PUBLIC EXPENDITURE MANAGEMENT HANDBOOK

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This handbook has evolved over the past two years. It reflects the contributions of many people. The handbook was coordinated by Malcolm Holmes, PRMPS. It draws heavily on the work of Ed Campos, Sanjay Pradhan, Ali Hashim, and Mike Stevens of the World Bank, and Bill Allan of the IMF. Other contributors include Allen Schick, Rob Laking, and Serif Sayin. Research support was provided by J.P. Singh and Shiro GnanaSelvan. Jane Armitage reviewed an early version of the handbook. Pascale Kervyn, Helga Muller, and Professor Philip Joyce reviewed the draft. Vicky Mendoza, Agnes Yaptenco, and Mariagracia Schierloh provided technical support and Barbara McGarry Peters edited the handbook. The report was produced by the Poverty Reduction and Economic Management (PREM) Network of the Bank under the guidance of Cheryl Gray.

Comments on the handbook should be addressed to Malcolm Holmes at the World Bank, 1818 H Street, Washington, D.C. 20433; telephone 202-473-7189, fax 202-522-7132, email address mholmes@worldbank.org. Additional material on public expenditure management, much of it elaborating on and updating material in the handbook, can be found on the Bank’s internal public expenditure web site. This web site will be regularly updated and it is intended to make it publicly available in the near future.
PART I

Guidelines for Improving
Budgetary and Financial Management
in the Public Sector
PART II

Diagnosing the Weaknesses and Improving Budgetary and Financial Management in the Public Sector
FOREWORD

Public expenditure issues are encountered wherever there is a discussion of government, the public sector, and development. Over the years, the World Bank has invested considerable resources in analyzing public expenditures and the impacts of different interventions on sustainable development. This work has both broadened and deepened our understanding of development priorities justifying government intervention.

This handbook highlights the fact that good analysis and sound policy are not enough to ensure sound and sustainable development outcomes. As was emphasized in the World Development Report 1997: The State in a Changing World, if the institutional arrangements—the rules of the game, both formal and informal—are not supportive or demanding of good performance, the results will not be sustainable on the ground.

Of particular interest is the concept of three levels of budgetary outcomes—aggregate fiscal discipline, strategic prioritization (allocative efficiency), and operational performance (technical efficiency). The need to pay attention to the interaction between these three levels, and to the institutional arrangements within which they are embedded, are compelling messages.

This handbook provides a broad framework for thinking about public expenditure management and how it affects budgetary outcomes. In addition, useful practical insights will reward the diligent reader. Those associated with the production of this handbook would acknowledge that this is not the final word on this subject. More empirical and theoretical work is needed. There is a particular need to understand the lessons from reforming OECD countries for Bank member countries. There is also the need to document the experience of developing countries and economies in transition if we are to have a fuller understanding of what works and what does not.

Masood Ahmed
Vice President
Poverty Reduction and Economic Management
INTRODUCTION

This handbook provides a framework for thinking about how governments can attain sound budget performance and gives guidance on the key elements of a well-performing public expenditure management (PEM) system.

The multiple purposes that budgeting serves - legislative control of the executive, macroeconomic stability, allocations to strategic priorities, managerial efficiency - make budget reform an ongoing task, a pilgrimage more than a destination. For any reform agenda, the handbook highlights the importance of the budget's interaction with other systems and processes of government. The handbook therefore focuses attention on three key principles that underpin a well-performing public sector: clarity in who has the authority to make what decisions, the matching of authority (flexibility) and accountability, and the capacity and willingness to reprioritize and reallocate resources.

PRINCIPLES OF SOUND BUDGETING AND FINANCIAL MANAGEMENT

The approach in the handbook is shaped by principles that focus on the institution\(^1\) and are widely accepted as underpinning sound budgeting and financial management.

**Comprehensiveness** and **discipline** lead the list. This is because the annual budget process is the only mechanism available, at least between elections, to discipline decision making. Comprehensiveness requires a holistic approach to diagnosing problems, understanding all the links and evaluating institutional impediments to performance and then finding the most appropriate entry point to launch phased reform that will eventually expand to become comprehensive. The budget must encompass all the fiscal operations of government and must also force policy decisions having financial implications to be made against the background of a hard budget constraint and in competition with other demands. Effective restraint requires comprehensive coverage, and choosing the most appropriate policy instrument to achieve a particular policy objective means that, for sound PEM, current and capital expenditure decisions need to be linked. Discipline, coupled with economy, also implies that the budget should absorb only the resources necessary to implement government policies.

**Legitimacy** means that decision makers who can change policies during implementation must take part in and agree to the original policy decision, whether it is made independent of or during budget formulation. Legitimacy also means that decisions made during the budget process should focus on those that affect policy. Associated with legitimacy is the principle that line agencies should decide how to make best use of inputs and that the community and the private sector should make decisions that they are best placed to make.

**Flexibility** is linked to the concept of pushing decisions to the point where all relevant information is available. Operationally, managers should have authority over managerial

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\(^1\) Institution is used in this handbook in the sense of the rules of the game - the humanly devised and socially shared constraints that shape human interaction. For a discussion of the implications of this approach, see “Introduction to the Guidelines for Assessing Institutional Capability” by Sue Berryman.
decisions and, programmatically, individual ministers should be given more authority over program decisions. This must be accompanied by transparency and accountability, but it also requires a tight strategy. Too often in the public sector, implementation is tight but strategy loose.

**Predictability** is important for efficient and effective implementation of policies and programs. The public sector will perform better where there is stability in macro and strategic policy, and funding of existing policy. This requires attention to the balance between the short term and long term. Fiscal policy must take account of the need to ensure the timely flow of funds to programs and projects. This requires a medium-term approach to the adjustment of budgetary imbalances, program development and evaluation.

**Contestability** in policy development and service provision is the quid pro quo for greater predictability as it ensures that existing policy is subject to review and evaluation and that line agency performance is subject to continuous improvement.

**Honesty** denotes a budget derived from unbiased projections of both revenue and expenditure. Sources of bias can be both technical and political. Optimistic projections soften the budget constraint on strategic priority setting and lead to a failure to implement priority policies efficiently and effectively.

**Information** underpins honesty and sound decision making. Accurate and timely information on costs, outputs and outcomes is essential.

**Transparency** and **accountability** require that decisions, together with their basis and the results and the costs, be accessible, clear and communicated to the wider community. Transparency also requires that decision makers have all relevant issues and information before them when they make decisions. Decision makers must be held responsible for the exercise of the authority provided to them. These are essential as quid pro quos for greater flexibility and also increase the demand for accurate and timely information.

**INSTITUTIONAL ARRANGEMENTS**

The handbook centers on improving institutional arrangements and management practices to create incentives for better resource allocation, resource use and financial management. The handbook illustrates effective institutional arrangements, but does not advocate a particular mechanism. It does, however, advocate that each country try to understand how its particular institutional arrangements impact on budgetary outcomes.

The approach has been influenced by the practice of both poorly performing and well-performing governments and by extensive research that builds on the theory of institutions. Theory and practice show that a country’s institutions - both formal and informal - have a decisive influence on budgetary outcomes at three levels:

- **Level 1:** Aggregate fiscal discipline
- **Level 2:** Allocation of resources in accordance with strategic priorities
- **Level 3:** Efficient and effective use of resources in the implementation of strategic priorities
The total amount of money a government spends should be closely aligned to what is affordable over the medium term and, in turn, with the annual budget; spending should be appropriately allocated to match policy priorities; and the spending should produce intended results at least cost.

The interdependence of the three levels is one of the most powerful findings of both practice and theory. The pursuit of aggregate fiscal discipline is often done in such a way as to undermine both level 2 and 3 performance - arbitrarily reordering priorities and devastating service delivery and operational performance more generally. Similarly, a lack of discipline and budgetary realism in making strategic policy choices leads to a mismatch between policies and resources, resulting in inadequate funding for operations. More positively, fiscal stability creates an environment that encourages sound level 2 and 3 performance. In turn, sound performance at these levels feeds back into fiscal stability.

*World Development Report 1997: The State in a Changing World* emphasizes the importance of reinvigorating institutional capability and on balancing restraint with flexibility:

State capability refers to the ability of the state to undertake collective actions at least cost to society. This notion of capability encompasses the administrative or technical capacity of state officials and of supporting systems and processes, but is much broader than that. It also includes the deeper institutional mechanisms that give politicians and civil servants the flexibility, rules and restraints to enable them to act in the collective interest.

**REFORMING PEM**

The handbook argues that improvements in PEM require:

- A greater focus on performance - the results achieved with expenditure. This has the potential to engage all stakeholders in pursuit of budgetary and financial management reform.

- Adequate links between policy making, planning and budgeting. This is essential to sustainable improvements in all dimensions of budgetary outcomes.

- Well-functioning accounting and financial management systems. These are among the basics that underpin governmental capacity to allocate and use resources efficiently and effectively.

- Attention to the links between budgeting and financial management systems and other service-wide systems and processes of government - for decision making, for organizing government, for personnel management. A well-performing public sector requires that all component parts work well and, where appropriate, together.
The handbook also provides guidance on how to recognize and deal with weaknesses in budgeting and financial management. It confronts concerns traditionally raised about donor-supported reform efforts. These include political commitment, the balance between simplicity and comprehensiveness, and country implementation capacity.

**Political commitment.** This clearly is important, but commitment does not occur in a vacuum. In many respects, political will is a function of the quality of the advice provided to politicians and the base of support for reform. Advocates of reform have to confront the reality that political interests are often served by non-transparent, non-accountable systems for resource allocation and use. Involving all relevant stakeholders by focusing on performance at all three levels of budgetary outcomes (aggregate fiscal discipline, prioritization and technical efficiency) is essential to changing the incentives of politicians. This also means that "big bang" reforms are less likely to succeed: the time frame for budgetary reform is not the short term, but the medium to long term. Whether donors contribute to undermining political will in particular situations also deserves attention.

**Simplicity/comprehensiveness.** This relates to keeping it simple. This is almost certainly true of reform efforts, but they must be based on comprehensive analysis. It is also true that reforming budgetary and financial management systems without paying attention to the other service-wide systems, processes and structures of government is likely to produce little change. An important aspect of comprehensive analysis is an assessment of the informal rules that might stand in the way of effective reform of the formal rules.

**Country implementation capacity.** An often heard refrain is to match reforms with implementation capacity. This is another form of the plea to keep it simple. A noteworthy dimension of this admonition is the need for donor coordination. The implementation capacity problem is importantly a function of donor demands. At the same time, the institutional approach taken in the handbook emphasizes expanding capacity by getting the incentives right. As a minimum, attempting to build capacity from the supply side without addressing the incentives embodied in the institutional framework will do little to improve performance. Building systems and processes that both encourage and demand performance will, in turn, unleash human and organizational capacity.

**WHAT’S WRONG WITH BUDGETING**

The decision to prepare this handbook came out of the continuing poor budget performance in many countries and draws strength from the improvement in budget outcomes over the past 20 years in a number of countries.

Poor performance is often to be found in the weak links between policy making, planning and budgeting (Box 1). At one level, policy making and planning are unconstrained by what a country will be able to afford over the medium term. At another level, policy making and planning are insufficiently informed by their budgetary implications and by their likely impacts in the wider community. The inadequacy of hard budget restraints on decision makers at the planning and budget formulation stage of the cycle leads to inadequate funding of operations, poor expenditure control and unpredictability in the flow of budgeted resources to agencies responsible for service delivery.
BOX 1
WEAKNESSES IN RESOURCE ALLOCATION AND USE

Weaknesses that undermine public sector performance include:

- Poor planning;
- No links between policy making, planning and budgeting;
- Poor expenditure control;
- Inadequate funding of operations and maintenance;
- Little relationship between budget as formulated and budget as executed;
- Inadequate accounting systems;
- Unreliability in the flow of budgeted funds to agencies and to lower levels of government;
- Poor management of external aid;
- Poor cash management;
- Inadequate reporting of financial performance; and
- Poorly motivated staff.

Readers will be all too familiar with the link between undisciplined fiscal policy and the resulting adverse consequences on the economy and on the poor - those least able to protect themselves. Less often is the link made between ineffective budgeting systems and unsustained policy choices and sectoral allocations delinked from strategic priorities. More rarely is the link made between poor budgeting systems and unsustained policy choices and sectoral allocations. Even where links are made, they rarely become a rationale for budget reform.

The inexorable growth of "investment projects" and public sector employment means that the annual budget process allocates extremely limited domestic resources to keep too many projects and activities alive. This places upward pressure on expenditure (manifested as arrears in many countries). The lack of comprehensiveness in the coverage of fiscal operations also leads to weak PEM systems. This is associated with a lack of transparency and the often well-founded assumption that there will always be some fund or donor to bail out the individual, the project, the program, the sector or the country. In turn, this soft budget constraint is reinforced by the lack of timely expenditure data and accountability mechanisms that focus attention on results.

Another characteristic of weak PEM is the incentive to spend budget allocations as soon as possible - there is no guarantee that the funds appropriated will be available later in the year. Perhaps the best indicator of the state of the PEM system is the relationship between what is budgeted and what is actually spent at the program level. Rather than looking for the problem in budget execution, reformers need to look at the relationship between policy making, planning and budgeting.

Poor aid management also signals a weak PEM system. Not surprisingly, countries heavily dependent on aid are more likely to have weak PEM. Major problems emerge from different priorities (not only between a donor and a country, but between donors) and the poor coverage of aid funding in the budget.
These weaknesses are not newly discovered. In 1980, Caiden wrote: "If ever there was a subject which has been overwritten, overanalyzed and overtheorized with so little practical result to show for the effort, it is budgeting in poor countries."

Box 2 outlines assumptions about budgeting in developing countries, as perceived by Caiden.

| BOX 2 |
| TEN COMMON (AND QUESTIONABLE) ASSUMPTIONS ABOUT BUDGETING IN DEVELOPING COUNTRIES |

- There is a common pattern of budgeting that will fit all circumstances.
- The aim of budgeting is economic planning.
- Improved budgeting depends on adequate resources.
- Budget decisions can be separated from policy decisions.
- Whatever is best coordinated is best.
- Comprehensive decisions are superior to partial decisions, and complex solutions are better than simple solutions.
- The prerequisites of budgeting are a matter of technique and will, rather than the product of environmental conditions.
- Politics are not as important as economics.
- Good budgeting is a matter of regulation.
- Budgeting is relevant to development.


The evolution of budgeting over the past 100 years has influenced the practice of resource allocation and use in all countries. It is easy to say that developing countries are different, but all countries need effective fiscal discipline, a capacity to allocate resources to strategic priorities and to use resources efficiently and effectively. It is reassuring that the key weaknesses that led to the burst of budget reform in OECD countries over the past 20 years all have their parallels in developing countries and economies in transition (Box 3).

Have we really learned anything in the past 20 years that justifies further writing, analyzing and, yes, even theorizing? We believe the answer is yes, and Schick's idea about "Getting the Basics Right" - discussed in the next section - gives us a clue as to why. What we have needed is a much broader view of what the basics are.
THE CHARACTERISTICS OF BUDGET SYSTEMS REQUIRING REFORM

Many of the weaknesses in budgeting reflect the failure to address linkages between the various functions of budgeting. The following factors contribute to budget systems and processes that create a disabling environment for performance in the public sector, both by commission and by omission:

- Almost exclusive focus on inputs, with performance judged largely in terms of spending no more, or less, than appropriated in the budget;
- Input focus takes a short-term approach to budget decision making; failure to adequately take account of longer-term costs (potential and real), and biases in the choice of policy instruments (e.g., between capital and current spending and between spending, doing, and regulation) because of the short-term horizon;
- A bottom-up approach to budgeting that means that even if the ultimate stance of fiscal policy was appropriate (and increasingly after 1973 it was not) game playing by both line and central agencies led to high transaction costs to squeeze the bottom-up bids into the appropriate fiscal policy box;
- A tendency to budget in real terms, leading either to pressure on aggregate spending where inflation is significant (which was often validated through supplementary appropriations) or arbitrary cuts during budget execution with adverse consequences at the agency level;
- Cabinet decision making focused on distributing the gains from fiscal drag across new spending proposals;
- Cabinet and/or central agencies extensively involved in micro decision making on all aspects of funding for ongoing policy;
- Last minute, across-the-board cuts, including during budget execution;
- Weak decision making and last-minute cuts cause unpredictability of funding for existing government policy; this is highlighted to the center by central budget agencies on the alert to identify and rake back "fortuitous savings;"
- Strong incentives to spend everything in the budget early in the year and as quickly as possible, since the current year's spending is the starting point for the annual budget haggle and the fear of across-the-board cuts during execution;
- Existing policy itself (as opposed to its funding) subject to very little scrutiny from one year to the next. (This and previous point epitomize the worst dimension of incremental budgeting);
- Poor linkages between policy and resources at the center, between the center and line agencies, and within line agencies because of incremental budgeting;
- A lack of clarity as to purpose and task and therefore poor information on the performance of policies, programs and services, and their cost because of poor linkages;
- The linking together (in association with the point above) within government departments of policy advising, regulation, service delivery and funding and an aversion to user charging; and
- Overall, few incentives to improve the performance of resources provided.
GETTING THE BASICS RIGHT

In 1997, Schick argued that the lesson for developing countries, from perhaps the most radical reform of the core public sector among OECD countries, was "Get the Basics Right" (Box 4). In other words, reformers should focus on the basics on which reform is built, not on particular techniques. This means that central budget agencies have to take the lead in putting in place the basics to support all three functions of the budget - control of public resources, planning for future resource allocation and management of resources - and should build institutional mechanisms that support and demand a performance orientation for all dimensions. "Getting the basics right" also means that there should be a balance between restraint and flexibility and recognizes that this will shift as the basics are embedded. Introducing mechanisms to promote transparency and accountability, key elements of the restraint framework, will check abuse of flexibility and generate demand for information. As chapter 5 emphasizes, however, budget reform is not something that can be neatly sequenced. Reform will attract the interest of decision makers where it is directed at solving a particular problem. Reformers must be opportunistic and use performance problems to drive a demand for "getting the basics right."

BOX 4
GETTING THE BASICS RIGHT

In elaborating his argument for "Getting the Basics Right," Schick states:

- Foster an environment that supports and demands performance before introducing performance or outcome budgeting.
- Control inputs before seeking to control outputs.
- Account for cash before accounting for accruals.
- Establish external controls before introducing internal control.
- Establish internal control before introducing managerial accountability.
- Operate a reliable accounting system before installing an integrated financial management system.
- Budget for work to be done before budgeting for results to be achieved.
- Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
- Have effective financial auditing before moving to performance auditing.
- Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

STRUCTURE OF THE HANDBOOK

The handbook is divided into two parts. Part I consists of five chapters.

Chapter 1 reviews the evolution of 100 years of budgeting practice, highlighting responses to the growing and multifaceted demands being placed on the budget. This chapter suggests that approaches to budgeting, resource allocation and financial management are constantly changing to reflect which of the three functions of budgeting is in the ascendancy - control of public resources, planning for the future allocation of resources or management of
resources. The Chapter focuses particularly on the lack of sustainability of budget reforms built around particular tools or techniques. Key messages are that reform efforts usually fail because they are incomplete and that public sector policy making, planning, budgeting, and management systems and processes must be integrated.

Chapter 2 elaborates the institutional arrangements that affect incentives for better budgetary outcomes, including mechanisms that improve aggregate fiscal discipline, strategic prioritization and operational efficiency. The chapter discusses the political nature of budgeting and the need to balance restraints with flexibility. Transparency and accountability figure importantly in this process. Transparency demands that the reasons for decisions and the results and costs of these decisions be accessible, clear and communicated to the wider general public. Transparency also means that decision makers should have all relevant issues before them when they make decisions. Accountability means that decision makers at all levels must be held accountable for the exercise of the authority (flexibility) provided to them. The chapter also argues that information on expenditure, costs and results is crucial to both decision making and effective expenditure control. The chapter ends by explaining how these concepts can be made operational at the three levels.

Chapter 3 deals in some depth with linking policy, planning and budgeting at both a sectoral level and across the whole of government. The chapter provides guidance on institutional mechanisms that facilitate the allocation of resources over the medium term based on strategic objectives. The chapter states that affordability must influence policy making, planning and budgeting early in the budget cycle and that adjustment will only be sustained where it takes place through policy change. A medium-term approach that encompasses all expenditure provides a linking framework and facilitates the management of policies and budget realities to reduce pressure throughout the whole budget cycle. The result is better control of expenditure and better value for the money within a hard constraint. Medium-term expenditure planning at the sector and government-wide levels are linked. Necessary components of the whole-of-government system include information on the costs of existing policies and programs over the medium term, a sense of what is affordable in aggregate over the medium term, and mechanisms to set priorities inter- and intrasectorally in the process of resolving the tensions between what is affordable and what is demanded.

Chapter 4 provides guidance on improving accounting and financial management information systems (FMIS), an essential part of an efficient PEM system. The chapter takes a modular approach to integrating a FMIS, starting with a core accounting system to meet basic information needs. The core would contain modules for accounts payable, accounts receivable and the general ledger. This system would support forecasting at the macro level, budget preparation and approval at the strategic level, and budget execution, core accounting and fiscal reporting at the operational level. Subsidiary systems that are also essential to a well-performing public sector are described - payment, cash, debt and civil service management systems, revenue administration, and auditing. With the core as a foundation, government could then expand as capacity developed to move toward a fully integrated FMIS.

Chapter 5 explains how current approaches to reform reflect the lessons of previous experience. This chapter argues that reform efforts fail not only because they are incomplete, but also because they are often designed to solve a technical problem when the problem lies in the institutional framework. The chapter suggests institutional changes that governments might need to make in the framework and points out that the changes are most likely to be successful where some overall vision of a well-performing public sector frames the reform
agenda. The chapter also suggests that sequencing take account of the state of the basics, but that reform proceed in parallel at the center of government and at the sector/organizational level. Central agencies focus on reforming the policy, planning and budgeting systems so that they are more supportive and demanding of a performance orientation, while sector and agency level bodies focus on developing outcome and output information, supported by cost information.

The key message of this chapter, and of the handbook, is that sustainable reform, whether it be comprehensive or concerned with one component of the system, will be built by considering all three levels of budgetary outcomes and the broader political, social and economic environment. The chapter concludes with a summary of the components of successful reform programs: aggregate, binding fiscal targets; incentives for better allocation and use of resources; autonomy of line agencies; and accountability of line managers. The conclusion also emphasizes the broader context within which reform is embedded and that a well-performing public sector requires: a clear understanding of who has the authority to make what decisions; the matching of authority (flexibility) and accountability; the capacity and willingness to reprioritize and reallocate resources.

Each chapter highlights in boxes particular concepts of sound resource allocation, budgeting or financial management, drawing on country experiences wherever possible.

Part II of the handbook contains diagnostic checklists and questionnaires for use by World Bank task managers and member countries to pinpoint country strengths and weaknesses in budgetary and financial management practices.
CHAPTER 1
DEVELOPMENTS IN BUDGET PRACTICE

An emerging consensus on the role of the budget across all countries centers on how the budget affects: (a) macroeconomic performance; (b) allocation of resources; and c) efficiency and effectiveness of resource use. This chapter reviews over a hundred years of budget reform, which contributed to the current consensus.

A HISTORICAL PERSPECTIVE ON BUDGET REFORM

The broad functions of budgeting that are competing for attention are: control of public resources, planning for the future allocation of resources and management of resources. The relative strength of each depends on the current view of the function of budgeting and budgeting tool and techniques, but also depends on the strength of particular organizations and/or institutional arrangements to support these functions. Throughout much of the century, Ministries of Finance and Central Banks (and the IMF) have been aggressive advocates of control of public resources. They have usually been supported by institutional arrangements whereby all revenues have to be paid into a central fund and only are drawn on by authority of the legislature. This helps explain why line item budgeting has been so enduring. Support for the other two functions has been much more ephemeral. Allen Schick’s argument in the Introduction, "Getting the Basics Right," i.e., focusing on the basics on which reform is built, not on particular techniques, means encompassing all three functions as legitimate and building institutional mechanisms that support a performance orientation for all of them. Central budget agencies have to take the lead in focusing attention on these three dimensions.

LINE ITEM BUDGETING

Prior to the late 19th century, budgeting in most countries was characterized by weak executive power, little central control and processes that were idiosyncratic. Traditional “line item” budgeting is itself a reform born of a concern that the lack of adequate spending controls was contributing to an environment where there was increasing danger of substantial corruption. For this reason, the budget reformers of the late 19th and early 20th century advocated budgeting systems that would promote accountability over the detailed use of resources. The early reform movement focused on the effective control of budget accounts, establishing economy and, to a lesser extent, efficiency as the primary values of budgeting.

In a line item system, expenditures for the coming year are listed according to objects of expenditure, or “line items.” These line items are often quite detailed, specifying how much money a particular agency or subunit will be permitted to spend on personnel, fringe benefits, travel, equipment, and the like. The most important focus of the budget system is to specify the line item ceilings in the budget allocation process and to ensure that agencies do not spend in excess of their allocations. In many systems, central budget offices and finance ministries play the role of “controller” through establishing detailed procedures designed to prevent overspending. The strengths of such a system lie in its relative simplicity, lack of ambiguity, and potential for control of
expenditures through easy comparison with prior years and through the detailed specification of inputs.

The line item approach was not compatible with the demands accompanying the expansion of government. Budgets organized according to line items gave no information about why money was spent, or on the efficiency and effectiveness of programs. Further, these line-item systems were almost all associated with a short time horizon, leading to failure to take longer-term costs into account. In addition, the focus on detailed line-item control led to micromanagement of agency budget implementation by central budget offices and finance ministries. Many subsequent budget reforms have attempted to remedy these deficiencies, first by focusing on management through a budgeting approach known as performance budgeting, and later by focusing on policy and planning through the more ambitious program budgeting. More recently, it has been recognized that the problem with budget structure is not so much with line item budgeting as with excessively tight ex ante control of the detail and the lack of a performance orientation in public sector institutions.

Performance Budgeting

This type of budgeting drew on a long-term concern with the efficiency of government and attempted to integrate information about government activities into the budget process so that budget decisions could be based to a greater degree on the relationship between what government did and how much it cost. The specific reform, known as “performance budgeting,” was designed to allow managers to develop measures of workload and unit cost.

A performance budget usually divides proposed expenditures into activities within each organization and a set of workload measures that relate the activity performed to cost. Performance budgeting allows the budget to be built, not incrementally (as in traditional line item budgeting), but on the basis of anticipated workload. Managers could arrive at a budget by simply multiplying the cost of a unit of output by the number of units needed in the next year.

Performance budgeting indicated a shift from budgeting based on expenditure control, to budgeting based increasingly on management concerns. The emphasis was not on making government-wide budgetary trade-offs, but on measuring the workload of an agency. The focus was on the work to be done, not on the usefulness of the objectives themselves. Performance budgeting was rarely adopted as a government-wide budgetary process, but is significant because it emphasized the integration of activity information and budgeting. This emphasis was to be continued in future reform efforts.

The major criticism of performance budgeting was that efficiency - an important goal in budgeting - is an inadequate criterion for allocation. One of performance budgeting’s key strengths - linking what was to be produced with the resources required within the annual budget cycle - was also a weakness in that it distracted attention from policy outcomes, which require a perspective beyond the annual budget cycle. What was needed, according to these reformers, was a method of budgeting that would also take into account the effectiveness of expenditures. These considerations led to program budgeting.
Program Budgeting

Beginning in the 1960s, reforms began to focus on planning for the use of public resources. The predominant early reform of this type, program budgeting, is most closely associated with the efforts to institute a planning-programming-budgeting system (PPBS) during the administration of U.S. President Lyndon Johnson. In this chapter, similar systems will be called program budgeting.

In contrast to performance budgeting, program budgeting was explicitly focused on budgetary choices among competing policies. While performance budgeting was designed to discover the most efficient method of accomplishing a given objective, program budgeting treated the objectives themselves as variable. Program budgeting was not a management system, but a resource allocation system. It was a specific alternative to the traditional manner of making budgeting trade-offs, which focused on marginal adjustments to the status quo. Program budgeting attempted to link program costs with the results of public programs.

Key to program budgeting is the program - a public policy objective along with the steps necessary to attain it. The budget is classified in terms of programs, rather than along organizational lines. Program budgeting requires that program objectives stretch beyond a single fiscal year. In addition, program budgeting requires effectiveness measures, which means the measurement of outputs and outcomes. Advocates of program budgeting hoped that budget allocation decisions would be made according to the marginal value that could be attained from varying use of public resources.

Program budgeting is the principal budget reform (beyond traditional line item budgeting) that has been exported to developing countries. In practice, program budgeting has not been very successful in either developed or developing countries. Criticisms range from those who believe that program budgeting is so flawed in concept that it would be inapplicable in any setting, to those who believe that the prerequisites that would be necessary to bring the reform to developing countries are currently not present.

The principal argument is that it flew in the face of existing budgetary traditions and relationships; in particular, many people strongly objected to the suggestion that the budget process, which is inherently political, could be made "rational." To these people, even the idea of a program (not at all self-evident) is political. Further, the effort often failed because the attempt to create programs independent of organizational affiliation proved impossible, in light of the incentives present for civil servants to think in organizational terms. Program budgeting has had an impact where programs have been agency or, at most, sector specific. In addition, critics argue that it is impossible to compare programs on the basis of effectiveness and choose among them, since there is no common index of worth for public programs.

Other critics do not see program budgeting itself as a flawed concept, but rather stress the conditions that are needed for program budgeting to be successful. These might include, for example, adequate information about programs and about social, economic and environmental conditions. Critics argue that these conditions are not present in many countries, thereby making it impossible for program budgeting to take root and flourish. In addition, they argue that developing countries often lack the trained personnel needed to carry out the requisite analyses, although this
point is usually exaggerated. More serious is the lack of stability necessary to enable longer-term budgetary planning and the lack of consistent political commitment necessary to allow the reform to be fully implemented. Boxes 1.1 and 1.2 present evidence for these criticisms, but particularly point out the lack of a necessary foundation for budget reform in Sri Lanka and Jamaica.

**BOX 1.1**

**PROGRAM BUDGETING IN SRI LANKA**

Sri Lanka engaged in budget reform in earnest beginning in 1969. This ultimately led to the widespread adoption of a system that closely paralleled program budgeting. By 1974, virtually the entire government was presenting the budget in a program budget format. By 1975, a modest amount of performance data was also being presented by each of the twenty-three ministries.

The program budgeting reform was spearheaded by a program budget unit, which was established in the Ministry of Finance in 1971. This unit issued guidelines on budget preparation, designed the required documentation, advised departments on the development of performance measures and objectives, and reviewed department performance against budgeted targets. By the mid-1970s, the Sri Lankan budget reform seemed set to succeed.

In 1977, the socialist government was replaced by a free-market focused government. The program budget unit was disbanded by the new government, depriving program budgeting of focus and impetus. Department budget offices continued to submit the required reports for a time, but the sanctions that had existed for failure to do so were eliminated and ministries became much more lax in their adherence. Further, by the 1980s, the government no longer had any method of forecasting cash flows. Following the recommendation of the IMF, each ministry was required to report monthly expenditures, but not in relation to programs or performance. Sri Lankan budgeting came full circle; cash flow budgeting triumphed over performance monitoring.

Program budgeting failed in Sri Lanka for these reasons: (a) the reform had found no powerful friends in the executive or the legislature; (b) there was a lack of skilled manpower to carry out the reform; (c) program budgeting occurred without important parallel financial and administrative reforms - particularly related to accounting and auditing - that might have sustained it; (d) the replacement of organizational structure with programs as the focus of decision making did not occur and, perhaps most important; (e) a rapid, comprehensive and centralized introduction of program budgeting was ill considered in the Sri Lankan administrative environment. A more cautious and selective approach would have increased the likelihood that the reform could have been sustained.

Source: *Government Budgeting in Developing Countries*, Chapter 6, Peter Dean.

However, the disappointments with program budgeting are not limited to developing countries. Many of the problems identified in developing countries contributed to disappointing results in developed countries as well. One problem is that such reforms can quickly be overwhelmed by the information they generate. Reforms linked to program budgeting also have a centralizing tendency that overwhelms the center and can alienate line agencies. Second, tools or techniques designed to enhance program or agency performance will only add value when they are introduced into a public sector where other institutional arrangements support a performance
orientation. Third, the performance information generated on program outcomes will be only one of the pieces of information feeding into resource allocation decisions. Too often there have been unrealistic expectations that the performance information will provide “the answer.” Even where a form of program budgeting has taken root, the links between annual budget allocations and longer-term policy outcomes are elusive.

**BOX 1.2**

**BUDGETING IN JAMAICA**

The Jamaica Public Administration Reform Project, approved by the World Bank Board in May of 1984, contained three components: human resource management, financial resource management, and line agency restructuring. The financial management reforms included US $600,000 to help the government convert from a line-item budget system to an output-oriented performance budget system.

This portion of the project was not considered a success. This is partially the result of poor project design, which did not recognize that the same problems that existed in the previous line-item system (poor organization, poor planning, and lack of expenditure and revenue forecasting ability) would impair a new system as well. The fact that accounts were kept only manually and in a line-item format was a significant impediment to the development of the new system. The starting point should have been a revamped accounting system, but no provision was made for this.

There were significant problems in implementation. The reports that were necessary for the operation of the system often either were not filed in a timely fashion, or not at all. The speed of implementation was satisfactory, but no corrective actions were taken in response to problems identified in the early phase. These included the fact that quantitative performance measures were often a very misleading proxy for the type and quality of goods and services provided. Budget presentation never translated into budget implementation nor into accountability for performance. Line ministries did not have commitment to the system, and the desire of the Ministry of Finance to hold ministries accountable for the use of line items undermined the reform to performance accountability.

Source: Project Completion Report, Jamaica: Public Administration Reform Project (Loan 2423-JM).

**Zero-based Budgeting (ZBB)**

In a “pure” ZBB system, a 1970s era reform, instead of concentrating on budgetary changes at the margin, all programs are evaluated each year. The process of arriving at a budget is literally to start from scratch. At the national level, that would require answering such questions as, “What if we didn't have an army and navy?” or “What if Social Security did not exist?” In practice, no government ZBB system went this far. Many more governments have used a variant of ZBB in which agencies were asked to rank their programs within funding limits. The question thus became, “What if the Ministry of Defense only received, e.g., 90 percent of the current year's funding?” This has not proved useful as an annual budget tool, although there have been examples where one-off use of this approach has been useful.
Advocates continue to suggest that the failures of these performance-oriented tools or techniques have been in implementation, rather than in concept. They contend that the system could succeed with strong political backing, a program of training, gradual introduction of the system, and complementary reforms that would encourage performance. Still, a truly successful performance tool or technique is hard to find anywhere, particularly at the central government level. What can be said is that where budgeting systems and processes are performance oriented it is because the institutional framework both encourages and demands performance. Such a framework embodies incentives for ministers to cooperate on key strategic decisions; for individual ministers to be given authority over program decisions and to be held accountable for living within their budgets; and for managers to manage, but the framework demands that they manage well.

The following chapters will focus on how all three functions - control of public resources, planning for future allocation of resources, and management of resources - can be addressed simultaneously and will emphasize the key role of institutional mechanisms that promote transparency and accountability. The focus will continue to be dominated by executive government. However, since the failure of many of the reforms based on the tools and techniques discussed above can be linked to their failure to address the interests of the full range of stakeholders who are affected by the performance of the budget, institutional mechanisms to engage these stakeholders are also highlighted. It is many of these latter factors that provide the incentives for politicians to take performance seriously.

The final chapter will argue that in considering the sequencing of reform, line item budgeting can be adapted to be a key component of a budget system and process that creates strong incentives for a greater performance orientation. It is one of the basics that has to be functioning effectively before more performance-oriented tools and techniques such as performance and program budgeting can be sensibly introduced. But the message of this handbook is that a performance orientation is not very much about particular tools, techniques or structures, but rather the appropriateness of a country’s institutional arrangements.
CHAPTER 2
INSTITUTIONAL ARRANGEMENTS FOR BETTER BUDGETARY OUTCOMES

The experience of the 100 years of reform, discussed in chapter 1, and important theoretical developments in the field of institutions have provided new insights into what goes into a well-performing budget system.

One is the acknowledgement that the budget has an impact on three levels of public sector outcomes:

1. aggregate fiscal discipline
2. resource allocation and use based on strategic priorities
3. efficiency and effectiveness of programs and service delivery

These three levels are a reformulation of the three functions - control of public resources, planning for the future allocation of resources, and management of resources - that have driven reform over the past 100 years.

A second insight is that institutional arrangements - the rules of the game, both formal and informal - influence the quality of the outcomes. Underlying the approach in this handbook is the premise that resource allocation is fundamentally political and that budgeting plays a key role in disciplining decision making - from the political to the managerial.

This institutional perspective in no sense means that the traditional concerns about budgetary performance are to be ignored. On the contrary, some - notably concerns about the budgetary information base - become even more important. The institutional approach looks at these issues through a somewhat different lens - the lens of the rules of the game. Perhaps the tendency to overestimate revenue in many countries reflects not so much technical shortcomings as the incentives operating on the system. Box 2.1 illustrates that politics lies at the heart of overestimating revenue. Perhaps the failure to implement advanced integrated financial management information systems (FMIS) is not a result of technical and capacity shortcomings, but rather the inadequate incentives to demand information for the potential users of the outputs of the system, notably politicians and high-level public sector managers.

A third insight is that the budget will only function effectively on the three levels if decision making and management systems and processes are performance oriented. Budgetary reforms will not automatically lead to better budgetary outcomes if nonbudgetary institutional arrangements are not supportive. The budget is too often seen as a process unto itself, when it is part of a broader set of governing, institutional and management arrangements. Figure 2.1 shows that the budget process, system and directly related institutional arrangements may largely explain level 1 outcomes. But, by the time we get to level 3 outcomes, the budget is only one influence among several, all of which need to be pulling in the direction of better performance if outcomes are to improve.
BOX 2.1
REVENUE PROJECTIONS IN THE PHILIPPINES

In the Philippines, overly optimistic revenue projections have marked the budget process. Politics accounts for a significant part of the problem. Strong pressures are imposed on analysts to produce such projections for the annual budget and the medium-term expenditure framework (MTEF). Because politicians in reality tend to cut (not raise) taxes and strenuously avoid legislating tax increases, the projected revenue stream rarely materializes. The end result has typically been cutbacks in the allocation of funds to agencies, required by “unforeseen circumstances.”

Two recommendations have been suggested to address these concerns:

1. Technical assistance might help develop a revenue estimating model. Since the existing poor quality of revenue estimation is in part due to the absence of adequate data, an important first step would be to ensure that the type of information needed for proper estimation of revenue is collected and processed. The second step would be to develop a more sophisticated revenue estimation capability in the Department of Finance.

2. Institutional reform might also help in making revenue projections more realistic. Cabinet and others should restrain themselves from pushing revenue analysts to make overly optimistic forecasts. One way to avoid this would be to have an outside group of experts make the economic forecasts which serve as the basis for the budget. This approach is used in several countries (e.g., Netherlands, which uses forecasts made by a committee of experts) and is accepted as an unbiased determination.


BALANCING RESTRAINT AND FLEXIBILITY

Chapter 1 points out that the focus of budgetary reform efforts has often been either too narrow or too technical (and more often than not, both). Institutional arrangements must be designed so as to discipline and facilitate decision making and the scrutiny of those decisions by the appropriate players, whether that be the President, ministers collectively, individual ministers, the legislature, the community, central agencies, line agencies, individual managers, or front line service providers.

These players often have dual roles, both as creators of institutional arrangements (regulators) and as performers of tasks (doers). A well-performing public sector will have a clearly defined system of authority delegation. Figure 2.2 highlights the downward delegation to agents, the upward reporting requirements by agents and the associated institutional arrangements and their organizational support, which underpin a well-functioning government. The conceptual framework mainly represents delegation of authority and control mechanisms...
Figure 2.1
RELATIVE IMPORTANCE OF DIFFERENT ELEMENTS OF THE INSTITUTIONAL FRAMEWORK AT EACH LEVEL OF BUDGETARY OUTCOME

INSTITUTIONAL ARRANGEMENTS

Level 1:
Outcomes
AGGREGATE
FISCAL DISCIPLINE

Level 2:
Outcomes
RESOURCE ALLOCATION AND USE REFLECTS STRATEGIC PRIORITIES

Level 3:
Outcomes
PROGRAMS IMPLEMENTED EFFICIENTLY AND EFFECTIVELY

BUDGETARY SYSTEM AND PROCESSES

OTHER SYSTEMS PROCESSES (e.g., human resources management system)
in a parliamentary system of government. There are, of course, variations of this model such as the more diffused system of authority and control within the presidential system of government. In such systems, the inter-relationships are not quite so linear, but mechanisms (checks and balances) have nevertheless been developed to balance autonomy and flexibility with restraint.

Figure 2.2
CONCEPTUAL FRAMEWORK

The regulatory design and the decisions on “which player does what” reflect a concern, implicit or explicit, for what is known as the agency problem. Agents to whom authority is delegated face incentives that are different from those of their principals. This can contribute
to outcomes at variance with those sought by principals, particularly considering the inevitable information asymmetries.

At the apex of the formal regulatory framework in most countries is the Constitution. Below that there are many formal and informal rules that bear on budgetary outcomes. These institutional arrangements regulate the relationships among the players, through a combination of regulations external and internal to executive government, simultaneously to impose restraints, define flexibilities and set, monitor and enforce standards. The latter requires information, transparency and accountability mechanisms.

Getting the right balance between restraint and flexibility is the key to better outcomes at all three levels. The challenge for each country is to determine the appropriate balance. Introducing mechanisms to promote transparency and accountability—key elements of the restraint framework—will check abuse of flexibility and generate demand for information.

**Restraint.** Far too often policy and planning decisions are insufficiently disciplined (restrained) by the realities of the budget constraint over the longer term. The absence of restraint early on in the policy, planning and budgeting cycle often results in weak expenditure control further down the line - a common symptom of poor expenditure management, and evident in many countries. A genuinely hard budget constraint has been shown to be one of the central features of a well-performing public sector (Box 2.2). But, to be fully effective, the constraint must be realistic, particularly in relation to sector policy demands, and it must involve a significant degree of predictability.

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**BOX 2.2**

**BUDGETARY INSTITUTIONS THAT PROMOTE AGGREGATE RESTRAINT HELP AVOID LARGE DEFICITS**

A recent study of 20 Latin American countries suggests that greater transparency and hierarchy (i.e., systems that give considerable power over departmental spending totals to the Ministry of Finance) are associated with lower budget deficits. The study found that countries with the least transparency and fewest aggregate spending controls ran public deficits averaging 1.8 percent of GDP, while those with the highest combined transparency/aggregate control mechanisms ran surpluses of, on average, 1.7 percent of GDP.


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Performance at all three levels of budgetary outcomes is adversely affected where the absence of restraint begins with weak aggregate fiscal discipline. At the same time, caution should be exercised since imposing overly rigid restraints at the top may help to maintain discipline at the aggregate level but may not necessarily translate into improvements at the sectoral and organizational levels. For example, the rules of the supranational central bank have contributed to aggregate fiscal restraint in many of the African Francophone countries affiliated with the CFA zone. This has led to the buildup of arrears in many countries, and it does not appear to have led to a greater concern for level 2 and, particularly, level 3 outcomes.
Lack of restraint in policy making and planning means that resources for the annual budget are too often already overcommitted. The consequence is inadequate funding for operations and maintenance. World Bank Public Expenditure Reviews (PER's) have shown clearly how future resourcing needs to support past and current policy, and planning decisions cannot be met. Box 3.3 in chapter 3 illustrates remedial actions. Yet countries, often with the active support of donors, continue to pursue an expansionary planning path. Decisions do not adequately consider future cost and the likely future aggregate resource constraint. Institutional mechanisms that symbolize and promote this situation are the dual budget system and the traditional Public Investment Program (PIP).

Mechanisms to promote aggregate fiscal restraint during budget formulation are important and help to improve overall expenditure control. However, restraint during the budget year is also important to minimize resource reallocations during the year. This practice is rampant in many countries, signaling that either the original budget did not reflect the real priorities of government or that financial and/or policy discipline does not exist (Box 2.3). Either way, strategic priorities are unlikely to be properly reflected in actual expenditure, and operational performance will be adversely affected. At the same time, the legitimacy of the budget process and the credibility of budget ceilings will be undermined.

BOX 2.3
DIVERGENCE BETWEEN BUDGETED AND ACTUAL SPENDING IN UGANDA

To increase allocations to important, yet underfunded, sectors, Uganda identified a number of Priority Program Areas (PPA’s) in the early 1990s that would receive priority in resource allocation. Donors supported this approach by linking funding flows to increases in budget allocations for PPA’s. However, review of actual spending patterns indicated that actual spending was largely at variance with budgeted priorities. Large amounts of supplementary expenditures were incurred by powerful ministries. The result was that the average deviation in actual allocation versus budgeted allocation for PPA’s was over 90 percent, with the range varying between 70 percent for the Ministry of Education and 590 percent for the Ministry of Justice.


Increased restraint contributes to better budgetary outcomes, but so does increased flexibility. The important task, therefore, as Schick put it in the Introduction, is "getting the basics right," i.e., to get the right balance between flexibility and restraint. Decision makers and managers should have flexibility to do their jobs and take actions needed to improve outcomes on the ground. However, appropriate restraints should be in place to ensure that their actions do not lead to indiscipline. The 1997 WDR identifies a variety of institutional mechanisms that impose restraint on decision makers and managers and help achieve this balance. These mechanisms include competitive pressure from markets, and voice and participation from civil society. Within the state, the mechanisms include checks and balances on the executive via the legislature and the judiciary. Within the executive, they include rules and restraints such as hard, but predictable, budget constraints, a clear strategy with explicit statement of priorities, requirements to report results, and accounting and auditing standards.
**Flexibility.** The importance of flexibility has been highlighted by the experience of core public sector reform in a number of OECD countries. At the operational level, increased managerial freedom, combined with a hard, but predictable, budget constraint, has been consistently identified as providing a key incentive for improved performance. For strategic decision making, giving individual ministers more responsibility for resource allocation decisions creates incentives to reprioritize expenditure within a hard budget constraint and increases accountability for results. Australian reforms of the 1980s illustrate this point (Box 3.3 in Chapter 3).

For many developing countries, the signs are that too little flexibility and too much restraint has often led to increasingly poor outcomes at all three levels, but particularly at levels 2 and 3. The separation of policy, planning and budgeting, the subject of Chapter 3, has had the major negative consequence of virtually eliminating the capacity and willingness of many governments to reprioritize and reallocate. Box 2.4 illustrates the negative consequences that flow from an inflexible implementation framework (level 3).

**BOX 2.4**
THE NEGATIVE EFFECT OF TOO MANY CENTRALIZED CONTROLS IN ECUADOR

By the early 1990s, Ecuador’s resource allocation and personnel administration systems were highly centralized and rule oriented. Yet, there was growing relations that despite the tight institutional framework, the system was failing to control and limit the use of publicly held financial and human resources. In fact, the proliferation of controls actually sowed the seeds of its own malfunctioning. The highly centered budget system had generated numerous devices for circumventing the normal budgetary process, including earmarked revenues and off-budget activities. Similarly, the centralized financial control system, including but not limited to extremely cumbersome procurement processes and a reliance on pre-controls, had led to a proliferation of autonomous entities exempt from many of those controls. The highly centered personnel management system also failed to improve public sector outcomes. Public employment, for instance, grew inexorably over the previous decade and a half and a plethora of labor regimes, as supplements and other devices for circumventing the controls built into that system emerged. These undermined good management and produced poor public sector outcomes.

The country is now in the process of undoing many of the centered controls and moving towards a more delegation-oriented institutional framework. However, movement is slow because of the resistance that is typically encountered in moving from a transaction-specific control regime to a more decentralized one. As an example, a plan was proposed in 1995 to devolve payment controls and two years later still had not been implemented, largely because of central agencies’ fears of fiscal indiscipline.


Too much flexibility, without appropriate checks and balances, is also problematic and has led to rampant corruption in many countries. Documented causes of high corruption levels are: distorted policy environments, a low probability of being caught and punished, and mild consequences if caught relative to the benefits of corrupt practices. The implication is that corruption flourishes where public officials have a lot of flexibility and discretion in decision
making, but are inadequately restrained by mechanisms that check arbitrary action. Overall, this undermines state credibility and investment, and growth suffers over the long run.

While too much flexibility and too little restraint engenders corruption, too little flexibility and too much restraint builds rigidities and inhibits innovation and change. An important starting point is to identify which level of decision making is best served by more or less flexibility and then build in transparency and accountability mechanisms to restrain flexibility.

As a general rule, strategy should be tight and implementation loose or, to put it another way, key strategic decisions should be more centralized, and operational decisions more decentralized.

The weakness in many countries is loose strategy and tight implementation. The center and the donor community may seek to make implementation tight because of the weak strategic framework. Strategy is often loose because policy formulation is dispersed among various government (and sometimes donor) agencies. Effective coordination mechanisms at the center of government are therefore crucial to developing a tight strategic framework. In the Republic of Georgia, for instance, streamlining has removed overlapping and conflicting positions and strengthened coordination. The fate of draft laws is now decided in the presence of all members of the President’s economic council before submission to the parliament. The reforms have helped to enhance consultation and coordination, thereby increasing transparency in central government decision making.

Transparency and Accountability

Transparency underpins accountability, whether this be transparency in the form of timely and reliable ex post external audits or in specifying ex ante performance targets. Transparency demands that the reasons for decisions and the results and costs of these decisions be accessible, clear and communicated to the wider general public. Decision makers must be held responsible for the exercise of the authority (flexibility) provided to them. In summary, decisions made, the basis upon which they were made, and their results and their costs must be made available.

A dimension to transparency not directly linked to accountability is also crucial to sound budgetary outcomes. This is that decision makers should have all relevant issues before them when they make decisions.

The task is to identify institutional arrangements that will help government confront these real world problems in building an effective public expenditure management system. Transparency and accountability mechanisms lie at the center of a system that will encourage commitment by all the players to government’s formal rules on spending and the deficit and to impose costs on politicians and bureaucrats for violations. Similarly, transparency and accountability are important to committing players to level 2 and 3 rules.

Recently, the IMF has developed a Code of Good Practices on Fiscal Transparency, which is summarized in Box 2.5. The entire Code can be found in Annex J.
Information

Lack of adequate information is one of the characteristics of weak budgeting systems. This usually begins with unreliable and late input information on expenditure and costs, which is crucial to decision making and effective expenditure control. The audit function plays an important role in turning input data into information. Audit features that are crucial, but often missing are: internal audit, a component of the management of executive agencies; external audit, independent of the executive; and timely audit reports.
BOX 2.5
IMF CODE OF GOOD PRACTICES ON FISCAL TRANSPARENCY

1. **Clarity of Roles and Responsibilities**
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.

2. **Public Availability of Information**
The public should be provided with full information on the past, current, and projected fiscal activity of government.

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

3. **Open Budget Preparation, Execution, and Reporting**
Budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

Budget estimates 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.

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

4. **Independent Assurances of Integrity**
The integrity of fiscal information should be subject to public and independent scrutiny.

Underpinning the expenditure information system is an accounting system. Most developing countries have the basics of an accounting system but do not use it effectively. In a number of countries accounting systems are not well integrated with planning, budgeting, cash and debt management, and auditing systems. Information on non-cash resources (assets, liabilities, people) often do not exist.

Performance information of either the outputs of government or the outcomes of government policy is scarce. A more results-oriented public sector will require this information. The challenge will be to define the information required for the various levels of decision making and to avoid overloading the center. Management information systems that integrate information on costs, expenditure, outputs, and outcomes will need to be developed.

A key point is if the institutional arrangements and the incentives embodied in those frameworks are set up “right,” i.e., if flexibility and restraint are appropriately balanced and mechanisms for transparency and accountability are introduced and enforced, quality information will be demanded and used to improve public sector performance.
OPERATIONALIZING THE THREE LEVELS

There is no single best way to classify these institutional arrangements. To assist diagnosis and action, it may be useful to focus on the roles and responsibilities of the various players, either as regulators or doers, through the policy making, planning and budget cycle.

Level 1: Aggregate Fiscal Discipline

Institutional arrangements for aggregate fiscal discipline can range from formal constitutional restraints on aggregate expenditure (Indonesia) through formal laws (Maastricht, New Zealand, Australia) to public commitments by the executive (with or without the commitment of the legislature - U.S.). Commitments of this nature can usefully be supported by formal legal requirements that all government revenue be paid into a single fund and only be available for spending where there is an appropriation of funds by the legislature. All of this should be supplemented by restraints imposed by financial markets and a free press. For many countries, international financial institutions may play a key role, particularly in the absence of open financial markets. An independent Central Bank can also play an important role in disciplining aggregate expenditure. For example, the supranational central bank of the CFA franc zone countries imposes limits on the advances it will make to member countries to 20 percent of the previous year’s tax revenues. A key point is that each country will choose the particular mix of institutional arrangements that will support aggregate fiscal discipline.

When players have made the commitment, they are technically required to produce an estimate of what is affordable, in aggregate, over the medium term. This will require a capability to model the economy (Jacques Polak in "The IMF Monetary Model - A Hardy Perennial" in Finance and Development, December 1997, gives evidence that this does not require sophisticated modeling techniques.). The level of government expenditure derived from the model can provide the constraint or can be used as a guide to the setting of the constraint. Determination of the estimates is not merely a technical exercise. Evidence shows that there are cases (Box 2.2) where incentives cause an overestimation of revenue in the budget and future years. While this overestimation may not lead to an undermining of fiscal discipline, the inevitable cuts in expenditure to achieve fiscal targets invariably have very damaging effects on level 2 and 3 outcomes.

The production of the fiscal framework will usually be the responsibility of the central economic agencies with input from the Central Bank. The aggregate expenditure ceiling will feed into the deliberations of the Cabinet on the appropriate stance of fiscal policy for the coming budget year. The ceiling, together with its rationale, should be part of the budget circular kicking off the annual budget cycle. The ceiling may need to be adjusted through the planning and formulation phase to reflect new information, but the adjustment should be kept to a minimum.

When decision makers formally set the aggregate expenditure ceiling at the appropriation (legislative) stage (implicitly or explicitly), they must enforce the ceiling, monitor actual expenditure during budget execution, and identify as far in advance as possible pressure points on aggregate expenditure. An important restraint on decision makers is the requirement that actual expenditure be reconciled with budget estimates during budget execution, and on time and publicly at the completion of the budget year.
Comprehensiveness and transparency are essential for effective aggregate fiscal discipline. Formal rules designed to achieve aggregate fiscal discipline create incentives for evasion, particularly to take activities off-budget or to engage in creative accounting. Extrabudgetary funds, earmarking and quasi-fiscal activities are among the egregious examples of ways of getting around aggregate fiscal discipline.

**Level 2: Resource Allocation based on Strategic Priorities**

Given aggregate fiscal discipline, the second key challenge is how to prioritize competing claims on scarce resources. Prioritization is fundamentally political. Politicians set priorities based on their understanding of the preferences of their key constituencies. The challenge is to structure institutional arrangements to provide the incentives for tight strategic allocation of resources and improve the quality of information needed to do this effectively.

Level 2 is the most difficult to "get right" because it is the most dependent on the political process. It is crucial that "political government" provide legitimacy to policy decisions and the resource implications over the life of the policy, by being at the center of the process of reconciling what is affordable in aggregate and strategic sector policy demands. The choices made at this level can be informed by information and analysis, but they are importantly value based and path dependent. Designing and sustaining institutional arrangements that facilitate and require choices to be made in the public interest is very demanding. Restraints, in terms of tight strategy and affordability, are crucial here, but there is an important component of flexibility required.

Characteristics of institutional arrangements that support sound strategic policy making follow:

- A cohesive political executive must have a vision of where to take the country and must legitimize decisions made.

- A forum is needed within which decision making is constrained by resource availability over the medium term and in which policies have to compete with each other as ideas, and for funding. This will be facilitated where there are tight links between policy making, planning and budgeting. The perceived legitimacy of the policies that emerge from this competition will be enhanced where civil society, the private sector and the legislature are appropriately involved.

- Programmatic decisions for budget formulation must devolve to line ministers. This requires a capacity at the center to assess the appropriateness of these decisions against the overall strategic policy objectives of government and their financial implications over the life of the policy. Sector expenditure ceilings will have to be decided upon in the forum. These sector ceilings will need to be consistent with the aggregate fiscal constraint and, as much as possible, be compatible with individual policy decisions made in the forum during budget formulation and with other existing policies. The latter will require estimates of the cost of existing policies over the medium term.
Where aid is important, there must be a cohesive and comprehensive approach to aid management. The strategic policy priorities of government must be the driver of decisions that involve aid financing.

To support these institutional arrangements, there is a need for information on:

- the cost of existing government policies over the medium term,
- output and outcome information on each of these policies, and
- cost, output and outcome information for new policy proposals.

In turn, the generation of reliable and timely information will require sound accounting systems and rules, well-functioning financial and nonfinancial management information systems, and a monitoring and evaluation capacity within the executive. An external audit function, independent of the executive, is a crucial element of the institutional arrangements for checks and balances.

Once the executive has formulated the budget, policy choices embodied in the budget must be presented to the legislature in a way that allows for effective oversight. Whatever the structure of appropriation chosen, the legislature must be provided with information on expected costs, expenditure, outputs, and outcomes of individual policies.

Monitoring for consistency with policy during budget execution is the responsibility of individual sector ministries. The legislature and the center can support this concern for the implementation of approved policies by requiring an ex post reconciliation of actual and budgeted expenditure by sector and program, and by requiring sector ministries and agencies to report publicly on actual outcomes and outputs.

The cycle begins again with this information feeding into the next budget round.

Level 3: Operational Performance - Efficiency and Effectiveness

Figure 2.1 shows that operational performance is dependent on many factors, only some of which are directly linked to institutional arrangements associated with budgeting. Those that can be directly linked include:

- the legitimacy given to policies through the decision making process, which is central to their efficient and effective implementation;

- the predictability of funding to approved policies - both within the budget year and from one year to the next (This is not an argument for protecting government expenditure at all costs and in all circumstances, but it is suggesting that if those responsible for implementation are to be given an adequate planning horizon then there must be the maximum amount of predictability in funding. Where changes in funding are required because of either changing macroeconomic or sector priorities, these should be effected as far as possible through policy change, as opposed to merely reducing - less often increasing - funding.)
the increased delegation to line managers of the authority to make financial decisions commensurate with the responsibility for producing outputs and achieving outcomes (The ex ante specification and subsequent reporting of outputs and outcomes discussed under level 2, together with external auditing of financial compliance and performance, provide the basis for the accountability of sector and line managers. However, they can only be held accountable where they have the authority to make decisions over the mix of inputs - both financial and nonfinancial - within a hard, but predictable, budget constraint.);

- a genuinely "hard" budget constraint - upwards and downwards - during budget execution.

Other conditions that determine the quality of operational performance include exit and voice opportunities (e.g., competition and client surveys), merit-based personnel practice and, more generally, a regulatory environment that encourages and requires sound operational performance. These issues are discussed in the 1997 WDR (See also Box 5.8 Disincentives to Sound Operational Performance in chapter 5).

Institutional arrangements that have the greatest bearing on organizational performance might be summarized as follows:

- resources and systems support commensurate with responsibilities (financial/human);
- clarity of purpose (outcomes to be achieved);
- clarity of task (outputs to be produced);
- authority (flexibility) to pursue the purpose and undertake the task;
- accountability for use of authority.

Building on the Framework

The following two chapters take the above discussion of the three levels and elaborate specific components of a well-performing budgetary system and process. Management of the three levels can be effectively integrated only through a perspective that goes beyond the annual budget cycle. Chapter 3 looks at the need to link policy, planning and budgeting in a medium-term expenditure framework (MTEF) at both the whole of government and sector levels. Chapter 4 outlines the key considerations in implementing a sound financial management information system (FMIS), the basic component that consistently underpins efficient PEM.

Part II of this handbook contains a questionnaire to assess the quality of institutional mechanisms (Annex A), a checklist of practices to assess a country’s stage of development and a matrix to assess financial management/budget reforms and to evaluate improvements (Annex B).