concern for the accountability of its officials.” For them, “to have officials accountable was the key to responsible government, unaccountability meant lawlessness.” 4 To this end, officials were required to report on their conduct ten times a year to the Assembly of the Citizens. If the explanations did not meet with the Assembly’s approval, officials were subjected to a trial, and indeed, where necessary, to impeachment. It was noted by historians that the prospect of being sentenced to death by the judicial system was often greater than the risk of dying in battle.

1 Kautilya, p 281.
2 Ibid, p 294. This principle is now included in the financial rules and regulations of many countries. In practice, however, the application of this principle has been relatively rare.
3 For an illustration of the experience of China, see Premchand (1995a).
Aristotle wrote: “Some officials handle large sums of money: it is therefore necessary to have other officials to receive and examine the accounts. These inspectors must administer no funds themselves. Different cities call them examiners, auditors, scrutinees and public advocates.” From that time, accountability went through six stylized stages described in box 7.1. More important is the fact that during this period of evolution, attention turned from estate preservation and management to accountability for actions and results. Estate preservation, however, has not been neglected. In fact, the idea behind the introduction of accrual accounting in recent years is to ascertain the trends in the net worth of a country, a concept similar to that of estate management.

Meanwhile, however, the growing public administration and management sciences have explored in some detail the functions of a modern executive. Barnard has devoted a considerable part of his attention to these aspects. In Barnard’s view, an individual’s actions are guided by an informal code of ethics (drawn from his moral environment), and more explicit and formal codes of organizations. He noted that “morals are personal forces or propensities of a general and stable character in individuals which tend to inhibit, control or modify inconsistent immediate specific decisions, impulses or interests and to intensify those which are consistent with such propensities.” He added that the responsibility was that of the individual: “The point is that responsibility is the property of an individual by which whatever morality exists in him becomes effective in conduct.” This concept of individual responsibility is partly included in Simon’s system of values that have a prominent part in decision making. These points of view indicate the distinctive beginning of managerialism as a school of thought, with its own impact on the concept of accountability.

6 Barnard (1968), p 261.
7 Ibid., p 267.
8 See Simon (1997).
Box 7.1
Conventional and Enhanced Financial Accountability

Over the years, events and ideas have forged some conventions of financial accountability. While it is difficult to be precise in enumerating the historical phases of financial accountability, some stylized stages can be construed from the pages of world history. Broadly, six stages have contributed to the expansion of the scope of financial accountability and thus to changing conventions. First, there were the practices of treasury management associated with kings and royal rule. As Kautilya wrote more than two millennia ago, “all state activities depend first on the treasury. Therefore a king shall devote best attention to it” (p 253). All revenues and expenditures were to be recorded in prescribed forms; these were then subjected to audit (inspection). Kautilya added: “Accounts officers shall present themselves for audit at the appointed time” (p 275). The king, advised Kautilya, should devote the “first 1½ hours after sunrise—to reports on defense, revenue and expenditure.” Similar practices later were found in contemporary China and Greece (the latter was not a monarchy). The endeavor in this phase was to devise machinery for the preservation and enhancement of royal wealth, or estate management. The above practices continued for more than a millennium and were enshrined in the principles of accounting devised by the royalty in England, and later in the approaches of cameralists in Europe. The second stage refers to the developments in England during the seventeenth century when, in response to the steady and growing demands of members of parliament, committees were appointed to review the “wisdom, faithfulness and economy” with which parliamentary grants were spent. This stage represented the assertion of the rights of legislators and endeavors, as a part of the procedures of the control of purse, to ensure financial accountability. The continuation of these endeavors contributed to the appointment of a commission on accounts (a predecessor of audit as practiced now) as well as a Commissioner of Accounts. During the third stage (nineteenth century), as a part of the Gladstonian reform of exchequer
management and its oversight by legislative committees, an independent audit agency was set up to review the regularity and economy of expenditures. The annual audit report was to be reviewed by a committee of the legislature representing the final stamp of approval or qualified approval of the financial transactions of government. The fourth stage refers to the developments during the twentieth century, in particular, after the second world war. The emergence and the gradual consolidation of the welfare state enabled the diversion of both governments and people from economy in expenditure (although it continues to be an important principle) to greater participation by the people and to greater public scrutiny of public transactions, as well as to delivery of services. The latter, in turn, contributed to more emphasis on performance or outputs. The response to these developments was in the form of economic development plans that reflected the people’s needs, and to performance budgeting in government, as well as performance contracts. Later developments contributed to refined systems of budgeting that emphasized economy (in the use of resources), efficiency (in achieving greater results within allotted resources) and effectiveness (in achieving program objectives). In the process, the scope of financial accountability came to be expanded rapidly and significantly. During the fifth stage, in addition to the above dimensions, emphasis was laid on prudent macroeconomic management. Governments were expected to be prudent (in using resources and in considering what could be achieved at what cost) and to take explicitly into account the assessment of the linkages between the budget and the economy. As a result, a kind of three-dimensional financial accountability emerged. The three dimensions are: (I) expenditure choices (to ascertain the degree of prudence); (ii) program management (propriety, economic management, adequate delivery systems); and (iii) regular dissemination of information (showing material matching, i.e., a process by which outputs and income are related in a timeframe to cost of services). The sixth stage, which is yet to emerge in final form and is meanwhile groping for clarity and acceptance, envisages enhanced financial accountability. In addition to conventional financial accountability, now governments may be accountable for ensuring that there are
Box 7.1 (cont’d.)

adequate systems to secure and improve results and to maintain the financial condition of the state (economic sustainability, flexibility in the use of resources, and reduced financial vulnerability). Furthermore, governments are expected to demonstrate that the selected programs are a part of the legitimate functions of a government and that the community can afford them. Financial accountability has thus expanded, reflecting changing tasks and expectations, and now people expect enhanced financial accountability to be fulfilled while complying with the requirements that constituted accountability in the preceding stages.

Avaliable history shows that the concept of accountability which was always inherent in the tasks, responsibilities, and broad administrative behavior of governments, has changed in terms of the clientele group to which it was addressed. From personal accountability to the king (for king and country a civil servant was expected to give his life when necessary) there was a shift to a responsibility to the elected representatives of the people and now, in addition, to the people themselves. (The various stages in the evolution of the concept of accountability are shown in the figure below). Accountability, now a multifaceted phenomenon, involves, three distinct segments relating to general accountability, fiscal accountability and to managerial accountability (as shown in the next figure). Financial management systems in most of these development stages remained rooted in the principle that no individual official was to be trusted. For this reason, in a greater part of financial management, time and process was devoted to the verification of payment claims and arrangements for the custody of money. The managerial approach, in contrast to the traditional belief, is based on the idea that an individual official, in order to be a creative and innovative manager, should be trusted and endowed
with commensurate autonomy. But autonomy is not equivalent to independence. Rather, the official should be subjected to accountability for results. The orientation to results is a significant departure from the previous practice and is intended to be a vast improvement over process-oriented behavior, and

From Conventional to Enhanced Accountability

1. Estate Management.

2. Observance of economy in expenditure.

3. Observance of economy and regularity in expenditures and institutionalized forms of oversight.

4. Delivery of services and emphasis on performance, observance of economy, efficiency and effectiveness of expenditures.

5. Prudence in economic management.

6. Emphasis on ensuring financial condition that promotes economic sustainability, expanded forms of oversight and program tests to ascertain whether they should continue to be a part of government operations.
Contents of Accountability

**General Accountability**
- Answerability for action.
- Sanctions where justification is not adequate.
- Ability to revoke a mandate.
- Public scrutiny of governmental actions.
- Citizen participation in the design of programs.

**Fiscal Accountability**
- Approval of policies and actions having financial implications by a representative body.
- Approval of an annual or a medium-term budget.
- Framework to ensure that in the process of economic management no actions are taken to impair the fiscal capacity of the community.

**Managerial Accountability**
- Appropriate rules are observed and that the authority is not abused.
- Risks are taken within delegated powers to achieve objectives.
- Responsibility for service delivery within specified cost, quality and time schedules.
- Observance of economy and efficiency.
subject to continuous second-guessing at various levels in the hierarchy. It is in this context that the specific aspects of financial accountability need to be considered.

Financial Accountability

Financial accountability, too, has grown within the range of parameters described above. In the process, it has developed its own chain of operations and institutions. The broad financial accountability chain, common to many governments is shown in box 7.3. In considering the relative roles of the institutions indicated in the chart, it has to be recognized that the role of donors and international financial institutions may be different from one country to another, as is the role of nongovernmental organizations and others (the latter category includes a wide range of contractors and other providers of services funded by different levels of governments), and of legislatures and clientele groups. In former centrally planned economies, client groups are represented, in principle, by the party representatives. In other countries, clients may form significant pressure groups having pervasive, if frequently subtle, influences on policymaking and the allocation of resources.

The main instruments of financial accountability are government budgets, periodically published data on public

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9 A civil society needs freedom to think and act and to function effectively. Such freedom implies a substantial degree of trust on the part of each individual regarding the actions of his fellow members of society. The question arises as to how one can get on with his life in the absence of that basic trust. Financial management systems were designed without taking this factor into account. Management philosophy, however, embodies this principle in its operational approaches; indeed, it has made it a cornerstone. Breach of the implicit trust is to be addressed as a part of the accountability framework. Government operations have grown so enormously that it is difficult to live without endowing every administrator with that degree of trust that every citizen shows to his fellow citizens. Continued dependence on misanthropy is likely to be counterproductive.
finances, annual accounts, and the investigative and other
general reports prepared by independent agencies. The main
components of these groups of instruments, their features

**Instruments of Financial Accountability:**
Features and Limitations

<table>
<thead>
<tr>
<th>Functional Area</th>
<th>Instruments</th>
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</thead>
<tbody>
<tr>
<td>General Fiscal Status</td>
<td>• Medium term fiscal strategy.</td>
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<td></td>
<td>• Development plan</td>
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<tr>
<td></td>
<td>• Medium term budgets</td>
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<td></td>
<td>• Annual balancesheets</td>
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<td></td>
<td>• Intergenerational accounts</td>
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<tr>
<td>Annual Fiscal Management</td>
<td>• Annual budget</td>
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</tbody>
</table>
and limitations, and the way in which they contribute to the fulfillment of financial accountability are illustrated in the table below.

<table>
<thead>
<tr>
<th>Features</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shows the current status of the economy and the future directions.</td>
<td>Often too broad to constitute a strategy.</td>
</tr>
<tr>
<td>Lays out the plans for future investments, maintenance outlays and financing patterns.</td>
<td>These plans concentrate on investments and new programs; quantitative aspects are specified.</td>
</tr>
<tr>
<td>Show the future financial implications of current and future policies.</td>
<td>This is mostly intended for purposes of information of the legislature and are not generally binding on governments.</td>
</tr>
<tr>
<td>Show the changing picture of assets and liabilities as a result of government fiscal operations.</td>
<td>These have yet to gain currency in many countries. Also, the preparation of balance sheets involves several technical issues that remain to be resolved.</td>
</tr>
<tr>
<td>Show the burdens on future generations arising from current operations and their patterns of financing.</td>
<td>The methodology of these accounts, as well as their usefulness are subjects of intense debate. Developing countries have not, as yet, shown any appetite for this.</td>
</tr>
<tr>
<td>Contains revenues, expenditures and debt estimates.</td>
<td>Many countries have yet to have legislatures endowed with powers to approve or reject proposals. In some countries, these are viewed more as debating forums rather than legislative bodies. Some countries have well established legislatures patterned on the U.K. or U.S. model.</td>
</tr>
</tbody>
</table>
### Functional Area | Instruments
---|---
- Approval of policies underlying annual budgets.
- Estimates of revenue and new tax proposals.
- Estimates of expenditure.
• In some countries, medium-term strategies and policies are sought to be discussed with the legislature prior to submission of annual budgets.

• Show the expected revenues from current policies and new policy initiatives.

• In some countries, multi-year appropriations are in vogue for developmental projects. In a few countries, extra budgetary accounts are substantial and may not require legislative approval.

• In some countries, legislatures have established consultative committees to channel constructive and crucial policy inputs before final decisions are made. The contribution of these committees remains to be assessed.

• These estimates, often considered to be needlessly optimistic, are now being reviewed in some countries by the Audit agency (eg. Britain). The added value of this review remains to be proven. Legislatures have their own means, where they are empowered, to assess the reasonability of estimates and to alter them. In British type systems, legislatures can reject government proposals only at the risk of resignation by the party in power.

• Show the outlays on programs and projects and serve as the basis for legislative appropriations.

• Legislatures, where empowered, authorize outlays on programs and projects. These appropriations, which provide the legal authority for spending, may not always assure full funding. Funding may be subject to the discretion of the Executive. In practice, there may be extensive underfunding impairing the implementation of projects and programs. In some cases, there may be legal earmarking and as such programs may not require annual legislation and may not suffer underfunding.

• Benefits from expenditure programs may not be fully shown and in any event may not reflect binding contracts except in the context of performance contracts.

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<td>Functional Area</td>
<td>Instruments</td>
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<tr>
<td>-----------------------------------------</td>
<td>--------------------------------------</td>
</tr>
<tr>
<td>Overall objectives and policies</td>
<td>• Described above.</td>
</tr>
<tr>
<td>• Public debt estimates.</td>
<td></td>
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<tr>
<td>• Donors and foreign aid.</td>
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</tbody>
</table>
Some segments of expenditures, e.g., public debt, may not require, in most cases, annual legislative approval.

In most cases, these estimates do not require legislative approval. New loans to be raised, including those raised externally, may not need legislative approval.

Fiscal deficit targets do not lend themselves to legislation in several countries. As such, they may not be enforceable. Failure to fulfill target may entail legislative criticism but not sanctions or penalties.

In most countries, foreign aid budgeting and accounting continues to be weak.

Project loans and externally raised loans do not, in most countries, require legislative approval.

Agreements with international financial institutions may not be submitted in most cases to the legislature, as no legislative approval is required.

International financial institutions have many means to ensure full compliance and accountability through extensive ringfencing, regular monitoring, and imposition of sanctions in the event of non-compliance.

The nonachievement of objectives such as macroeconomic stability, income distribution, service provision, patterns of financing, may receive general attention in the legislatures and other bodies but entail no sanctions or penalties except through the ballot box. The leeway available to the executive is considerable, while accountability is limited. Furthermore, the above instruments except for entitlements, are not justiciable in any court of law.

<table>
<thead>
<tr>
<th>Features</th>
<th>Limitations</th>
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<tbody>
<tr>
<td>Show the servicing costs and the amounts of debt to be raised.</td>
<td>In most cases, these estimates do not require legislative approval. New loans to be raised, including those raised externally, may not need legislative approval.</td>
</tr>
<tr>
<td>Estimates where provided, show the likely amounts to be received from donors and international financial institutions.</td>
<td>Fiscal deficit targets do not lend themselves to legislation in several countries. As such, they may not be enforceable. Failure to fulfill target may entail legislative criticism but not sanctions or penalties.</td>
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<td>Functional Area</td>
<td>Instruments</td>
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<tr>
<td>Budget implementation.</td>
<td>• Release of funds spending agencies.</td>
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<td></td>
<td>• Cash management.</td>
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<td></td>
<td>• Award of contracts.</td>
</tr>
<tr>
<td></td>
<td>• Carryover of funds.</td>
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<td></td>
<td>• Outlays on transfers to other levels of government and on entitlements.</td>
</tr>
<tr>
<td></td>
<td>• Personnel limits, reappropriations.</td>
</tr>
<tr>
<td>Features</td>
<td>Limitations</td>
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<tr>
<td>-------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>• Plans for time-sliced releases of funds.</td>
<td>• In some countries that have a system of exchequer control, release of funds may require approval of the Controller or Auditor General, on behalf of the legislature. In a few others, legislation may specify the periodicity of releases from approved appropriations.</td>
</tr>
<tr>
<td>• Intended to facilitate the mobilization of domestic debt and ensure a smooth inflow and outflow of resources.</td>
<td>• This is a function of the executive. Experience shows that this could lead to patronage and to a form of crony capitalism.</td>
</tr>
<tr>
<td>• Specification of work to be done.</td>
<td>• Contracts are not required to receive legislative approval. Details of contracts are not required to be reported to the legislature.</td>
</tr>
<tr>
<td>• Funds may be allowed to be carried forward into the next fiscal year.</td>
<td>• With a view to avoiding year-end rush of expenditure, some governments are now allowing select carryovers of funds.</td>
</tr>
<tr>
<td>• Reveal the portfolio of government expenditures.</td>
<td>• This procedure constitutes a violation of the contract between the legislature and the government. Despite this, these transactions are not reported to the legislature.</td>
</tr>
<tr>
<td>• These are areas on which limits may be imposed by the legislature.</td>
<td>• Most transfers are determined, as are entitlements, by previous legislation and as such, do not require specific approval by the legislature.</td>
</tr>
<tr>
<td>• Governments have considerable leeway to work within limits. Frequently, limits may be circumvented, for example, temporary employees, leases rather than purchases, unbundling to escape limits, through legal means.</td>
<td>• Reappropriation may be selectively undertaken by the Executive within the framework of delegated powers.</td>
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</table>
### Functional Area

<table>
<thead>
<tr>
<th>Functional Area</th>
<th>Instruments</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>- Performance contracts and measures.</td>
</tr>
<tr>
<td></td>
<td>- Supplementary budgets: Recessions.</td>
</tr>
<tr>
<td></td>
<td>- Excess expenditures.</td>
</tr>
<tr>
<td>Accounts</td>
<td>- Appropriation accounts.</td>
</tr>
</tbody>
</table>
These contracts are relatively of recent origin and provide a legal basis for services. Measures reflect quantitative aspects aimed to enhance the quality of accountability.

- Addictions and restrictions on allotted funds.
- Expenditures over specified limits.
- Show the disposition of the funds approved by the legislature and the extent to which the budgetary intent has been fulfilled.

Many governments rely on regular civil service and performance contracts have yet to gain extensive acceptance. These contracts do not require approval by the legislature, although they may be submitted for the information of the legislature.

- Performance measures are mostly given for projects and selected programs. These measures are devised by the executive and are neither binding nor are required by the legislature. As such failure to achieve may entail, at best, a justification.

Supplementary budgets require legislative approval. Although there is a prescribed timetable, legislation may be enacted when needed. Selectively, expenditures may be undertaken in anticipation of legislative approval.

- Rescissions or reductions in allotted funds may be undertaken by the executive and may not even be reported to the legislature.

In British type systems, excess expenditures are required to be approved on an ex-post basis. In the U.S. type systems, excess may be collected from the official responsible for that act.

- Limits are often circumvented through hidden debt including arrears in payment which need not be reported to the legislature.

Audited accounts are required to be submitted to the legislature for its review and approval.

- The structure of accounts varies among countries, but are mostly too aggregative in nature. The accessibility to the public is limited.
<table>
<thead>
<tr>
<th>Functional Area</th>
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<tbody>
<tr>
<td></td>
<td>• Periodic reports.</td>
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<tr>
<td>Evaluation</td>
<td>• Periodic reports.</td>
</tr>
<tr>
<td>Audit</td>
<td>• An annual audit report.</td>
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<tr>
<td></td>
<td>• Periodic investigative reports.</td>
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<td></td>
<td>• Efficiency audit.</td>
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</tbody>
</table>
Public Financial Accountability

- Show the intra-year status of government finances.
- Show the results of programs and the cost-effectiveness with which they have been carried out.
- Evaluation is primarily a technique used by the executive. The application of this approach is still limited. The reports, when published, may be made available to the public and the legislature.
- In some countries legislative committees may undertake evaluation with the assistance of the audit, or on its own.
- In either case, there may be no sanctions for failure. Justification may be provided.
- This shows the failures of the executive in the financial area.
- Audit reports are frequently delayed. Most of them concentrate on financial and regularity audit.
- The purview of audit, does not include policy aspects. It is dependent for its success, on the legislative support it receives.
- Shows the misuse or fraud in selected areas.
- The application of this technique is still limited; when applied, however, it has the potential of resulting in sanctions.
- Shows the efficiency in the process of resource utilization.
- As with investigative audit, the applicability of this technique has been limited largely for the reason that government budgets have not yet adopted, in several cases, performance approaches in operationally binding terms.

### Features vs. Limitations

<table>
<thead>
<tr>
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<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Show the intra-year status of government finances.</td>
<td>- Until recently, these were not either submitted to legislatures or published in the media. Now, however, in response to the demands of financial markets, governments are slowly engaged in the periodic publication of fiscal data. - In countries where the fiscal performance is subject to credit rating, financial data are now regularly published.</td>
</tr>
<tr>
<td>- Show the results of programs and the cost-effectiveness with which they have been carried out.</td>
<td>- Evaluation is primarily a technique used by the executive. The application of this approach is still limited. The reports, when published, may be made available to the public and the legislature. - In some countries legislative committees may undertake evaluation with the assistance of the audit, or on its own. - In either case, there may be no sanctions for failure. Justification may be provided.</td>
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Some specific features that have a significant impact on the financial accountability debate may be noted here. First, although the instrumentation may be wide-ranging, it needs to be recognized that not all of them are to be found in all countries. Some countries have minimal instruments such as an annual budget and a set of annual accounts. The other instruments have yet to find acceptance and practice in many countries. Second, it appears that in most countries where the instruments may be basic and not too sophisticated there may still be an effective machinery in regard to the financial relationships with donors and international financial institutions. This is largely due to the extensive range of techniques used by the donors and others. Aid provided by donors also comes with stiff and far-reaching conditionalities. Donors and international financial institutions have regular and systematic approaches to monitoring actual progress in the field. In some cases, they may also supervise the projects and programs they finance. Moreover, fear of losing financial support makes the recipient countries pay particular attention to foreign-aided projects and agreements with international financial institutions. Furthermore, the violation of agreements could have a significant and quick adverse impact on the credit ratings of a country. These aspects also suggest that where oversight bodies are keen to be effective, there are improved chances for the fulfillment of financial accountability. The regrettable aspect of the financial transactions with donors and international financial institutions is that most of these may not require explicit approval by the legislature and information on them may not be available to the public, although this weakness is being addressed through the opening of Web sites by international financial institutions. But in countries where access to cybertechnology is limited, information about this important area may not be available to the public. The dissemination of information in this regard depends, to a very large extent, on the approaches of recipient governments. They may be less inclined to share information with the public if that informa-
tion shows that government has pursued policies that have not been conducive to improved economic welfare and, on the other hand, have increased the burdens and further diminished the benefits to the community. This also illustrates how public scrutiny, an important component of accountability, is adversely affected.

Third, many of the dimensions of accountability still have to be fulfilled. In many countries, performance aspects of programs and projects, and their linkages to the financial resources, are not specified. A consequence is that while governments are generally responsible for providing a service, the community has very scant information for assessing the efficiency with which the service has been provided. In most cases, cost information is not available even to governmental agencies. Thus, where no quantitative targets are available, there can be little accountability. Moreover, the services may be provided by nongovernmental organizations with funding from governments; the accountability of such providers to the legislatures is somewhat distant and often weak. To that extent, it may not be easy to locate responsibility for failures in the provision of services, and even if it is located, sanctions may not be feasible. These aspects illustrate that the machinery for providing fiscal accountability has over the years lagged behind the pace of growing demands on accountability as shown in the figure below. Many financial management systems have yet to achieve the capability to secure economies in expenditure and efficiency in operations. The preponderance of soft constraints and perverse incentives (such as the rush to spend as a fiscal year draws to a close) effectively preclude economies. The same may be said about prudence in economic management and achievement of improved performance. Where quantitative targets are not available, the effective exercise of oversight becomes difficult.
Financial Accountability Chain

Donors and IFI's

Central and Federal Governments

Agencies

Clients

Donors and IFI's

Regional, State and Provincial Governments

Agencies

NGO's and Others

Legislature

Clients

Donors and IFI's

Local Governments

Agencies

NGO's and Others

Councils

Clients

NGO's and Others
Factors Hindering Financial Accountability

Experience shows that several factors have hindered the effectiveness of institutions that are responsible for ensuring financial accountability. These include the following:

- Certain expenditures are excluded from the purview of oversight bodies. Some expenditures are incurred outside the budget. These transactions may be carried out through extrabudgetary accounts or through executive decree. Further, defense expenditures continue to be shrouded in secrecy for reasons of national security. Although it is generally difficult to evolve suitable measures of performance in regard to defense operations, selective costing could be computed for some programs. Several industrial countries have made considerable progress in computing the costs of selected operations. Progress in this area remains to be made in most developing countries. Similarly, public debt operations, which continue to dominate government budgets, have received little scrutiny. Experience with privatization also shows that the realm of accountability has been relatively small in comparison to the totality of transactions.

- Established systems of oversight such as audit and legislative control have many limitations. Specific factors contributing to this underachieving machinery are described in detail in box 7.2.

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Defense opaqueness reflects a cruel irony. Outlays on protecting the common man are not fully revealed to the public with the result that an individual has no idea as to how he is protected or the full costs of protection, not to mention the effectiveness of that protection.
Box 7.2
Financial Accountability:
Factors Contributing to Underachievement

In many countries, there are institutions and procedures established to achieve financial accountability. The two most important institutions in this regard are independent audit and the legislature. Both of these experiences show have been less than effective in fulfilling their charters, let alone the expectations of the public. The underachievement is mostly due to the limitations that these institutions encounter in the process of fulfilling their mandate. These are described below.

Audit

In a number of countries, audit agencies still have developed fully and become fully independent. Even in those countries where audit has existed for several years, its contribution has not been effective in ensuring financial accountability. This is largely due to the following factors:

- In most cases, audit is not empowered to review policy matters. Audit agencies do not have as yet full authority in most countries to follow the trail of the budget peso or rupee to the last stage where it is spent. Thus, local governments, nongovernmental bodies, private contractors who perform agency functions on behalf of the central or federal government are not within the orbit of primary audit. In most cases, the audit conducted by the audit agency is limited to financial compliance audit (regularity and compliance of laws), and efficiency audit remains to be fully developed.

- In a large number of cases, audit agencies have yet to develop expertise in areas such as public debt (which represents a significant block of government outlays) and foreign exchange management.

- Audit agencies in many cases follow the track of accountability and appropriation audit and lay very little emphasis on investigative audit into special areas. Even in
countries where investigative audit is undertaken, a judicious combination of regular audit and investigative audit remains to be achieved.

- The effectiveness of audit, even in its own chosen areas, is dependent on the support it receives from legislative institutions. These institutions may often be governed by party politics or by issues of the day, rather than by considerations of institutional development.

Legislative Institutions

The practices in this regard vary considerably from being forceful and decisive to being complaisant or without deliberative and legislative powers in regard to budgets. Moreover, the following limitations stand in the way of the realization of the full potential of financial accountability:

- In several countries, particularly those that have practices modeled on Whitehall’s, legislatures can only reject government policies (which run the risk of a change of the party in government), but cannot modify them. In recent years, consultative committees have been set up in some countries to provide opportunities for legislative inputs into policymaking. Experience in this regard is limited and does not justify optimism. Elsewhere, experience shows that legislators may be more interested, where party discipline permits, in pork barrel politics rather than on the major premises of macroeconomic policies.

- In many cases, major portions of public outlays are covered by existing legislation, thus limiting the scope of legislative control. In some cases, e.g., public debt, governmental operations may not require legislation. Until recently, agreements with international financial institutions were not submitted for legislative approval or information.

- Legislatures rarely have opportunities to discuss macroeconomic policy issues. Also, discussion is largely handicapped by lack of expertise in this area.
• The portfolio of expenditures of central governments, as noted earlier, has been changing in recent years. Central governments are increasingly becoming cash counters transferring funds to autonomous agencies, nongovernmental organizations, and state and local governments. Services provided by the street-level bureaucracy are mostly within the realm of state and local governments, while funding responsibilities reside with the central government. In some cases, such as in the European Community, disbursing power has moved from national to supranational governments. This growing distance between funding and delivery of services has exacerbated the problem of financial accountability and, as yet, a satisfactory solution has to be evolved to reduce the gap between the two. In some cases, it is argued that state and local governments have their own audit agencies and legislatures and, therefore, the composite picture of accountability is complete. In practice, however, oversight bodies at the state and local levels differ in their approaches, and the expected complementarity among the various levels still has to be achieved. Financial relationships between governments and nongovernmental organizations continue to be a black box. More often than not, nongovernmental organizations lack the expertise, and an adequate regulatory framework for monitoring the activities of nongovernmental organizations still has to evolve.

• It is generally agreed that, as in corporate governance, public organizations, too, should endeavor to hold managers accountable for their actions. The implementation of this simple (at least in appearance) requirement in public organizations has become a complex and frequently intractable matter.
Two factors would appear to have contributed to the complexity. First, most public organizations are hierarchical in nature. Even where tasks and responsibilities have been decentralized, in practice power may be concentrated in a few hands. Hierarchical organizations such as those found in the civil service, defense management, and police administration have contributed to a thick fog of diffused responsibility, in turn making it extremely difficult to pinpoint the person or the authority responsible for poor performance. To tackle this problem, performance contracts with chief executives have been drawn up, and task-oriented agencies that are primarily concerned with policy implementation have been created. But the application of these approaches, it is argued, has been carried out in “too crude and simplified a fashion.” In most cases, the agencies have yet to form a consensus on the type of accountability they should have. Experience shows that the local bodies or the policymaking departments (ministries) tend to view accountability as a form of control. Consequently, the paradoxical result has been that ministers and chief executives become more powerful through direction and arm-twisting. Performance contracts, too, cannot be all encompassing and there are gray areas where responsibility for actions is difficult to locate. Meanwhile, the monitoring of performance contracts and their enforcement have brought added costs, at the same time that the distinct cost advantages of chief executives over the traditional civil service remains to be proven.

• The formulation of performance indicators through the establishment of direct and explicit relationships between the inputs of money and manpower and the tasks of an agency has been and continues to be a formidable task. Several problems are being encountered in this regard. First, a one-size-fits-all approach is apparently being taken such as through the formulation of workload data for categories like “policy formulation.” Government departments tend to have a distinct personality of their own which is not always captured through these general, ambiguous, and frequently nonempirical categories. Second, the formulation of agency tasks tends to be broad and general, notwithstanding exhortations to the contrary. At one stage, the task of the Health Authorities in Britain was to “carry out the priorities of the government of the day.”¹² This type of approach has the effect of redefining the problem rather than solving it. Third, the formulation of performance indicators has been and continues to be a unilateral exercise undertaken by the executive wing of governments, which is somewhat akin to the defendant in a legal dispute determining the parameters and the course of the judicial process.

• The overall framework of financial accountability gives access to the public by providing information on the actions of the executive. Such access may not, however, enable detailed scrutiny for several reasons. First, the annual accounts and related documents show the overall results of actions taken during a year but are less helpful in illuminating the factors contributing to a specific action. Second,

in several cases there may be full compliance with the budget estimates, and all laws and regulations may be fully adhered to. But this compliance by itself does not mean that the objectives of budgetary policy have been achieved or that the delivery of services has been performed well. The audit, too, is concentrated in several cases on the financial control process rather than achieving value-for-money or efficiency audit. Third, government, which has the monopoly on the information needed for accountability, has not been above managing the information to its advantage. Being economical with truth has become, it is frequently suggested, an ingrained habit of the bureaucracy.

As a result of all of the above factors, citizens often feel that their access to information does not necessarily translate into full-fledged scrutiny and accountability. The other means available to them (box 7.3) may be expensive and incapable of yielding immediate results. The opportunity to use the ballot box, as a means to revoke the policies is limited as it has its own schedule and therefore may not be exercisable with the prospect of immediate results.
Box 7.3  
Citizens and Financial Accountability

The overarching purpose of financial accountability is to keep the citizen informed of the progress made in the mobilization of financial resources and in their use to meet the needs of the community. Citizens have a variety of instruments at their disposal to make financial accountability a reality. In principle, citizens have the power to revoke the decisions made by the executive and the legislature; they have the capacity to move the judiciary when they find policies and decisions to be discriminatory or to have an adverse impact on the community; they can undertake public scrutiny of government policies through their access to the information available in the public domain. In some instances, they may participate in making financial decisions, in monitoring the progress made by various programs, and in evaluating the results of policies. Selectively, public opinion may also play a significant role in the imposition of sanctions and penalties against delinquent officials.

In practice, however, in each of the above areas, the citizen remains somewhat distant from the focus of financial accountability. This aloofness stems from the nature of the instruments chosen for the purpose of financial accountability. In most countries, revoking the decisions made by governments tends to be difficult except in the tax area. In several countries, full budget documentation is not available to the public. Although progress has been made in recent years in publicizing the nature and magnitudes of fiscal deficits, the issue remains confusing to many in view of the existence of many extrabudgetary accounts and numerous transactions between these and the general account, and the constitutional imperatives of a balanced
Budget. There have been many instances, however, where the tax proposals have been altered or withdrawn in the light of popular opposition and potential political consequences. Details of expenditure programs are rarely provided, and where provided, are highly aggregated and sketchy. Thus, public scrutiny, which is the basis for financial accountability, is rarely fulfilled. An associated feature is that periodic financial data, which have been published selectively in recent years, are directed more to the financial markets than to ordinary citizens. Audit reports are primarily intended to serve the needs of legislatures and their committees and are not structured to address the concerns of citizens. The voice of citizens in regard to the delivery of services tends to be muted in view of the growing distance between those responsible for funding and those who deliver services.

Citizens can take recourse to the judiciary, but only in those cases where there are inequities in the existing legislation. Although general issues may be taken up in public-interest litigation, judicial intervention has been more in the tax area than in expenditure matters.

At the local levels, citizens in many Western democracies have gained a voice in determining contract awards, in monitoring progress, and in evaluating completed programs. But in most developing countries, the executive continues to have a dominant role and the options of citizens are limited to discussions within party caucuses, or organized protests where they can air their grievances. In these countries, citizens have little role in the imposition of penalties and sanctions.

Thus, the language and structure of financial documentation limits the scope of public debate and scrutiny. A good deal of progress still has to be made in taking financial accountability closer to the public.
Although accountability has always been inherent in the responsibilities of an official or an institution, it has acquired a new impetus and many dimensions in recent years as efforts to strengthen fragile democracies and the links between the civil society and forms of government continue. The new impetus and the growing demands for stronger accountability in general and financial accountability in particular have their origins in the following factors:

- In recent years, notwithstanding a steady increase in the size of the bureaucracy, there has been a perception of continuing sizeable waste in government operations. The socialization of inefficiency has contributed to distrust of governments. Opinion polls conducted in Western democracies since the second world war reveal that this distrust has been growing.

- As an integral part of the above perception, there is also the generally shared view that bureaucracies tend to be self-serving with scant regard for their clients’ needs. Moreover, it is also believed that bureaucracies lack accountability.

- While in normal circumstances legislatures would have been expected to perform a major role in ensuring financial accountability, they tended to be ineffective as bureaucracies acquired additional powers in day-to-day economic decision making. Legislatures may discuss the policies of governments or may approve or reject them. In reality, however, policies reach legislatures at too late a stage—in aerodynamics terms, when the plane is already about to take off, when aborting the plan could mean unpleasant consequences. Opportunities for crucial inputs into policymaking are few, and major chunks
of expenditures are either already committed or beyond the scope of legislative intervention. Year-end scrutiny tends to be spotty, with major attention devoted to issues of sleaze or those that damage the political prospects of the ruling party. There is also a perception that the machinery for accountability, where it already exists and operates, is often slow and parochial, contributing to a discord between the rapid pace in the advancement of expectations and the scope of response of the institutional machinery. Experience also shows, as in the case of the European Community, that where the institutional machinery has been designed during recent periods, insufficient attention has been paid to ensuring adequate financial accountability.

- Recent efforts to install or strengthen management capabilities (prompted by the new public management philosophy) envisage greater roles for managers. They are expected, within the limits of financial resources and endowed autonomy, to deliver services at the specified cost and quality and within the given timeframe. Such additional delegation of financial powers and autonomy undertaken as a part of the new public management approach may further weaken the accountability machinery with its hollow core.

- There is an overall gap between the intent and performance of governments. The reality, as perceived by the people, is that services are deteriorating even as the debt burden increases, and the community’s suffering has increased even as governments traditionally considered strong and fiscally viable have become weak because of other internal and external developments.

These factors accentuate the need for appropriate financial accountability to stop the erosion of confidence in government and restore credibility.
It is in this context of a sense of disenchantment with the existing systems of accountability and the lack of their effectiveness that there has been a growing demand for improved and, more importantly, effective systems of financial accountability. This additional stimulus for achieving financial accountability (box 7.4) is being addressed in different ways.

Moving Ahead: Recent Developments

In recent years, particularly in the early 1990s, there has been a growing recognition of some of the above problem areas. As a result, there have been more efforts to consolidate the progress made toward financial accountability. More specifically, these efforts involved further strengthening financial management in government agencies, imparting a set of moral values in public service, and, on the part of international financial institutions, formulating a fiscal transparency framework.

In the area of financial management, accounting systems are being organized on an accrual basis and corporate approaches are being applied. Four advanced countries have already moved to accrual accounting or are scheduled to complete this transformation in the next few months. As an integral part of this effort, accounting standards with specific applicability to government operations are being developed. In some cases, budgets, too, are being prepared on an accrual basis. Once these innovations are fully implemented, there is a distinct prospect that activity-based costing will emerge as the anchor for expenditure management and financial accountability. In a number of cases, performance contracts are being developed as concordats between agency heads and the government. Although many of the difficulties relating to perfor-

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13 For an account of these developments in Australia, New Zealand, United Kingdom, and the United States, see Premchand (1999c).
mance measurement continue, the hope is that, with more experience, improved indicators with the potential to enhance accountability can be developed. Moreover, it is likely that the shift of emphasis from inputs to performance and results will transform the culture of government organizations into a management-oriented one. Audit agencies, too, have been developing agendas combining traditional financial audit with investigative audit and oriented to ascertaining value for money (e.g., in European countries). In the United States, since 1998, investigative audit has been combined with the financial audit of all the operations of the government, as required under law. While none of these instruments is entirely new, the emphasis and, in some cases, the revival of some ideas merit recognition.

Moral values, as Barnard envisaged them, were essentially a part of the informal and, to some extent, private aspects of an official. In recent years, however, there has been a view (e.g., in the United Kingdom) that in order to restore public confidence in the system of public administration, standards of public life are needed. Accordingly, there has been an emphasis on the need for selflessness, integrity, objectivity, accountability, openness, honesty, and leadership. These qualities, which have always been essential, would undoubtedly increase public confidence in governments. At the same time, it must be noted that if at least six of these qualities were firmly entrenched in public administration, then accountability would be automatic and even self-enforcing. Experience suggests that

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14 See Premchand (1999b). The exhortation for standards in public life may be inherent in human condition in view of what Montaigne called a long time ago, the 'ordinary vices' associated with human behavior. Included in these vices were treachery, disloyalty, cruelty, and tyranny. Judith Sklar suggested that 'dishonesty' be added to the list. Despite these periodic reminders, and admonitions from the religious establishments that some of these sins might invoke divine wrath, ordinary vices continue to dominate day to day to economic life. Indeed, some of the public standards, e.g., selflessness, may be contrary to the spirit of economic rationality that emphasizes the virtue of maximizing profit.
mere exhortation of the need for these values would not have any major impact particularly since the laws aimed at penalizing corruption in public life have had so little enduring effect.

Meanwhile, international financial institutions, which have seen their developmental policies jeopardized by the levels of corruption and the consequent losses suffered by society, have also initiated efforts to strengthen institutional development. They have begun to formulate a framework to promote financial transparency and accountability. The framework they propose is more in the nature of a minimum agenda (box 7.5). Many countries already have the features of the proposed framework. The problem, as noted earlier, is not the lack of institutions and instruments but the lag between the intent and the practice, and other factors contributing to underachievement and, in a few cases, to failure of the prescribed machinery. It would appear by implication, that the suggested framework is applicable more to those former centrally planned economies that have yet to make the complete transformation to democratic forms of government. Even in these countries, there is a good deal of vertical accountability (within the hierarchical system of organization) and often quick and severe penalties for violations. In terms of horizontal accountability, the party congress, particularly at the provincial and local levels, plays a crucial role in the allocation of resources, their utilization, and accountability. What needs to be recognized is that these countries have their own form of accountability even though that form may not be similar to those found in some democracies.
Box 7.5

Financial Accountability:
Minimal Agenda Not Adequate

Recently several international financial institutions have taken initiatives to issue guidelines on the ways in which financial (the term used by the international agencies is ‘fiscal’) transparency and accountability may be achieved by countries. Being international guidelines that seek universal applicability, they are more concerned with the general rather than the specific features of a particular country. The guidelines envisages (a) a medium term fiscal strategy; (b) a comprehensive annual budget; (c) periodic data to be published on the status of government finances, and annual accounts to be submitted to the legislature, and (d) identification and publication of government liabilities including contingent liabilities. The guidelines envisage the functioning of a legislature endowed with powers to review the budget and annual accounts.

Many of the features described above are found in most democracies, in one form or another. The role of the legislature as a deliberative body and engaged in the enactment of legislation is yet to be established in some of the former centrally planned economies (most former centrally planned economies in Europe have already made this transition). Meanwhile, the party congresses have been taking an active role in the consideration of the annual report on the economy and the budget. They have also made a beginning in the establishment of an audit agency. Here again, the former centrally planned economies in Eastern Europe have made rapid progress (with the help of European organization of Systems Audit Authorities and the Audit agencies of some industrial countries) in the establishment of independent agencies endowed with powers to undertake financial and investigative audit.

The experience of many countries in regard to the features enumerated by international financial institutions shows that they provide, at best, a modest beginning in the process of achieving financial accountability, largely because the systems and operational techniques utilized by the relevant governmental institutions leaves a good deal to be desired.
Toward a Constructive Agenda

A paradoxical feature of the current situation is that the expectations and demands of the public are growing faster than the existing machinery for accountability can handle. The solution does not lie in reducing the scope of accountability but in producing more viable and responsive accountability machinery. In evolving such machinery, the following aspects merit specific attention.

Several countries have medium term fiscal strategies, either in the form of development plans, or global visions, or in the strategies formulated in the wake of economic crisis experienced, during recent years, by some Asian countries. These strategies are too general and are more indicative of the likely goals to be reached and are scarce in the specification of the means (as required by a strategy) to achieve those goals. Moreover, insufficient attention is paid to uncertainty, high-risk areas and associated vulnerabilities. The strategies also lack enforceability and the imposition of sanctions, in the event of failure, as needed by financial accountability.

The budget, even on a comprehensive basis — a goal that remains to be achieved by some Asian countries, is far from accessible to the general public. Budgets tend to have a unique language of its own, and some mysteries that defy probing by the public. Details on expenditure programs and the likely benefits are scant and in many cases doctored.

The periodic reports, which are being published by many countries, are too aggregative in nature and are intended for the benefit of domestic and external financial markets. Annual accounts, which in most countries are required to be audited,
is not of recent origin. Indeed, it has been a part of the framework of legal accountability for a long time. These accounts are mere records of transactions and do not offer any benchmarks for performance assessment. They remain inaccessible to the general public.

The effort at revealing liabilities, particularly in a cash based budget and accounting systems, is a welcome one. The most significant part of liabilities is external and internal debt. Data on debt are regularly published by many countries, although, on occasion, some countries have attempted to doctor them too. Several countries also publish data on contingent liabilities stemming from guarantees (although the coverage is far from uniform or comprehensive). No attempts are made to publish data on liabilities relating to arrears in wage payments, repayment of debt and settlement of claims by contractors. Hidden or informal debt remains an area of darkness for the public.

Thus, the framework of accountability offers a hollow core rather than an effective one. Provision of information is equated with public scrutiny; the existence of an audit agency of a legislature is viewed in this oversimplified model of accountability, as fulfillment of financial accountability. The important need is to look into the working of the institutions and ascertain as to why their full potential is not being realized.

- Financial accountability is no longer limited to ensuring that the budgeted amounts have been spent and that the specified annual objectives of an organization have been met. While these elements will continue to be important, it appears essential that accountability be enlarged to include the success achieved in ensuring economic sustainability. The interest of the community is in satisfying itself that the policies pursued enhance the strengths of the economy and that the financial balance of the community is not jeopardized. This enhanced
accountability should be the cornerstone of every effort. Accountability for economic performance should go hand in hand with financial performance and the provision of services.

- Accountability will not be achieved unless it becomes an integral part of service delivery, and of political agenda at the national level.\(^\text{15}\) To achieve the former, it may be necessary to arrange for more formal participation of the client groups. At the national level, legislatures may not be very interested, depending on the political climate, in pursuing limited accountability. There is thus a need to strengthen the role of the legislature in the management of the economy through more opportunities to review and approve government policies. Categories of expenditure that are now exempt from legislative approval should be reviewed and reduced. In addition, the society should have more opportunities to review policies and program results and, where necessary, to impose sanctions.

- The measurement of economic and program performance should form an integral part of financial accountability. The formulation of performance measures should not be left to the executive but should form part of tripartite deliberations comprising client groups, the executive, and the legislature. The formulation of performance measures is a com-

\(^{15}\) Accountability is not a mere technical process and therefore cannot be entirely apolitical, even when fully objective. A distinction needs to be made, however, between proper political use and abuse of the accountability process. The former seeks to enrich the level of political discourse so that the community’s understanding may be illuminated; the latter is a tactical weapon in an adversarial process.
plex task and the pursuit of a one-size-fits-all approach is bound to be counterproductive. Rather, the diversified nature of government transactions needs to be explicitly recognized. To this end, organizations may be divided, as a first step, into those that are (i) production-oriented (where outputs and outcomes are observable) (ii) procedural in nature (where internal activity, but not the outcome, can be monitored) (iii) craft-oriented (those engaged in ensuring compliance of rules and regulations), and (iv) those that are responsible for coping with difficult situations (outputs and outcomes may be uncertain).\(^1^6\) The performance measures should facilitate risk taking and should be flexible.

- Accountability should not be limited to the imposition of sanctions. If this were the primary objective, then there would be a good deal of defensive policymaking and the bureaucracy may be inhibited from taking risks. Accountability should therefore aim at investing resources to secure lasting improvements in the administrative machinery that would also prevent or minimize institutional recidivism (box 7.6).

- The accountability framework should reflect, in the light of the preceding observations, vertical aspects within a hierarchy and among supranational, national, and subnational governments, and horizontal aspects reflecting the relationships with the legislature, client groups, and the society itself.

In evolving the above type of framework, it should be noted that care should be taken to avoid having too many laws,

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\(^1^6\) This approach is adopted from Wilson (1989), pp. 160–171.
Box 7.6
Beyond Financial Accountability

Financial accountability involves the identification of the losses suffered by the community. Inevitably, the identification contributes to the “naming and shaming” of individuals, organizations, and institutions whose actions have contributed to such losses. This is frequently viewed as an integral part of the audit system. The identification of guilty individuals and organizations is expected to lead to the imposition of penalties and sanctions on them. This represents the concluding stage of accountability.

The “naming and shaming” and the imposition of penalties can lead to tension, hostilities, or adversarial relationships between those that are in governmental agencies and those outside. The continuation of such adversarial relationships could also harden obsession but not necessarily lead to improved systems. While human failures should be punished, it must also be recognized that many of the lapses may be systemic. Addressing individual crimes and misdemeanors without looking into the underlying contributory factors could lead, and indeed has led, to institutional recidivism.

Just as a judicial system looks beyond the incarceration of the criminal to the correction and reform of the individual to reduce potential crimes, so also governments and the community have the need, indeed the obligation, to reform the system of financial management, to strengthen it so that the hopes of the community can be fulfilled with minimum friction. The rules, and regulations, and too many layers of officialdom (craft organizations). Otherwise, accountability could become an oversight mechanism that is too invasive and that stifles initiative and imaginative handling of public affairs. The shift in the concern from the process to results and performance would be difficult to achieve if management is not endowed with the needed freedom to act. Maintaining a balance between delegation of autonomy and direct oversight is indeed a difficult task.
experience of many countries shows that, apart from greedy individuals who seek to exploit situations for personal gain (which translate in this zero-sum game into losses for the community), the financial management system that has structural and procedural flaws needs to be improved. This positive aspect of investing in improved financial management systems should form an integral part of a constructive agenda.

Recent developments in technology are such that their gradual deployment is likely to give a strong boost to participatory decision making. In the not too distant future, electronic technology may make possible a kind of town-hall meeting, where each individual in the comfort of his home may indicate his or her personal preferences in regard to a proposed action. Such participatory decision making, which is a significant step toward linking the democratic tradition with a civic society, could lead to yet another phase in financial accountability. Financial accountability envisions the promotion of a management culture in public organizations so that performance may be specified and evaluated. The increasing provision of public services by the corporate world has widened the choice of benchmarks. Here again, an agenda that envisions a greater involvement of the community in the promotion of a management culture is likely to contribute to improved financial accountability. In sum, the emphasis on punishing the guilty should be tempered by an explicit recognition of the need for improved systems of financial management and the promotion of a management culture of accountability.

but the success of accountability is dependent, in the final analysis, on the ingenuity shown in this respect.

Conclusions

It is important that the framework for financial accountability be formulated with care and caution, so as to inspire public
confidence and restore the credibility of government. Accountability narrowly defined and aiming only at financial process controls is no longer adequate. The scope of accountability needs to be expanded to include overall economic management as well as delivery of services both by governmental and nongovernmental agencies. The objectives should not be limited to the pursuit of sleaze, but should include a more constructive agenda aimed at strengthening operational systems of public administration. The dimensions of accountability have grown over the years, and access to information on government operations, while facilitating public understanding, does not by itself complete the process of public scrutiny. Many of the initiatives taken in recent years still have to be fully implemented or taken to their logical conclusion. A framework of financial accountability encompassing all these aspects remains to be formulated and that by itself constitutes a major agenda for the future. This need for enhanced accountability has to be tempered by a recognition of the extensive preparatory work implied in this effort. Accountability can be fulfilled only when organizations are given specific goals and, more importantly, are endowed with additional capacity to achieve these goals. Countries have a good deal to do on both these fronts. Emphasis on one goal without corresponding effort devoted to the strengthening of administrative infrastructure could contribute to underachievement of goals and yet further erosion of the credibility of governments.
Chapter 8

Transparency and Accountability for Public Financial Integrity

Nihal Jayawickrama

Introduction

The overwhelming majority of people, in all countries across the globe, are not economists or accountants, nor are they actively involved in the government of their countries. Neither the intricacies of financial management, nor the relative merits of different systems and the philosophies underlying them, are ever likely to be the focus of their attention. But it must astound and appall them when they discover, usually long after the event, that those who had taken upon themselves the responsibility of governance had actually robbed them, and that the management system had not been able either to detect or to prevent such pillage. I do not refer to “speed money” or “grease payments” with which the people of this region are only too familiar. I refer instead to the “grand corruption” which, we are told, had been indulged in by both elected and appointed officials from Pakistan to the Philippines, through India, Bangladesh, Sri Lanka, Thailand, Indonesia, Malaysia, China, South Korea, and Japan. Ordinary people in these countries must naturally ask what it is that is wrong with a financial management system within which officials can defraud the national treasury and not be detected or held accountable until after they or their regimes have ceased to exist.
A Flawed System

There must be something fundamentally wrong with the system if decision makers at the highest levels of government are able to “sell” their discretion in privatization exercises, in public procurement, and in respect of major civil engineering contracts, and not be detected. For example, in respect of the privatization of the water authority of the city of Jakarta, it was only after he was ousted from office that it was publicly revealed that President Suharto had instructed his Minister of Public Works to divide the city into two geographical units and to award two concessions to two of the many foreign companies interested in the project. One was French, the Lyonnaise des Eaux, and the other was British, Thames Water International. The local partner of the former was a longtime business associate of the President, and the local partner of the latter was the President’s eldest son. According to the Asian Development Bank, over the last twenty years, one East Asian country is estimated to have lost US$48 billion on account of corruption, surpassing its entire foreign debt of US$40.6 billion. In another Asian country, over the past decade, state assets fell by more than US$50 billion, primarily on account of deliberate undervaluing by corrupt officials responsible for a privatization program. In a South Asian country, US$50 million was misappropriated daily on account of mismanagement and corruption. At the same time, studies of corruption in government procurement in several Asian countries revealed that 20–100 percent more had been paid for goods and services. How is it possible for a private company dealing with the government to pay to be included in a list of prequalified bidders or to restrict the size of the list, to pay for inside information, to pay to have the bidding specifications structured so that the corrupt firm is the only qualified supplier, to pay to be selected as the winning contractor,

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and then to pay to set inflated prices or to skimp on quality—and yet not be detected at any stage of that crooked and tortuous journey?

There must be something fundamentally wrong with the system when even officials of lesser rank are able to demand money with impunity for doing acts that they are required by law to do or to provide services that they are prohibited by law from providing. A recent national household survey on corruption in Bangladesh, conducted by the national chapter of Transparency International in that country, revealed that:

- 41 percent of households had paid a “donation” to have their children admitted into schools;
- 36 percent had made payments to or through hospital staff to secure admission into hospitals;
- 65 percent had bribed land registrars to record a false sale price for a land transaction;
- 54 percent had bribed either employees or “other influential persons” to secure bank loans;
- 33 percent had paid money to obtain electricity connections;
- 37 percent had paid less for water “by arrangement with the meter reader”;
- 47 percent had been able to reduce the holding tax assessment on house and property “by arrangement with municipal staff on payment of money”; and
- 63 percent of those involved in litigation had paid bribes to either court staff or the opponents’ lawyers.

Eighty-nine percent of those surveyed were convinced that judges were corrupt; and 97 percent thought the police service was corrupt. A survey in Bangalore revealed that in a government maternity hospital in that city one had to pay even to see one’s own baby, the price for a baby boy being higher than for a baby girl. Some assistance in diagnosing the flaws in the system may perhaps be forthcoming if one were to shift the focus to those systems that do in fact function, and function very well.
A Diagnosis

In each of the past four years, Transparency International (TI) has published a Corruption Perception Index (CPI). It is not an assessment of the corruption level within a country. Instead, it is an attempt to assess the level at which corruption is perceived to affect commercial life, in the view of several thousand businessmen, risk analysts, and business journalists. In an area as complex and controversial as corruption, no single source or polling method has yet been developed that would combine a perfect sampling frame, a large enough country coverage, and a fully convincing methodology. TI therefore chose the option of a composite index. The CPI is a “poll of polls.” The 1998 index is based on seven credible surveys conducted by reputed organizations using different sampling frames and varying methodologies. The strength of the CPI is based on the concept that a combination of sources into a single index increases the reliability of each individual figure. The probability of misrepresenting a country has been lowered by including only those that have been the subject of at least three surveys, the premise being that the imperfections of one may be balanced by those of at least two others. The perceptions reflected in the CPI may not necessarily be a fair assessment of the actual extent of corruption within a country, but they are a reality. If those in a unique position to observe the behavior of public officials and politicians wrongly believe that they are corrupt, the reasons for that mistaken belief need to be identified and remedied.

In the TI Corruption Perception Indices for 1995–1998, ten countries achieved consistently high scores for integrity, remaining throughout among the twelve least corrupt countries in the world. They are Australia, Canada, Denmark, Finland, New Zealand, Netherlands, Norway, Singapore, Sweden, and Switzerland. Also at the top end of the scale in the CPI for 1998 are the United Kingdom, Ireland, Germany, and Hong Kong. At the other end of the scale, among the countries perceived to be among the most corrupt in the world, are Indonesia,
India, Nigeria, Pakistan, Russia, and Venezuela. Another Asian country at the bottom end in 1998 is Vietnam. It is not suggested that corruption is wholly absent in the first group of countries, or that corruption is peculiar to the developing world or to societies in transition. Indeed, among those found guilty recently of corruption were the Auditor-General of New Zealand and ministers in Canada and Australia. The significant difference is that corrupt acts were detected and punished in these countries without the need for a revolution or even a change of government. In contrast, the long and tedious criminal investigations in India into alleged massive corruption among the highest in the land, which were set in motion by an activist Supreme Court, have not produced any tangible results. Therefore, if the first group is compared with the second, it is not difficult to identify what the former possesses which the latter do not: legal and institutional mechanisms that work, a feature that is conspicuously absent in the latter. In the one case, governance is not only participatory but also transparent and accountable; in the other, it is not. The majority of the countries in Asia and the Pacific probably swing within this spectrum. Assuming that a government is participatory, this comparison suggests that even the most sophisticated financial management system cannot curb or contain corruption in the absence of both transparency and accountability. These are different, yet interrelated and interdependent, concepts.

Transparency in Public Financial Management

In the field of public financial management, transparency implies that the procedures and methods of decision making and the disbursement of public funds are open and visible to all. There are at least three methods by which such transparency can be achieved:
Access-to-information law

The British colonial administration bequeathed to its colonies and dependent territories a tradition of secret government. The ubiquitous Official Secrets Act enabled governments to classify all its documents as top secret—secret, confidential, or restricted. The trend toward open government, which began in the United States in the mid-1960s, percolated to Canada, Australia, and New Zealand nearly two decades later. The recognition by these countries of a statutory right to information, and a decade and a half of its implementation, has not borne out any of the fears originally entertained and expressed by their respective governments as they grudgingly or with little enthusiasm conceded to the community the right to know. Public administration has not collapsed under the burden of an access-to-information law, nor has the cost proved overwhelming. On the contrary, studies indicate that most government departments have come to terms with the innovation without undue difficulty, and the cost has continued to be but a fraction of each government’s total information budget.

About seven years ago, I drafted an access-to-information law for a group of legislators and a coalition of nongovernmental organizations in Hong Kong. For many years, the Hong Kong community had been denied official information relating to matters such as dangerous slopes, environmental pollution, and town planning. Insinuations had been made about the refusal to release telecommunication consultancy reports funded with public money, and dissatisfaction on the failure of the government to involve the community in the decision-making process on high-cost projects such as the new airport at Chek Lap Kok and the new University of Science and Technology had reached the proportions of a public outcry. In 1996, on the eve of the transfer of sovereignty, presumably on instructions from London, the Governor exercised his constitutional veto and introduced instead a nonenforceable code of practice.
The draft Hong Kong law adopted four methods to achieve its objective. First, every government agency was required to publish annually a statement of its operations. This statement included a description of its structure and functions, as well as a register of all categories of documents in its possession, in sufficient detail to facilitate access. Also required to be published were its policy documents. These included interpretations, rules and guidelines, any statements of policy, practice, or precedents issued to its officers, and, of course, its procurement rules. Second, a legally enforceable right of access to information in documentary form held by the government was recognized, subject only to such exceptions as were reasonably necessary to protect public interests and the private and business affairs of other persons. Access was to be provided by giving the applicant a reasonable opportunity to inspect the document or by supplying him with a copy. Third, recognition was granted to the right of a person to apply to amend any record containing information relating to him which, in his opinion, was incomplete, incorrect, out of date, or misleading. Fourth, a two-tier appeal system to bodies independent of the government was provided against any refusal to provide access. A substantial portion of the draft law dealt with exempt documents. Among the subjects generally excluded from scrutiny were executive council discussions, judicial functions, law enforcement and public safety, intergovernmental relations, and internal working documents.

Access to information is a powerful mechanism of accountability. To the extent that shrouds are lifted off government, and the decision-making process made visible, to that extent are opportunities for corruption minimized and the abuse of power lessened. In a small and impoverished village in the state of Rajasthan in India, a local grassroots NGO recently demonstrated the potential of an access-to-information law after it secured the enactment of such a law through a 53-day hunger strike. It immediately invoked the new law and revealed to the community the massive and systematic abuse of
development funds by local politicians and government functionaries. In its own quaint fashion, through a six-hour puppet show, it publicized by reference to muster rolls the amounts of money said to have been paid to workers long since dead or migrated or nonexistent, and by reference to bills and receipts the hundreds of bags of cement claimed to have been purchased and used to repair a small primary-school building. Within weeks, much of the looted money was recovered.

Demystification of the budget

The annual budget is invariably couched in language and presented in a format that is unintelligible to all but the initiated. Comments on it are invited and obtained only from those at the commanding heights of the economy or in the ivory towers of academia. Public response is usually sought only on such prosaic and plebeian issues such as the increase in the duty on cigarettes or the reduction in respect of alcohol. But no single act in the legislature has such a profound impact on the lives of people throughout the country as the annual budget and its related legislation. If it is presented in a form that is easily accessible to, and understood by, ordinary people, and then disseminated in cooperation with the free media, not only will the budget be subjected to greater scrutiny and more widespread comment, but a process would begin which would involve the public in open consultation on choices and preferences in the utilization of national resources. At the micro level, it would enable, for example, parents armed with the knowledge of how much money has been allocated to the schools that their children attend to demand to know how and where that money has been spent. The public audit of the government’s financial management, thereby secured, is potentially a potent weapon in the struggle against corruption. It is capable of being achieved, and will certainly be more productive, if donors conditioned their aid not by specifying policies to be followed but by undertaking a “transparency audit” in recipient countries.
Annual reports of government departments

Once upon a time, in what was then Ceylon, government departments published annual reports. These were not glossy promotional material or fancy performance indicators. They were each an authoritative, matter-of-fact narrative, whether by the Director of Public Works, the Director of Agriculture, the Director of Education, or the Director of Medical Services, of the performance of their respective departments. These reports ceased publication shortly after independence, as did the annual Civil List which rendered the civil service transparent by providing the public with detailed information on the qualifications and movement of its members. Today, these archival documents serve the needs only of historians and research students. However, such annual reports (which are insisted upon by law in respect of every publicly quoted company), even if confined to a simple narrative of how financial resources allocated in the annual budget have been utilized by the relevant department, will be a valuable instrument in the quest for transparency.

Accountability in Public Financial Management

Accountability requires that those who hold positions of public trust should account for their performance to the public or their duly elected representatives. Accountability, therefore, implies that decision makers are monitored by, and are responsible to, others, each of whom is, in turn, responsible to the people of the country. In respect of public financial management, there are at least three independent and essential mechanisms through which accountability is enforced.
The Auditor-General

The Auditor-General stands at the pinnacle of the financial accountability pyramid. As the officer responsible for auditing government income and expenditure, he acts as a watchdog over financial integrity and the credibility of reported information. His responsibilities include ensuring that the executive complies with the will of the legislature as expressed through parliamentary appropriations; promoting efficiency and cost-effectiveness; and preventing corruption through the development of financial and auditing procedures designed to effectively reduce the incidence of corruption and increase the likelihood of its detection. In the United Kingdom, where the Auditor-General is by law designated as an officer of the House of Commons, the elected house of Parliament, his functions have been described thus:

The [Auditor-General] audits the Appropriation Accounts on behalf of the House of Commons. He is the external auditor of Government, acting on behalf of the taxpayer, through Parliament, and it is on his investigations that Parliament has to rely for assurances about the accuracy and regularity of Government accounts.\(^2\)

To be effective, the Auditor-General must be independent of the institutions being audited. His independence will be compromised if, for instance, the executive branch of government were to be responsible for overall financial management of his office, and were to determine staffing levels and classifications and the allocation of resources. Equally unacceptable are an appointment process and a removal procedure which

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are exclusively within the control of the executive. The nature of his duties requires that the independence and tenure of office of the Auditor-General be constitutionally protected, and that his office be accountable only to the legislature.

It appears to be the practice in certain countries to contract out to private-sector accountancy and auditing firms some of the responsibilities of the Auditor-General. This appears to undermine both the independence and the effectiveness of the audit. Apart from the inherent danger of a conflict of interest arising in such situations, private-sector firms are unlikely to share the considerable expertise of the Auditor-General’s office in public-sector audit. While the Auditor-General should have the freedom to diversify the skill base of his office by recruiting on contract competent persons from the private sector, constitutional propriety demands that his office be strengthened rather than that his legitimate functions be farmed out to others, whether subject to his overall control or not.

Public Accounts Committee

The Public Accounts Committee of the legislature receives the Auditor-General’s report, and enables a representative committee of legislators, usually under the chairmanship of an opposition member, to hold the executive to account. The effective discharge of this responsibility presupposes that the legislature is elected at genuine periodic elections, by universal and equal suffrage and by secret ballot, in conditions that guarantee the free expression of the will of the electors. An example worthy of emulation is that of South Africa where the entire parliamentary process has now been rendered as open as possible to the public and the press. All select committees, including the Public Accounts Committee, are required to meet in public, and if they wish to go into closed session, the reasons for doing so must be debated in public.
The Ombudsman

An Ombudsman who receives and investigates allegations of maladministration is an important instrument of accountability. The complaints may range from neglect, inattention, delay, incompetence, inefficiency, and ineptitude in the administration or discharge of duties and responsibilities, to bribery, favoritism, nepotism, and administrative excesses. The Ombudsman examines procedures, practices, and processes, but is usually not vested with power to make binding orders. On the basis of his findings, he makes recommendations in the expectation that, if maladministration or corruption has been identified, the relevant public officials will undertake remedial action. The Ombudsman is an independent officer to whom citizens have direct access, and whose independence and security of tenure are constitutionally protected.

While the office is Scandinavian in origin, two of the most effective Ombudsmen are in the Pacific states of Papua New Guinea and Vanuatu. In the latter, the Ombudsman, Marie-Noëlle Ferrieux Patterson, is also mandated to investigate and report on breaches of the constitutionally entrenched leadership code. In over 40 reports issued in the past four years, she has revealed, among others:

- “compensation payments” to several members of parliament and ministers;
- a bloated public service, in part due to politicians and in particular the prime minister appointing political allies, family members, and friends to offices for which they were not qualified;
- the purchase by politicians, with money borrowed from the state superannuation fund, at grossly undervalued prices, of houses belonging to the government; and
- the construction at a cost of US$4 million of a rarely used sports stadium named after the then prime minister.
National Integrity System

The mechanisms referred to above cannot, of course, function in a vacuum. They are elements of a comprehensive national integrity system whose other “pillars” include an independent judiciary, a freely elected legislature, a meritocratic civil service, an independent anticorruption agency, a free press, the private sector, and civil society; and whose other “tools” include a declaration-of-assets law, conflict of interest rules, readily accessible and transparent procurement rules, a constitutionally entrenched bill of rights, protection for whistleblowers, administrative reform, and the judicial review of administrative action. These collectively sustain and support a country’s integrity.

Conventional wisdom dictates that a country should also enact legislation to criminalize corruption, in whatever form it surfaces. The significance of such legislation is often overestimated. In many countries, notwithstanding laws that prescribe criminal sanctions, corruption continues to flourish. While such legislation is necessary, and may eventually help to establish a value system that could contribute to the creation of an anticorruption culture in the country, containing corruption is not simply a matter of enacting criminal laws. When laws do exist, they are usually not applied at all, or when they are, they tend to be directed at “small fish” rather than “big fish,” or selectively at political opponents no longer holding public office. The emphasis of an anticorruption strategy should therefore be on reforming systems, not scouring the murky waters for the elusive “big fish.” Another reason not to go “fishing” at all is that any serious attempt to reform systems requires the active participation of the government. Even a relatively corrupt government may be persuaded to initiate and support a reform program that would eventually strengthen the national integrity system if such a program is not perceived as being a threat to its own survival until the next general election. Indeed, a preoccupation with prosecutions and inquiries into the present or the past will detract from the urgency of an anticorruption
strategy that involves legal and institutional change. It often makes sense to wipe the slate clean and look forward to the future rather than remain focused on the past.
Impetus for Improvement in Public Financial Management

There is a groundswell of frustration in the Pacific Island countries (PICs). Economic growth has, on the average, barely kept up with population growth in most PICs, despite high aid-to-GDP and investment-to-GDP ratios. Unemployment, particularly among the young, is very high. Social problems associated with high unemployment have emerged, and are of increasing concern.

Unsustainable budget deficits resulting in internal and external financial instability are now common. Most PICs have witnessed and are witnessing unsustainable balance-of-payments deficits, dwindling external reserves, escalating government debt, crowding out of the private sector, loss of consumer and investor confidence, declining public- and private-sector investments, and slow growth.

Accordingly, there is a growing feeling among the people that national resources have been wasted or have certainly not been used efficiently. Public confidence in the government’s ability to engage in sound, decisive fiscal management to address the poor economic performance and
associated social ills is rapidly eroding. Demand for efficiency, transparency, and accountability in government and in public financial management in particular is on the rise.

Almost all PICs are in the midst of difficult stabilization, adjustment, and reform exercises. Most of these are aided and supported by the ADB. Central to these exercises is the overhaul and improvement of the public financial management systems in these countries.

**Economic and Social Impact of Corruption**

Corrupt practices are likely to have the following effects:

- selection of unsuitable and more expensive equipment and projects;
- substantial increase in the contract price during implementation if a favored contractor is involved;
- shoddy work, leading to expensive repairs and high maintenance costs, which are borne by the recurrent budget;
- forgone future revenue streams; and
- diversion of government services away from those in need to those who can afford to make the illegal payments demanded by corrupt officials.

In small, open, fragile economies, the economic and social impact can be very serious. Budget deficits are likely to widen with direct negative impact on the balance of payments, external reserves, liquidity in the banking system, and ultimately on confidence, investment, and growth in the economy. Unsuitable or unnecessary expenditures at inflated prices on equipment and projects result in much reduced returns in terms of GDP generated for each dollar of public-sector investment, i.e., in very high average ICOR for the government’s Public Sector Investment Program. To the extent that those who benefit from corrupt practices are likely to be economically better
Observations on Public Financial Accountability

off and powerful, corruption is likely to worsen economic and social inequity within the country. Even more seriously, corruption saps and erodes the moral authority of the political leaders and renders them impotent and ineffective in marshalling the energies of all sectors of society in the pursuit of national development.

Improving Transparency, Accountability, and Performance

Fiscal transparency and accountability requires, among other things, ready access by legislators, the media, and the public to complete information about fiscal targets, objectives, forecasts, and fiscal sustainability and vulnerability assessments. Detailed budget documents and audited financial statements should be made available to them, as should statements confirming compliance by the authorities with statutes and rules governing open procurement and contracting, employment, access to services, tax expenditures, and taxpayer treatment by the income-tax and customs administrations.

In a parliamentary system, the organization of the opposition party should be strengthened and given technical support to enable it to analyze the budget and policies effectively. The finance secretary and the governor of the central bank should hold briefing sessions on the budget for all legislators, including members of the opposition, before the budget debate.

Budget Formulation

As mentioned in other chapters, a carefully prepared macroeconomic framework is critically important for budget formulation. This framework should be prepared by an economic policy group or macroeconomic committee made up of the heads
of the central bank, the treasury, and the national planning and statistics bureau.

In the case of the PICs, a simple approach would do to start with. A simple model should be used as follows:

\[ M_3 = \text{NFA} + C_g + C_p + OIC \]

where \( M_3 \) = money supply
\( \text{NFA} \) = net foreign assets
\( C_g \) = claims on government
\( C_p \) = claims on the private sector
\( OIC \) = other items, net

Working committees, composed of officials of the four government departments mentioned earlier plus outside experts, would project the major macroeconomic variables: GDP, balance of payments, revenue, government expenditures, external reserves, and price movements. Demand for money could be calculated simply as the sum of nominal GDP growth and a modest estimate of growth in monetization. Within the limits of the targeted \( M_3 \), iteration would be done to protect a reasonable growth in bank credit to the private sector, and an optimum level of overall deficit and government borrowing requirement would finally be arrived at.

Projections of government expenditures and revenues would take into account existing and proposed policies, programs, and measures. The proposed fiscal, monetary, income, and exchange-rate policies that underpin the budget would be formulated as part of the exercise. The macroeconomic framework to be approved by the cabinet and ultimately the legislature would clearly show targets, assumptions, statistics, and projections; policy proposals and objectives; assessments of fiscal sustainability, debt-to-GDP ratio, revenue-to-GDP ratio, and fiscal vulnerability; maturity schedule of government debt; and usable reserves. The recommendations of the macroeconomic committee would help
determine the overall size of the current and capital budgets and the budget financing program.

After the macroeconomic framework is approved by the cabinet, the budget committee, made up possibly of the heads of treasury, planning, and public service, should set the sectoral ceilings within the overall budget ceiling. But the formulation of sectoral policies, projects, and programs and the determination of expenditure priorities are the responsibility of the spending ministries, departments, and agencies. Spending agencies must undertake micro analysis, questioning the merits of ongoing programs and targeting the reduction of expenditures that benefit narrow groups of richer people, as well as expenditures with only a slight impact on large sectors of the population.

More sophisticated techniques for economic projections could be progressively adopted as the economic policy group gains technical capacity.

**Multi-year Expenditure Programs (MYEPs)**

MYEPs consistent with the macroeconomic framework need to be adopted and/or strengthened. Public-sector investment programs (PSIPs) should be well thought out and priority should be determined by the assessed social and economic returns of projects. The responsibility for the formulation and execution of sectoral PSIPs belongs to the relevant ministries.

PSIP or medium-term capital expenditures and multi-year recurrent expenditures should cover three-year periods and be rolled at the end of each year. The multi-year recurrent expenditures should incorporate current expenditures associated with the PSIP and the consequences of current and ongoing policies. The planning office should assist the ministries in project preparation and help ensure consistency between selected projects and sectoral and national policies.

Aid should be treated as a financing item. The careful preparation of forward programs would help reduce the
possible distortion of priorities by donors and strengthen the government’s effective control over aid allocation.

The macroeconomic framework, the annual budget, and multi-year expenditure programs should be examined, discussed, and endorsed by a subcommittee of civil-service heads of ministries before being submitted to the cabinet. This ensures that the ministers will be better briefed, agreements easier to arrive at, and decisions made more rationally.

**Oversight and Control**

The constitutions of most PICs require all monies coming to the government to be paid into the consolidated fund, from which releases can be made only through legislative appropriation. This provision should be strictly observed as it forbids the establishment of extrabudgetary funds, such as those that could come from aid receipts.

All proposed sectoral policies or draft legislation with financial implications must be analyzed by the finance ministry before they can be discussed by the cabinet. A provision to this effect could be embedded in the cabinet procedure handbook or in the finance act itself.

The power to negotiate government loans should be vested exclusively in the minister of finance. Government borrowing, which must be tied to the financing of the approved budget expenditures, should require a legislative act or at least a legislative resolution, and foreign loans entered into by government statutory bodies and other entities must be subject to central-bank oversight. Government guarantees or lending should require similar parliamentary authorization.

Limitation transfers, or “virements,” between personnel expenditures and other current expenditures need to be controlled, and the number of staff members by broad categories should be shown in the budget. Transfers within budget categories may be approved by the minister concerned but
transfers between budget categories should require higher approval or supplementary appropriations.

Expenditures by spending ministries and agencies have to be authorized through warrants issued by the minister of finance. Such warrants should be based on the projected cash-flow position of the government to optimize its borrowing program and minimize the overall costs of borrowing.

The head of the treasury should be empowered to levy surcharges. Under this provision, accounting officers who do not collect revenue due, overspend appropriated amounts, neglect tendering procedures, or violate any other financial regulations could be made to pay a surcharge up to the total sum lost, which would be deducted from future salary payments.

Financial Statements to the Legislature

The minister of finance, on behalf of the government, should report to the legislature on changes in the budget resulting from changing economic circumstances, and also on progress in budget execution (i.e., budget outcomes against objectives). The treasury should complete the following financial statements within three months from the end of the fiscal year:

- financial position on the balance date;
- statement of revenue and expenditures, covering the annual appropriation and supplementary appropriations;
- statement of borrowings, accumulated debt, debt service, and contingent liabilities;
- statement of emergency expenditures during the year; and
- comparative actual figures for the previous fiscal year.
Auditor General/Commission of Audit

This is a constitutional post, responsible to the legislature. It should be endowed with wide investigative and reporting authority over government and the operations of government entities. In consultation with the treasury, the auditor general should establish accepted accounting practices for the preparation of government financial statements. The auditor general must have right of access to all information held by ministers, departments, and government entities and the right to copy information, to require explanations, and to enter premises.

The auditor general should have the power to direct officers or employees to:

- provide information;
- appear before the auditor general; and
- grant access to anyone authorized by the auditor general.

I would recommend a provision, similar to that in the Philippine Constitution, which gives the Commission of Audit discretion and authority to disapprove any disbursement of public monies if deemed unwise or unreasonable by the Commission. This is a considerable extension of power beyond that of merely ascertaining the correctness and legality of expenditures or simply bringing to the attention of officers expenditures that were irregular, unnecessary, or extravagant in the opinion of the auditors.

International Financial Scams

International scams are promoted aggressively in the PICs. These present enormous risk as the amounts involved are generally multiples of a country’s annual budget or external reserves. They have worked, in a number of cases, mainly through the active involvement of corrupt leaders within a country.
The approach is standard. The promoters of a scam insist on secrecy and on negotiating only with political leaders and ministers, keeping out central bank and treasury officials, lawyers, and accountants, who tend to ask searching and awkward questions. Typically, the scams promise much but ask for certain payments upfront. Scams so far attempted and over which substantial sums have been lost include:

- the promise of substantial external loans on ridiculously soft terms, with promoters demanding and receiving upfront fees for “services to be rendered”;
- the promise to build a multimillion-dollar power plant as a gift with the issuance of promissory notes by the central bank to the promoters when the agreement is executed; and
- the issuance of letters of guarantee by the government and the central bank to enable the promoters to raise hundreds of millions of dollars and invest the proceeds in highly lucrative investments, the income from which will be shared with the government.

Measures for countering these scams which have been recommended to governments in the PICs include:

- the establishment of a committee of officials with technical expertise to vet and negotiate with the promoters of such schemes;
- instructions from the cabinet to all ministers to refrain from dealing with such promoters and to refer them instead to the committee of officials.
- the vetting of promoters by international companies that provide such services for a fee; and
- cooperation among central banks and between central banks and other relevant bodies in establishing and regularly updating a databank of relevant information to assist in vetting promoters of scams who come into the region.
The Ombudsman

A number of constitutions in the PICs provide for the establishment of the constitutional post of Ombudsman. To allow independence for the post, the appointment is made by the head of state in consultation with the government and selected leaders. The powers vested in the post vary considerably from country to country.

The case of Vanuatu presents a useful model which other countries could adapt for their own use. A comprehensive Leadership Code spells out in some detail the standards of behavior for leaders. The powers of the Ombudsman are provided in the Constitution and in a separate legislation, the Ombudsman Act. The Ombudsman administers and polices the Leadership Code, and investigates leaders, including ministers, politicians, public officers, directors, and executives of statutory bodies and public-sector enterprises. Investigations can be initiated either upon the receipt of complaints from the public, or at the Ombudsman’s own initiative. The Ombudsman’s reports are submitted to the Prime Minister and the Director of Public Prosecution. Sanctions imposed as a result of these reports include:

- loss of position;
- criminal proceedings; and
- civil action by the state, members of the public, or other entities.

As elsewhere in public financial management, having comprehensive legislation is certainly important, but the effectiveness of the post of Ombudsman depends critically on the person who occupies it and the strength and integrity of the police, the office of the Director of Public Prosecution, and the judiciary. This leads us to the next part.
Other Issues

A well-thought-out legislative framework is a necessary condition but is not sufficient for sound public financial management. Legislative provisions are not always complied with, either because of ignorance or because of simple lack of enforcement by the political leaders and public servants.

Public officers, particularly heads of ministries and departments, are required to know the financial rules and to administer them firmly and strictly. They have the duty to tell the ministers what they can or cannot do under the law. This brings to the fore the need for constitutional provisions that entrench the independence of the public service from political interventions.

Training of legislators, and particularly the members of the legislative committee on audit, is critically important.

The treasury and the auditor general’s officers need to have terms and conditions that recognize the urgent need for acquiring qualified and experienced accountants. Training programs also need to be emphasized not only in these departments but also in the budget and accounting sections of the spending ministries and agencies.

The accounting and treasury operations of the government should be progressively computerized. And the bureau of statistics needs to be strengthened to assist in the formulation and ongoing review of the macroeconomic framework and the formulation of sound economic, financial, and social policies for the government.

These are only some of the many possible measures to strengthen public financial accountability and reduce the opportunities for corruption, particularly for small, open island economies such as in the Pacific. It is quite clear in any event that problems need to be diagnosed openly and realistically, and a range of actions taken to address those problems that are particularly important in the country concerned. Many countries now recognize this, and it is hoped that this recognition will expand with the assistance and encouragement of the international community.
Chapter 10

Public Financial Accountability for Integrity and Results: The Case of the Philippine Bureau of the Treasury

Leonor Briones*

Introduction

This paper describes the formal mechanism in the Philippines for ensuring public financial accountability, and examines in detail an agency that plays a crucial role in public financial accountability, the Bureau of the Treasury. At the same time, it goes beyond the formal system and places great importance on the role of media and civil society, as well as information technology.

The first section of the paper examines the concept of accountability in public finance as developed in the Philippine experience, starting with the constitutional provisions on accountability. As in other countries, the Constitution is the basis for all laws, rules, and regulations that govern the conduct of the government and the rights of citizens in the Philippines. The second section explains how accountability promotes

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aggregate fiscal discipline in the Philippines and describes various institutional mechanisms to ensure fiscal discipline. We next deal with accountability and the strategic allocation of budgetary resources, the link between planning and budgeting, then a discussion of the crucial role of leadership in promoting financial accountability. To make the general discussion more concrete, the paper then looks at the Philippine Bureau of Treasury (BTr) as an illustration of how financial accountability works in practice. Two specific components of the BTr system are noted: the electronic auction of Treasury bills and bonds, and the Registry of Scripless Securities. The last section presents some conclusions.

Accountability in Public Finance

In the words of Francisco S. Tantuico Jr., former chairman of the Commission on Audit of the Philippines: “Public accountability is the foundation of integrity. It cuts to the soul of government. It unmasks the government of the day of whatever façade it wears.” The Constitution of the Philippines describes public accountability thus:

Public Office is a public trust. Public Officers and employees must at all times be accountable to the people, serve them with utmost responsibility, integrity, loyalty and efficiency, act with patriotism and justice and lead modest lives.

And Ledivina V. Cariño, dean of the National College of Public Administration and Governance of the University of the Philippines, defines accountability as:
...the evolution of the actions of appointed career officials in terms of whether their actions are within or outside the bounds of their authority. It may be promoted through the imposition of external controls and through the inculcation of self-regulating values.¹

Dean Cariño identifies the different levels of administrative accountability as: (i) traditional accountability, which focuses on the regularity of fiscal transaction and faithful compliance as well as the adherence to legal requirements and administrative policies; (ii) managerial accountability, which is concerned with efficiency and economy in the use of funds, property, manpower, and other resources; (iii) program accountability, which pays attention to the results of government operations; and (iv) process accountability, which emphasizes procedures and methods of operations.

Public financial accountability and audits

Public financial accountability is promoted primarily through the conduct of regular audits. Traditional audits include legal and compliance audit. These are generally limited to audits that examine the legality of financial transactions as well as compliance with established rules, regulations, and procedures. Performance audits look into actual outputs of agencies in relation to programmed goals. Concepts of performance audit have been further developed into program results audit and value-for-money audits.

Financial accountability and reporting

Reporting to oversight entities, the President, the legislature, and the public is an important and indispensable component of financial accountability. In the Philippines, specific laws require all heads of offices and agents of government to submit reports on the status of their accomplishments. This or may or not always happen.

R.A. No. 6713, the Code of Conduct for Civil Servants in the Philippines, which was issued on 20 February 1989, requires all heads of offices and agencies of the government and government-owned or -controlled corporations (GOCCs) to submit and render their annual performance reports.

Section 62 of Presidential Decree No. 1177, a law that has become a part of the Philippine Administrative Code of 1997, also requires all heads of agencies and offices of the government to submit a semiannual report of their accomplishments, both work and financial results, to monitor the efficiency and effectiveness with which budgeted funds are being utilized.

Furthermore, individual audits of all government agencies and instrumentalities are consolidated into three main reports: the consolidated audit reports on national government agencies, GOCCs, and local government units. These audit reports are submitted to both houses of Congress (the House of Representatives and the Senate), as well as to the President of the Philippines. These are also open to the public.

Strengthening financial accountability: The role of the media and of civil society

Reports that are regularly submitted to the different oversight agencies of the government as well as to the legislature and the executive compose the formal reporting system. It is assumed that these reports eventually reach the public.

However, increased participation of civil society in governance has resulted in greater public concern for financial
accountability. Thus, the public expects and demands that it be informed regularly and promptly on the financial status of the government, as well as the performance of financial agencies.

The media—radio, television, and print media as well as electronic media—serve as an essential conduit for informing the public. Because of their reach and access to different sectors of society, the media are frequently utilized as a mechanism for speedy and timely reporting to the public on government operations.

Thus, reports that are regularly submitted to different oversight institutions promptly reach the public. Examples are the regular cash operations report on revenues, expenditures, and the cash deficit in relation to programmed goals; the report on the state of the public debt; and the quarterly reports on economic performance.

Since these important reports reach the public at the same time that oversight officials receive them, public reaction is instantaneous. Oftentimes, public debates ensue, impelling officials to explain to the citizens the meaning and implications of developments in the financial system. There have been occasions when policies have been modified in response to public reaction.

The impact of increased public participation in finance through the media is twofold. First, the public is kept up-to-date on financial policies, programs, and accomplishments. It is able to react and even debate with policymakers. Secondly, public officials now recognize that their ultimate accountability is not only to oversight institutions but to the public itself. They learn to consult affected sectors of society and to communicate with them.

As noted earlier, civil society is now increasingly concerned with governance, particularly accountability. Crises of global proportions, e.g., global environmental concerns as well as regional economic crises, have mobilized civil society into pushing for national, regional, and even international action. In the Philippines, the impact of the Asian financial crisis on
the Philippines has sensitized Filipinos to the risks of overborrowing and lack of accountability. The state of the economy and its financial status have become the subject of intense public interest. Public officials are often called to account for their performance or the lack of it.

In recent years, the Philippines has had one of the most dynamic civil societies. Nongovernment organizations, private voluntary organizations, and political movements have been instrumental in bringing to public attention issues of public finance and accountability. Very often, because of their grassroots orientation, they have the capacity to translate complex economic and financial issues in terms that are understandable to the man or woman on the street. These macro issues are the everyday concerns of ordinary citizens.

The heightened role of media and civil societies has led agencies to report directly and immediately to the public, thus eliciting immediate public response. While the law does not explicitly require this, it has broadened concepts of public accountability far beyond formal requirements, and enables civil society to exact accountability directly from officials responsible for maintaining the financial system of the country.

**How Accountability Promotes Aggregate Fiscal Discipline**

In the Philippines as well as in other countries, formal mechanisms ensure accountability and promote fiscal discipline. The Development Budget Coordination Committee is one such mechanism. It is composed of the Department of Budget and Management (DBM), the National Economic and Development Authority, the Department of Finance (DOF), the Bangko Sentral ng Pilipinas, and the Bureau of the Treasury. It provides the linkage between planning and budgeting and establishes the aggregate targets for the annual government expenditure program and ceilings of government spending for the various sectors.
Another mechanism that promotes financial accountability in the Philippines is the Cash Programming and Monitoring Committee (CPMC), created in accordance with the DOF-DBM Circular No. 1-90A on 19 November 1990. It is headed by the Treasurer of the Philippines. The CPMC was created to provide closer coordination between DOF and DBM in the release of funds based on the short-term calculation of cash availability. It is directly responsible for controlling the release of the Notices of Cash Allocation vis-à-vis the inflow of revenues, as well as ensuring that the deficit target is not exceeded. The CPMC also facilitates the management of cash balances by the Bureau of the Treasury and rationalizes the flotation of government securities while encouraging agencies to optimize cash utilization in the implementation of priority programs and activities of the government.

At the level of the Bureau of the Treasury, the Cash Flow Committee is a formal mechanism to ensure fiscal discipline, by monitoring cash operations and the level of debts on a day-to-day basis.

An effective public accountability system promotes aggregate fiscal discipline. Two features of such a system make this possible. First is efficient and effective monitoring and reporting as required by law, rules, and regulations. In the Philippines, two crucial reports on fiscal performance are submitted monthly. These are the cash operations report and the report on the public debt.

The cash operations report is submitted by the Treasurer of the Philippines to the Secretary of Finance. It contains information on levels of revenue, expenditure, and borrowing on a monthly basis, thus allowing fiscal performance to be monitored on a monthly basis. Shortfalls in revenue, as well as excesses in expenditure, are immediately pinpointed and corrective action is undertaken. The report also enables policymakers to identify well-performing as well as underperforming agencies, leading to corrective action or to agency commendation, thus exercising fiscal discipline on a
timely basis and dealing with problems before they get out of hand.

Second, fiscal discipline is enhanced by regular monitoring done by media and civil society. Mention was earlier made of two reports that are submitted monthly by the Bureau of the Treasury: the cash operations report and the report on the public debt. Days before these reports come out, members of the media bombard the BTr and the Department of Finance with calls, to get the numbers first and come out with scoops. Once the reports are out, the results are avidly discussed on radio, TV, and print media. Civil society organizations then take over and put pressure on policymakers if performance has been less than satisfactory.

At present, the Bureau of the Treasury prepares preliminary reports every two weeks to keep the Secretary of Finance update. This enables him to take immediate action if there are danger signs.

Because timeliness is very important in fiscal performance, and again because these two reports are regularly expected by the media and civil society, the Treasurer personally oversees the preparation of these reports and constantly thinks of ways to improve them and make sure they are submitted on time.

Constant watching by media and civil society makes fiscal agencies more sensitive to public reaction and enhances discipline. As a result, both the Bureau of the Treasury and the Department of Finance keep an eagle eye on fiscal performance, knowing that the size of the monthly cash deficit is considered by the public as an indicator of good performance as well as fiscal discipline.
Leadership and Public Financial Accountability

In addition to formal mechanisms, media, and civil society, leadership plays a crucial role in promoting financial accountability.

The National College of Public Administration and Governance pioneered studies on graft and corruption in the Philippines, which further led to a wide array of research on the topic. The role of leadership in bringing about public financial accountability was a common finding of these studies. Agencies identified as “flagships” of accountability were known to be headed by people who themselves actively initiated strategies and tactics to bring about accountability.

The Philippine Bureau of the Treasury (BTr)

The functioning of the BTr illustrates how the combination of formal mechanisms, media, civil society, and leadership can bring about financial accountability in the Philippines. The BTr is a member of the cluster of agencies within the Department of Finance. It is known as the custodian of all government funds. But the functions of the Bureau are not limited to this. The BTr is also very active in national policy formulation, particularly in financial management, public borrowing, and capital market development. On the operations side, the Bureau is responsible for the management of the assets and liabilities of the national government, as well as the fidelity bonding of all accountable government officers and/or personnel. The Bureau also prepares the annual financing program of the national government.
The BTr information system and its role in promoting accountability

Timeliness is of the essence in promoting accountability. Opportunities for graft and corruption usually abound where there is inefficiency and delay. Appropriate information technology can reduce and even eliminate these opportunities because chances for negotiation and bargaining are reduced. Decisions are made faster and are more transparent.

The role of information technology is illustrated in two major features of the BTr information system wherein opportunities for misbehavior have been reduced to zero. These are the electronic auction of T-bills and -bonds, and the Registry of Scripless Securities. When the information technology system of the Bureau was not yet in place, auctions of Treasury bills took two days. The process was laborious and cumbersome as bids were all written down on boards by at least 30 personnel and required computations using simple calculating machines. Bidders were informed of the results of the auctions only a day after the bidding. With the setting up of the Automated Debt Auction Processing System (ADAPS) and the Registry of Scripless Securities (ROSS) in the Bureau, the new auction process minimizes the risk of loss as a result of delays in the submission of bids and facilitates the process of decision making.

At present, the electronic auction of T-bills and -bonds is done primarily through the Automated Debt Auction Processing System. ADAPS was developed with the assistance of the Policy Training and Technical Assistance Facility. Considered to be among the most advanced systems in Asia, ADAPS facilitates the much faster processing of auctions in T-bills and -bonds in the Philippines. Largely because of ADAPS, delays caused by floods, traffic, and force majeure in the auction process are eliminated. Most importantly, ADAPS promotes greater transparency in the auction operations as it enables faster decision making in the rejection or acceptance of bids and lessens the opportunities for consultations among bidders. The whole
auction process takes only about five minutes. Through ADAPS, all bids on Treasury bills and bonds are submitted promptly, enabling the Auction Committee to decide whether or not to accept the bids. In another ten minutes, bidders are informed of the results of the auction.

The Registry of Scripless Securities maintains the registry of all securities transactions. As the term implies, it is a system designed to facilitate the scripless trading of government securities. Like ADAPS, ROSS provides greater transparency in all transactions involving government securities and minimizes the risk of loss from accidents and theft.

**Conclusion**

Fiscal and financial outturns depend on a variety of factors other than the financial accountability systems. However, the accomplishments in the Philippines in recent years owe much to the working system of financial accountability. To conclude with just one concrete example, the typical government agency is usually clogged with pending cases involving discipline and accountability. However, when the current Treasurer of the Philippines assumed office, she was delighted to learn that there was only one pending case in the Bureau. This case involved the breaking of the plastic cover of the finger-scanning machine and an amount of ₱1,000. Considering the fact that Treasury operations include the entire national budget of over ₱565 billion, only one pending case of administrative discipline would seem like a near miracle.

The Philippine experience, specifically the Bureau of the Treasury, has shown that public financial accountability can be achieved through a combination of the following factors:

- strong legal basis, organizational structure, rules, regulations, and procedures;
- regular monitoring and reporting to the public through the media and civil society organizations;
• appropriate information technology system and
timely processing of reliable information; and
• strong leadership committed to ensuring public fi-
nancial accountability—a leadership committed to
promoting good governance.

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Annex I

AN ANTI-CORRUPTION POLICY FOR
ASIA AND THE PACIFIC

The problem of corruption, here defined as the misuse of public or private office for personal gain, is an ancient one that can be found in every government. It can also be found in the private sector, and in the interactions between the public and private sectors. A balanced approach to combating corruption must address both sides of the equation, and make it more difficult and risky for those who would give bribes as well as those who would receive them.

Recently, a powerful combination of factors has emerged in donor and recipient countries that is providing momentum to the global anticorruption effort. At the same time, the latest empirical analysis is demonstrating that although the effects of corruption are complex and varied, it clearly exerts a negative impact upon development. As a result, the environment in which multilateral development banks (MDBs) operate has changed. Pressure for more active measures against bribery and graft is no longer likely to be isolated and sporadic, but will remain an important element of the broader debate over good governance and sound development management.

As a major multilateral development institution and one of the leading sources of development funding in the Asian and Pacific Region, the Asian Development Bank (ADB) welcomes this emphasis on anticorruption initiatives as part of its broader work on governance issues. The Bank’s Board paper, “Governance: Sound Development Management”, recognizes the importance of accountability for public officials, and

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transparency and predictability in government operations—critical principles in the fight against corruption.\textsuperscript{2}

At the broadest level, the Bank’s anticorruption policy is intended to reduce the burden that widespread, systemic corruption imposes upon the governments and economies of the region. More specifically, the Bank’s policy is centered upon three objectives:

- Supporting competitive markets, and efficient, effective, accountable, and transparent public administration as part of the Bank’s broader work in governance and capacity building;
- Supporting promising anticorruption efforts on a case-to-case basis and improving the quality of the Bank’s dialogue with its developing member countries (DMCs) on a range of governance issues, including corruption; and
- Ensuring that the Bank’s projects and staff adhere to the highest ethical standards.

The bulk of the Bank’s effort will be directed toward broader measures to improve the quality of governance in the DMCs. This effort will have two components. The first will seek to reduce the scope of direct government intervention in the economy, in the belief that markets should be efficient and competitive, and have as few barriers to entry and exit as possible. This will reduce the opportunity for firms or officials to take advantage of artificially restricted markets or suboptimal pricing to demand monopoly rents.

The second component will focus upon supporting improvements in public administration and public sector management. Efforts to strengthen management information systems, for example, should enhance transparency and ac-

countability, and strengthen the capacity of governments to monitor their expenditures. Measures to strengthen audit functions or to ensure adequate control over disbursements can play the dual role of helping to improve performance while making theft and embezzlement more easily detected. Procurement reform, which the Bank is already pursuing in a number of the DMCs, can reduce costs while making fraud and abuse more difficult to perpetrate. Steps to strengthen civil service establishment management will help to eliminate “ghost employees”, and efforts to decompress pay scales and improve employment conditions will lower the incentive for illicit behavior. Measures to improve procedures for recruitment and promotion should help avoid abuse of patronage, nepotism, and favoritism, and help foster the creation of an independent, meritocratic civil service. The reengineering and streamlining of business processes can improve the efficiency and effectiveness of the public sector while simultaneously reducing opportunities for corruption.

In advancing such initiatives, the Bank affirms its desire to adopt a proactive and not a reactive stance. Most priority governance initiatives will have significant positive externalities that will make corrupt behavior more difficult to engage in and more readily detected once it occurs. Over the longer term, the Bank is likely to be much more effective if it focuses its anticorruption efforts upon measures for prevention and not on short-term efforts aimed at prosecution.

The Bank may also be called upon to assist the DMCs in pursuing an explicit anticorruption program. Bank assistance will be guided by three considerations: (i) the extent to which Bank assistance is requested by the DMC; (ii) the degree to which the request is consistent with the Bank’s broader country operational strategy and ongoing efforts in the field of governance and capacity building; and (iii) the extent to which the request falls in an area where the Bank has expertise. Under this element of the policy, the Bank may also support regional anticorruption initiatives or anticorruption-related research.
ADB staff should exercise caution in addressing several sets of initiatives that will typically remain beyond the Bank’s scope of involvement. They include efforts to influence the domestic debate within the DMCs regarding an anticorruption strategy or set of anticorruption initiatives; anticorruption programs that are highly politicized in nature and targeted at a particular individual or political party; and initiatives that are largely cosmetic and designed to foster the illusion of progress without the substance. To ensure consistency with the Bank’s Charter, any anticorruption initiatives supported by the Bank must be apolitical in nature and motivated solely by essential economic considerations or concerns about the probity of Bank operations.

The Bank has several mechanisms for engaging in dialogue with the DMCs on issues of governance (including corruption), ranging from the country operational strategy and the country assistance program discussions, to country portfolio review missions, to project appraisal, implementation, and review missions. Bank staff charged with country strategy and program formulation, including the drafting of the country operational strategy and country assistance program documents, as well as staff responsible for loan or TA projects, should address corruption in the context of broader governance and capacity-building issues. They should be knowledgeable about issues of corruption and its impact within their particular geographic and/or sectoral sphere of operations. They will use these mechanisms to discuss and recommend ways in which the Bank can help advance the principles of sound development management, including measures that would help to combat corruption, in any country where corruption affects Bank projects and the country’s general prospects for economic growth.

Country portfolio review missions and project review missions may provide a useful venue for discussing the policies and practices that impede the efficient implementation of Bank projects. Under most circumstances, staff who suspect that
corruption may have occurred or may be occurring within a given Bank project should follow the procedures outlined in paragraph 64 of this document and report the matter to the Office of the General Auditor, who will determine the optimal course of action. In rare cases where rapid follow-up actions may be needed, staff can address such issues explicitly with the relevant company, executing agency, or appropriate investigative agencies after clearance from their director and, the Office of the General Counsel (OGC). Any discussion with a given firm or government agencies should, however, be limited to a specific Bank operation or set of operations.

If the Bank’s efforts to reduce illicit behavior among its DMCs are to be credible, it is essential that Bank staff be beyond reproach and the Bank’s internal regulations and procedures support the highest ethical standards. Toward this end, the third pillar of the Bank’s anticorruption policy calls for more robust internal measures to enhance the integrity of Bank operations along five dimensions: (i) maintaining the integrity of Bank lending and TA operations; (ii) strengthening the Bank’s procurement policy; (iii) updating the Bank’s Code of Conduct and creating independent internal reporting mechanisms to address allegations of corruption among Bank staff or within Bank operations; (iv) improving the quality of oversight for Bank loans and TA grants; and (v) ensuring that all Bank staff are familiar with the anticorruption policy and act in a manner consistent with both the letter and the spirit of the policy.

If there is credible evidence of corruption in a Bank-financed loan or TA grant, the Bank will address the issue in a dialogue with the DMC. Breaches of specific loan regulations or covenants could result in a decision by Management to blacklist the firm involved, suspend disbursements, or cancel the loan. In keeping with the evolving practice of IMF and the World Bank, Management and staff will consider issues of corruption more explicitly in the formulation of the country operational strategy and the country assistance program. Cases may occur in which corruption has reached such proportions
that it poses a significant impediment to the probity of Bank operations or the attainment of a country’s fundamental development objectives. Under such circumstances, Management could elect to lower or suspend Bank lending and TA operations to that country after consultation with the country and the Board.

Conversely, situations may also exist where a given country has made significant progress in improving the efficiency, effectiveness and integrity of its public and private sectors. Under such circumstances, Management may elect to accelerate the lending program or provide additional TA resources to ensure sustainability for the reforms.

In the light of the complex and highly differentiated nature of corruption, it is important that Bank Management and staff be granted some degree of flexibility in dealing with individual cases within the parameters laid out in this policy. While acknowledging the need for fairness and consistency in its operations, and strongly affirming the importance of a “zero-tolerance” policy when credible evidence of corruption exists among Bank staff or projects, the Bank notes that different types of corruption will require different responses. There is a need for careful judgment based on accurate information and the specifics of the situation. The Bank’s anticorruption effort will place particular emphasis upon the implementation of practical and cost-effective prevention control measures, in a fashion consistent with the Charter principle of “economy and efficiency.”

An Anticorruption Task Force under the leadership of the Project Coordination and Procurement Division was recently convened to examine Bank procurement policy. Having taken into account the advantages of harmonizing the anticorruption effort among the MDBs with regard to procurement and the engagement of consultants, the Bank will introduce anticorruption provisions effectively identical to those adopted by the World Bank in respect of rejection of proposals, loan cancellation, declaration of ineligibility, and inspection rights. The Bank
will also introduce an optional “no-bribery pledge” in the bid form that will be similar to that of the World Bank. It will also introduce a mandatory clause that, when the contract is to be financed wholly or partly by the Bank, the contract documents shall include an undertaking by the contractor that no fees, gratuities, rebates, gifts, commissions, or other payments, other than those shown in the bid, have been given or received in connection with the procurement process or in the contract execution. Following the adoption of the anticorruption policy paper by the Board, provisions to this effect will be incorporated in the Bank’s “Guidelines for Procurement” and the “Guidelines on the Use of Consultants by the Asian Development Bank and its Borrowers” and submitted to the Board for approval. The “Guidelines” will be supplemented by provisions in the Bank’s loan regulations allowing the Bank to cancel loans where there is evidence of corruption or fraud in connection with the award of a contract being financed by the Bank.  

With regard to the Bank’s internal policies and procedures, several measures are necessary to ensure that they are consistent with those of other MDBs and evolving best practice. Currently, there are no independent channels whereby Bank staff can report possible incidents of corruption and have them investigated. Under this policy, OGA will serve as the initial point of contact for allegations of fraud and corruption among Bank projects or staff. In consultation with the Strategy and Policy Office (SPO), OGC, the Budget, Personnel, and Management Systems Department (BPMSD), Central Operations Services Office (COSO), and other relevant departments, OGA will consider appropriate measures to be adopted under this policy to ensure that all Bank staff and projects adhere to the highest standards of ethical conduct.

In May 1998, Management approved revisions to Administrative Order No. 2.02, Section 4, which contains the Code of Conduct outlining staff ethical duties, rights, and responsibilities in greater detail than was previously the case.

The Bank will undertake a number of measures to improve the quality of project monitoring and audit. The capacity of OGA will be strengthened to enable it to address anticorruption issues effectively. Specialized training in forensic accounting and other investigative techniques will be provided, which will also be extended to select financial analysts and project implementation officers. Ongoing OGA efforts to streamline internal work procedures to free up greater resources for audits of high-risk and high-impact areas will continue. OGA will devote more time to conducting audits of project procurement—related activities, which will help prevent and detect corruption or other forms of fraud. OGA will strengthen its exchange of information with supreme audit institutions in the DMCs, and—working in collaboration with other Bank departments—it will play an active role in assessing the need to upgrade the audit capability of such institutions.

The relevant sections in the “Project Administration Instructions” and the Loan Disbursement Handbook will be revised to require that qualified accountant(s) be recruited by the executing or implementing agency, and that robust internal control systems and accounting systems be in place for a project before loan disbursement can be made. Greater resources will be made available for upgrading the quality of project monitoring and implementation missions. Consideration will be given to the design of appropriate efficiency indicators, which will be utilized in monitoring financial and physical progress on a quarterly basis. The quality of the Bank’s management information systems will be enhanced to provide managers with more timely information for monitoring project processing, loan administration, and the status of mission budget utilization.

These measures will be ineffective if Bank staff are unfamiliar with the provisions of the Bank’s anticorruption
policy and Code of Conduct or fail to exercise due diligence in the performance of their duties. While it is not the intention of this policy to turn Bank staff into “police officers”, or to make the objective of reducing corruption paramount over other development goals, all departments and staff have a strong obligation to ensure the integrity of Bank operations within their respective areas of responsibility. Bank staff should familiarize themselves with the content of this policy and staff guidelines, and be prepared to respond appropriately as required.

In conclusion, this paper recommends a number of concrete actions to establish the Bank’s anticorruption policy. These measures can be broken down along three lines: recommended revisions of Bank policy and staff guidelines, new programming initiatives, and administrative changes.
I. Clarity of Roles and Responsibilities

1. The government sector should be clearly distinguished from the rest of the economy, and policy and management roles within government should be well defined.

   • The boundary between the government sector and the rest of the economy should be clearly defined and widely understood. The government sector should correspond to the general government, which comprises the central government and lower levels of government, including extrabudgetary operations.

   • Government involvement in the rest of the economy (e.g., through regulation and equity ownership) should be conducted in an open and public manner on the basis of clear rules and procedures, which are applied in a nondiscriminatory way.

   • The allocation of responsibilities between different levels of government, and between the executive branch, the legislative branch, and the judiciary, should be clearly defined.

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• Clear mechanisms for the coordination and management of budgetary and extra-budgetary activities should be established, and well-defined arrangements vis-à-vis other government entities (e.g., the central bank, and state-controlled financial and non-financial enterprises) should be specified.

2. There should be a clear legal and administrative framework for fiscal management.

• Fiscal management should be governed by comprehensive laws and administrative rules applying to budgetary and extrabudgetary activities. Any commitment or expenditure of government funds should have a legal authority.

• Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.

• Ethical standards of behavior for public servants should be clear and well publicized.

II. Public Availability of Information

1. The public should be provided with full information on the past, current, and projected fiscal activity of government.
• The annual budget should cover all central government operations in detail and should also provide information on central government extra-budgetary operations. In addition, sufficient information should be provided on the revenue and expenditure of lower levels of government to allow a consolidated financial position for the general government should be presented.

• Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of key budget aggregates for the two years following the budget.

• Statements should be published with the annual budget giving a description of the nature and fiscal significance of contingent liabilities, tax expenditures, and quasi-fiscal activities.

• The central government should regularly publish information on the level and composition of its debt and financial assets.

2. A public commitment should be made to the timely publication of fiscal information.

• Specific commitments should be made to the publication of fiscal information (e.g., in a budget law).

• Advance release date calendars for fiscal reporting to the public should be announced.
III. Open Budget Preparation, Execution, and Reporting

1. Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

   • A statement of fiscal policy objectives and an assessment of sustainable fiscal policy should provide the framework for the annual budget.

   • Any fiscal rules that have been adopted (e.g., a balanced budget requirement and borrowing limits for lower levels of government) should be clearly specified.

   • The annual budget should be presented within a comprehensive and consistent quantitative macroeconomic framework, and the economic assumptions and key parameters (e.g., effective tax rates) underlying budget estimates should be provided.

   • Existing commitments should be distinguished from new policies included in the annual budget.

   • Major risks to the annual budget should be identified and quantified where possible, including variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g., financial restructuring).

2. Budget estimates should be classified and presented in a way that facilitates policy analysis and promotes accountability.
• Government transactions should be on a gross basis, distinguishing revenue, expenditure, and financing, and classifying expenditures on an economic and functional basis. In addition, expenditure should be classified by administrative category. Data on extrabudgetary operations should be similarly classified. Budget data should be presented in a way that allows international comparisons.

• A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.

• The overall balance of the general government should be a standard summary indicator of the government’s financial position. It should be supplemented by other fiscal indicators (e.g., operational balance, structural balance, and primary balance) when economic circumstances make it inappropriate to base judgments about fiscal policy stance on the overall deficit alone.

• The annual budget and final accounts should include a statement of the accounting basis (i.e., cash or accrual) and standards used in the preparation and presentation of budget data.

3. Procedures for the execution and monitoring of approved expenditures should be clearly specified.

• A comprehensive, integrated accounting system should be established. It should provide a reliable basis for assessing payments arrears.
• Procedures for procurement and employment should be standardized and accessible to all interested parties.

• Budget execution should be internally audited, and audit procedures should be open to review.

4. Fiscal reporting should be timely, comprehensive, and reliable, and should identify deviations from the budget.

• During the year, there should be regular, timely reporting of budget and extrabudgetary outturns, which should be compared with original estimates. In the absence of detailed information on lower levels of government, available indicators of their financial position (e.g., bank borrowing and bond issues) should be provided.

• Timely, comprehensive, and audited final accounts of budget operations, together with full information on extra-budgetary accounts, should be presented to the legislature.

• Results achieved relative to the objectives of major budget programs should be reported to the legislature.

IV. Independent Assurances of Integrity

1. The integrity of fiscal information should be subject to public and independent scrutiny.

• A national audit body, or equivalent organization, should be appointed by the legislature, with
the responsibility to provide timely reports to the legislature and public on the financial integrity of government accounts.

- Macroeconomic forecasts (including underlying assumptions) should be available for scrutiny by independent experts.

- The integrity of fiscal statistics should be enhanced by providing the national statistics office with institutional independence.
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