

PROJECT AND ADVISORY ASSISTANCE PROGRAMME

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PUBLIC EXPENDITURE MANAGEMENT

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FOREWORD

The Economic Development Institute of the World Bank (EDI), the Economic Commission for Latin America and the Caribbean (ECLAC) and the Latin American and Caribbean Institute for Economic and Social Planning (ILPES), sponsored a Seminar on **"Projects Data Bank and Public Sector Investment Programming"** which was held in Kingston, Jamaica, 20-22 November, 1991.

Taking into consideration the need for strengthening the exchange of experiences of methods, tools and instruments for improving the overall public investment management, the three sponsoring institutions decided to make a wide distribution of the papers submitted to the Seminar.

It is expected that the dissemination of these documents, prepared by the speakers and by the Caribbean Governments, will facilitate an integrated analytical and operational approach in improving project effectiveness and promoting institution-building.

Edgar Ortégón
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BUDGETARY PROGRAMMING AND EFFICIENT PUBLIC EXPENDITURE MANAGEMENT

Noemi Caiden

INTRODUCTION: THE NATURE OF BUDGETING

For those concerned with public sector investment planning, the budget is central. As a policy instrument it implements structural adjustment planning, which should set the framework for public investment plans. As the instrument which allocates annual expenditure, it is critical to the realization of those plans.

Budgeting may be defined in many ways. In its broadest sense it encompasses the revenue system, the macroplanning system, the annual decisionmaking cycle determining expenditure priorities, capital budgeting, the financial management system (budget execution, disbursement, cash flow management, internal control), and the accounting and auditing systems. For our purposes, a narrower definition seems more appropriate. Budgeting may be seen as the annual process for determining revenues and expenditures, including decisions made throughout the year and their monitoring and evaluation.

The relevance of budgeting for effective public investment planning is clear. The budget is the legitimate source for all expenditures including those for investment. It is the primary mechanism for expenditure control, governing disbursement, monitoring and audit of funds. As a tool of management, the budget programs and allocates expenditures. As an instrument of planning, it makes policy for expenditures and revenues over an extended period of time, relating efficiency and effectiveness to spending policies. All budget systems share to some degree the functions of control, management and planning, and balance them according to

capacity and circumstances. But where budgeting does not fulfil its allotted functions effectively, public purposes, including public investment plans, will be frustrated.

Public investment plans rely on effective budget systems for their implementation, but budgetary programming differs from public sector investment planning in important respects. Essentially, the tasks of budgeting are different and more varied. Budgeting is broader in scope, including not only development, capital and investment expenditures, but also recurrent or operating expenditures. It is also broader in purpose, since it has to coordinate macroeconomic with program and project management both in the long- and short-term. The budget process involves more and varied participants, including not only those in the executive administration, but also legislators, officials of the central bank, managers of state enterprises, interest groups, the media and the general public; but it is the particular concern of the officials of the ministries of finance. All these participants have different backgrounds, training, outlook and objectives.

Although it is a rather straightforward mechanism, budgeting may fulfil a variety of purposes, and it is necessary to choose and prioritize those purposes to fit the environment. Some of the purposes of budgeting are as follows:

Program Information, Efficiency, and Effectiveness. The budget process enables oversight of programs. The effort to retain or increase funding provides incentive and sanction for efficient and effective performance.

Choice. Because all expenditures are placed together in a single budget, it is possible to assess the relative worth of proposed expenditures.

Direction. The budget directs allocation of revenues in advance, and any discrepancies are exceptional and illegal. Thus the budget is a plan or prediction for the year.

Policy. The budget constitutes a forum for annual policy review and forecast. In addition to balancing revenues and expenditures, it is the primary mechanism for control of government fiscal policy.

Comparison. The regular production of annual accounts allows comparisons from one year to the next, also constituting measures of performance over time.

Does the budget fulfil these purposes in Caribbean countries? What kind of budgeting is useful for them? What features of the environment impinge on budget processes, and thus on public sector investment planning?

BUDGETING TO MANAGE THE ENVIRONMENT

Effective budgeting is appropriate budgeting. Budgeting needs to be designed to support an approach to public sector investment planning which, rather than implementing isolated projects, focuses on long-term sustained and integrated investment efforts directly tied to an investment strategy related to national objectives. To do so, it is necessary to work through and improve existing institutions, such as the budget process, rather than simply imposing assistance from outside. Those involved in planning and managing public investment need to take into account the characteristics and problems of the budget process, which are related to the management environment.

The environment of many developing countries, including those of the Caribbean, is characterized by complexity, change and uncertainty, with limited resources available to deal with them. Derick Brinkerhoff in a recent book, Improving Development Program Performance: Guidelines for Managers (Boulder, Colorado: Lynn Rienner, 1991) suggests that in such an environment, where ability to control outcomes is limited and unpredictable, managers have three tasks: to look out at the environment, to look in to the program and its operation, and to look ahead to outputs and performance.

Managing the environment. Traditionally budgeting functions have been handled through direction and control. But in uncertain and constrained environments, more effective management requires consideration of the bureaucratic setting and an array of institutional actors, the policy context, the client groups, and a variety of stakeholders, as well as the general features of the environment. It is necessary to manage through negotiation, exchange, compromise and coalition building.

Managing budgetary programming. Where conditions are uncertain and resources are constrained, prediction is difficult and budget plans easily break down during the current budget year with serious effects on programs. In particular capital or investment projects are likely to be cut back, or existing projects cannot operate because of lack of allocation for operating expenses. It is therefore necessary to choose, design and adapt an institutional network that will respond positively to change and uncertainty, and will enable commitments to be made and kept. Elements to be considered include information flows and interactions, the allocation of authority and responsibility, the channelling of cooperation, the nature of incentives, and the levels of formality and complexity.

Managing budgetary performance. In order for budgetary processes to support program performance, particularly in public investment programs, a two fold approach is desirable. First, it is necessary to establish methods for assessing performance and to operationalize them in the budget process. Second the system of performance assessment should contribute to a longer term capacity to sustain program performance.

PROBLEMS WITH EXISTING BUDGET SYSTEMS

Traditionally budget systems do not fit the environment of developing countries well. While the formal processes seem to fulfil some objectives, more searching analysis reveals that they have serious deficiencies. At a minimum, budgets should reflect the elements of unity, annuality, appropriation and audit. In practice, there has been considerable difficulty in making budgeting work according to these principles.

Unity. Unity means that all expenditures are included in a single budget. In many developing countries, it is usual for many expenditures to be "off-budget" in special or earmarked funds. This is particularly the case where donor funds are involved. The results of this practice are often dysfunctional; budgetary control over off-budget funds is lost; the central budgetary authority has less room to maneuver; the budget is no longer a complete source of information about expenditures; decisionmakers cannot compare expenditure proposals on an even basis.

Annuity. Annuity means that decisions are made to determine expenditures on an annual basis. In practice, given uncertainties, it has been very difficult to predict revenues and expenditures for even one year. The quality of budget estimating is often poor, leading to unrealistic funding projections,

underfunding of some projects and underspending in others, and changes during the budget year. In particular, the practice of "repetitive budgeting" appears to be widespread i.e., the initial budget allocation is only a starting point, and in reality the budget is made throughout the year. Budgeters, both in central finance authorities and in agencies, have adapted to uncertainties in estimating through the use of incrementalism i.e., using last year's expenditure as a base and adding an increment, rather than approaching their needs in an analytical or realistic fashion.

Appropriation. Appropriation is a primary budget control, since it stipulates that monies may only be expended accordingly to the amounts allocated in the budget. But where the budget is late, or is changed during the course of the year, or allocations are unrealistic, or many expenditures are not in the budget at all, budgetary control, management or planning even for one year are impossible. In addition, slow disbursements and rigid cash management systems disrupt smooth allocation of funds and add to costs.

Audit. Audit checks that expenditures have been made in accordance with budgetary allocations. In practice, accounting systems are often weak, accounts are subject to delays, accounting and budgeting categories are not aligned with one another, and audit findings are not followed up.

These budget problems result in poor and inaccurate information flows, problems in relating programs and funding over time, underspending, lack of counterpart funds, adversarial relationships and lack of trust. Too little attention has been given to support systems for budgeting, particularly accounting and cash flow management. Often budgeting has appeared as an obstacle to effective program management, and particularly public investment planning.

Past critics have traced difficulties in achieving effective budgeting in developing countries to the type of classification used in the budget. Typically, most budgets in industrialized, as well as developing countries, use a line item or object classification, which lists inputs (such as personnel, or materials) according to their cost, without regard to the users or effects of these inputs. Reformers have advocated reforms such as performance or program budgeting.

Performance budgeting classifies the budget according to activities, and costs out those activities. It makes it possible to set up standard costs for each unit of activity (e.g. student-teacher ratios, nurse-patient ratios) and to assess performance of a given organization according to the standard criteria. Performance budgeting also enables budgets to be constructed on the basis of anticipated workload, and allows managers to work toward greater efficiency by relating the performance of their organizations to cost of activity accomplishment.

Program budgeting classifies the budget according to programs, and allocates resources according to the effectiveness of those programs. It incorporates a more analytical and planning approach to the budget, based on the outcomes of government programs. Program budgeting aims for optimal allocation of resources, and allows comparison of all programs to ensure maximum effectiveness.

Although performance and program budgeting have remained popular reform proposals, they have not been very effective in practice. Countries which have undertaken ambitious restructuring of their budgets have frequently been disappointed with the results. One set of problems has related to implementation, in particular lack of commitment and understanding by staff, and a short time span for achievement of across the board reform. More intrinsic difficulties have arisen because of the hierarchical nature of the reforms, which rely to a large extent on centralized

decisionmaking, while lower level participation is confined to provision of complex information. Information demands have been too onerous, and often impractical where programs cut across organizational lines. It has been difficult to make comparisons among unlike programs, and even the establishment of programs themselves on any clear logic has proven an obstacle. It has been charged that the analytical emphasis of these methods, based in the bureaucracy, ignores the political element. In any case, budget execution has required use of line items, resulting in additional complexity because it has been necessary to construct "crosswalks" from one system to another. Perhaps the most important problem has been that these complex and expensive systems have failed to elicit the necessary commitment needed to implement them properly because they have failed to provide an answer to the most pressing questions of budgeters in developing countries. They have not aided budgeters in coping with issues arising from constraint and uncertainty, or given sufficient emphasis to the causes of poor budget performance.

What then are the objectives of budgetary programming? The following are suggested as useful points of departure:

Support for public sector investment planning. It should be remembered that budgets serve broader purposes, and need to take a variety of purposes into account. However, budgets may support public sector investment planning in a number of ways. For example, they may employ a multi-year perspective which tries to forecast resources over a period longer than a year; budget execution processes may support program monitoring; budget authorities may cooperate in joint screening of projects at flexible intervals; the budget may lend legitimacy to the public sector investment plan; operational (recurrent) funding may be coordinated with investment or development spending.

Responsiveness to stakeholders within and outside the bureaucracy. Where budgets are imposed without meaningful participation, distortions in priorities often occur, needs are neglected, and breakdowns occur. Budget processes should allow for explication and participation. Particularly where public sector investment planning is involved, consultation outside the bureaucracy should be built into the process. At the same time, regular and open budget processes should discourage corruption, irregularity and fraud, as well as ad hoc decisionmaking. In other words, budgeting should strengthen planning.

Efficiency, economy, effectiveness, and productivity. Budget processes should incorporate analytical techniques where appropriate to evaluate expenditures and aid decisionmaking. The experiences of several industrialized countries in attempting to redirect expenditures in accordance with a changed role for the state may be of interest in this regard.

Honesty, particularly the prevention of fraud, waste, abuse and corruption. Budget documents should be transparent, easy to read, and incorporate useful information. They should be backed by timely and accurate accounts, which reflect correctly the activities of government. Budget processes should incorporate checks and encourage law-abiding conduct (as opposed to "getting around" or blatantly disregarding the rules).

Multi-year perspective. Since it has proven difficult for many countries even to implement a budget for one year, it may be unrealistic to expect multi-year budgets. Nevertheless, most public investment requires a long-term sustained effort, which requires the assurance that resources will be forthcoming over a number of years. Several governments have experimented with rolling budgets over a period of two or three years. It is important to realize that long-term commitments of funds involve a

trade-off in short-term flexibility, and that activities protected in this way gain priority over those requiring annual approval.

Accountability. Any budget system should incorporate elements of accountability, and this is particularly the case with public sector investment planning, where accountability should be required throughout the process.

What experiences may be useful to Caribbean countries in assessing and possibly redesigning their budget systems? Several industrialized countries, including Canada, Britain, Australia, New Zealand and Sweden, have made radical changes in their budgeting methods. While approaches differ somewhat according to context, and in their depth, certain common elements may be discerned.

Management decentralization. Instead of departments working to detailed line item budgets, agency managers are provided with resources which they may use with considerable freedom to achieve stipulated results for which they are held accountable. All the examples above utilize management decentralization to some degree.

Continuity. Sweden and Australia work within a three-year planning system, though they retain annual budgets. In Sweden agencies may transfer resources within limits from one year to another within the three-year period.

Use of information systems. Information systems are used to enable calculation of budgetary parameters and continuous monitoring of transactions. They are also used to hold managers to specific results.

Emphasis on efficiency. There is an emphasis on efficiency in the achievement of set objectives, constant scrutiny of activities and flexibility in the use of resources.

Emphasis on privatization. In addition to considerable privatization of public activities, including contracting out, agencies are treated as cost centers, responsible for achieving results at given costs. New Zealand has gone the furthest in this direction, and has adapted its accounting system accordingly.

This public management model of budgeting might be summarized as follows: Policies are set at the center related to wider economic trends and adjusted according to economic movements. Agency managers are set objectives and made responsible for achieving them with allotted resources and in the most efficient manner possible at their discretion. The system is held together through the flow of information that transmits data regarding costs and results, enabling impacts to be assessed, priorities to be set, program adjustments to be made, and value-for-money audits to be conducted. Efficiency is achieved through managerial flexibility, which rewards managers for results and penalizes them where they fall short. Accountability is improved because of the availability of accurate and relevant information, and the capacity to enforce priorities. Resources and activities, income and expenditure, are considered together as a simultaneous equation.

Another approach of interest is that of the Integrated Financial Management and Control System, which is in the process of being implemented in Bolivia. The system, known by its Spanish initials, SAFCO, has involved the following elements:

Law. Numerous antiquated, conflictive and inadequate laws have been replaced by a single law providing a systems-based framework for financial management, integrated with public sector management as a whole.

Budget. An inoperative and chaotic budget has been replaced with modern participative provisions and guidelines which will permit the formulation of a realistic financial plan by those responsible for its implementation.

Accounting system. The complete absence of reliable financial data has been replaced by a new integrated accounting system to provide information needed by managers at all levels.

Cash flow management. Disbursements based wholly upon availability of cash to pay only the most obstinate or influential creditors have been replaced by a true cash management system in which the treasury has the function of managing budget execution.

Audit. A compromised and corrupted supreme audit institution has been replaced by an independently managed and financed institution with the potential to perform professional audits.

Training. Training courses have been initiated for financial managers and audits, and comprehensive career path training programs have been planned.

Processes. Complex processes for payment of creditors, payroll, and pensions have been simplified.

(This account of the Bolivian reform has been drawn from James P. Wesberry Jr., Report on Participation in World Bank's Bolivia Public Financial Management Operation II Pre-Appraisal Mission, November 1-8, 1990, pp. 4-5).

Such reforms are not easy to achieve. Jamaica's experience in introducing performance budgeting in 1984 is a case in point. Implementation suffered from a lack of consistent political commitment, insufficient participation by the managers and staff of the departments concerned, and from technical problems in the

design of the project. In addition, it failed to develop clear program classifications and to address overcentralization of financial resource management. Thus, over six years later, the budget did not provide full and adequate information on resource allocation; the quality of budget estimates, particularly in capital expenditures, was poor; many changes are introduced to the budget during the year because of inadequate forecasting of funding constraints; there is no multi-year planning framework; accounting reports are delayed, slowing down disbursements; and the cash management system is rigid and overly centralized. A new Financial and Program Management Improvements Project is expected to address these problems.

There are thus a number of questions regarding the relationship of the budgeting and public sector investment planning systems. How may budgeting be strengthened to support public sector investment planning? What resources are needed and what steps should be taken?