Understanding and reforming public expenditure management

Guidelines for DFID

Version 1

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<th>Full Form</th>
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<tr>
<td>CAPE</td>
<td>Centre for Aid and Public Expenditure Management</td>
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<td>CEE</td>
<td>Central and Eastern Europe</td>
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<td>CFAA</td>
<td>Country Financial Accountability Assessment</td>
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<td>DFID</td>
<td>Department For International Development</td>
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<td>FMIS</td>
<td>Financial Management Information System</td>
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<td>FSU</td>
<td>Former Soviet Union</td>
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<td>IFI</td>
<td>International Financial Institution</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>MTEF</td>
<td>Medium Term Expenditure Framework</td>
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<tr>
<td>NGOs</td>
<td>Non-government Organisations</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>ODI</td>
<td>Overseas Development Institute</td>
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<td>OPM</td>
<td>Oxford Policy Management</td>
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<td>PEM</td>
<td>Public Expenditure Management</td>
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<td>PER</td>
<td>Public Expenditure Review</td>
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<td>PRSPs</td>
<td>Poverty Reduction Strategy Papers</td>
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<tr>
<td>SWApS</td>
<td>Sector Wide Approaches</td>
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<td>UNCDF</td>
<td>United Nations Capital Development Fund</td>
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PART I: Introducing PEM guidelines

This section will help you to:

• Use these guidelines as a reference tool.
• Appreciate why PEM is important for you as a DFID adviser.
• Identify the role of DFID in PEM reform.
1 HOW TO USE THESE GUIDELINES

CHAPTER PURPOSE

Read this chapter to understand:

• The objectives of these guidelines.
• The structure of these guidelines.

1.1 OBJECTIVES OF THE GUIDELINES

These guidelines have been written for governance advisers and economists within DFID. However, others in DFID, and officials in other development agencies and in developing or transition countries may also find them useful. Their objective is to provide a coherent approach, a set of basic principles, and some diagnostic tools to utilise in the design and implementation of DFID support to Public Expenditure Management (PEM) reforms in partner countries. To make the most of these guidelines, the reader will need to learn how to apply the principles to particular contexts. They should be a living document and feedback would be welcomed.

To respond to requests for PEM support, governance advisers and economists will also need to know something about the nuts and bolts of PEM systems. The DFID Economists Manual on Aid and Public Expenditure Management, produced by the Centre for Aid and Public Expenditure (CAPE) at ODI, provides more detail on some areas and should be referred to. It also covers issues surrounding the interface between aid and the PEM systems of partner countries. Other texts providing more detail on particular matters are referred to in the guidelines.

These guidelines will not convert the reader into an expert in PEM reform or do away with the need for specialist consultancy inputs in particular aspects of PEM. But they should give the reader a sense of the big picture, how one aspect of the system links with another and what implications that may have for the pacing and sequencing of reforms. They should also help DFID advisers to be wary of the most common problems and, over time, to develop an instinctive feel for what is important and what is not.

1.2 STRUCTURE OF THE GUIDELINES

The guidelines are split into five parts:

• Part I: Introducing PEM Guidelines. Highlights why PEM is important to DFID and explains how to use these guidelines as a reference tool.

• Part II: Defining PEM. Provides you with an understanding of the objectives and components of PEM. It also provides references to investigate technical aspects of PEM in more detail.
• Part III: Starting the change process: a guide to diagnosis. Outlines the three key steps to completing a comprehensive diagnosis and provides a framework for diagnosing strengths and weaknesses of a PEM system.

• Part IV: Designing PEM reform. Identifies issues to consider in providing advice to governments on the pace and sequencing of reform. Also provides an overview of some of the change management issues relevant to PEM reform.

• Part V: Debates and key issues in PEM. Builds awareness of some of the key debates and issues in PEM.
Why is PEM important to DFID?

Chapter purpose
Read this chapter to understand:

• Why public expenditure management is important.
• Why DFID is becoming increasingly involved in supporting reforms in PEM.

2.1 PEM – why the new interest?

In recent years, there has been a dramatic surge of interest in public expenditure issues amongst governments, development agencies and the wider public. Governments are increasingly realising the importance of public expenditure as a tool for achieving their objectives, particularly in the area of poverty reduction. Countries with similar incomes and growth over the past three decades have seen significantly different impacts on poverty. These differences partly reflect divergences in the ability of governments to direct resources to activities that support the poor. This is compounded by variations in the efficacy of delivering public services, especially basic social services, to the poor. The answer does not lie only in spending allocations: the policy and institutional framework for expenditure management and service delivery is often of equal or greater importance.

On the part of development agencies, the growing interest in PEM also stems from disillusionment with the traditional “enclave approach” to aid projects. This approach has frequently failed to bring even short-term benefits, while consistently undermining long-term institutional development. Even where positive development results are achieved in the short term, external projects may well permit the transfer of recipient government resources into non-developmental uses. So long as aid is fungible, there is little point in focusing only on aid outcomes, while the wider environment for public administration and service delivery remains weak.

In common with other development agencies, DFID now seeks to support development as far as possible through government actions and institutions. The British Government’s 1997 White Paper stated that “where we have confidence in the policies and budgetary allocation process and in the capacity for effective implementation in the partner government, we will consider moving away from supporting specific projects to providing resources more strategically in support of sector-wide programmes or the economy as a whole”.

In most DFID partner countries there are serious weaknesses in PEM. These serve to undermine the effectiveness of all poverty reduction measures, whether funded by development agencies or by government, and to limit the extent to which development agencies are able to move away from traditional project based support. Thus, DFID has a very strong interest in supporting PEM reform.

1 Fozzard and Lindelow (2000).
2 DFID (1997)
Governments must lead reforms. Development agencies can only play a useful role as supporters to government-owned initiatives. Of course, governments do not speak with one voice and there will always be a range of interests to consider and weigh up. In these circumstances, the interpretation of "ownership" is not simple. Yet still, the golden rule is: “Do not wade in unless invited!” The ways in which DFID is likely to be invited to support the reform or improvement of PEM systems include:

- DFID will often be invited to work in partnership with the World Bank and other development agencies to assist governments in reviewing PEM systems and developing reform initiatives. This may be in the context of a Public Expenditure Review or part of the preparatory work for a Poverty Reduction Strategy Paper.

- Sector ministries will often approach DFID for support in the development of sector programmes and budget procedures. Their success will always be influenced by the quality of PEM; hence, sector programmes will often contain PEM components. Indeed, it is usually a sign of poor PEM if aid requests reach DFID direct from sector ministries in a way that bypasses the central agencies. Sector programmes, in particular, need the full involvement of the central agencies.

- DFID will sometimes be approached directly by governments to support PEM reforms at the central level. The focus may be on specific areas such as auditing or accounting systems or it may involve broader initiatives such as the introduction of medium term expenditure frameworks (MTEFs).

These requests for support will need to be fielded by governance advisers and economists. Developing and managing projects that respond to these requests, will require at least a broad understanding of the key issues in PEM diagnosis and reform.
PART II: Defining PEM

This section will help you to understand:

- The objectives of PEM
- The ways in which the budget process, policy process and institutional environment impact on PEM.
3. WHAT IS PEM?

CHAPTER PURPOSE
Read this chapter to learn about:
• The objectives of PEM systems.
• The ways in which the budget process, policy process and institutional environment impact on PEM.

3.1 OBJECTIVES OF PEM

Politicians and public servants share the task of allocating and managing public money. Politicians, with advice from public servants, must decide the amount to be spent, the balance between revenue and expenditure, how funds are allocated among public activities and entities and how these resources will be managed and accounted for.

The processes through which these decisions are made and implemented are known as the PEM system. It seeks to deliver on the three key objectives in Table 3.1.

<table>
<thead>
<tr>
<th>Objective</th>
<th>Explanation</th>
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<tr>
<td>Maintain fiscal discipline</td>
<td>Keeping spending within limits created by the ability to raise revenue and keeping debt within levels that are not prohibitively expensive to service.</td>
</tr>
<tr>
<td>Promote strategic priorities</td>
<td>Allocating and spending resources in those areas that make the greatest contribution to the government’s objectives.</td>
</tr>
<tr>
<td>Deliver value for money</td>
<td>Efficient and effective use of resources in the implementation of strategic priorities.</td>
</tr>
</tbody>
</table>

Source: World Bank (1998a)

These three objectives are interdependent. Ideally, they will be mutually reinforcing but this is not automatically the case. In many ways, fiscal discipline comes first. In a situation of escalating debt and debt servicing costs, governments are forced to focus on reconciling expenditure and revenue levels. However, often the methods chosen to pursue fiscal discipline will undermine the achievement of strategic priorities and value for money. This is particularly true where budgetary cuts are made within year in an arbitrary and unpredictable manner (see Box 3.1). When helping governments to tackle fiscal discipline, try to avoid approaches which impact negatively on strategic prioritisation and value for money.
Box 3.1  **Pursuit of fiscal discipline can undermine other PEM objectives.**

A recent analysis of a major primary health care programme in South Asia found that the approach to pursuing fiscal discipline was hindering the ability of managers to deliver services efficiently.

The Ministry of Finance was making expenditure cuts to the programme in order to control overall expenditure in the face of unpredictable revenues. This made it difficult for managers to plan effectively and recruit the appropriate level of staff. Fiscal discipline was being maintained at the national level with disastrous consequences at the programme level. At this level expenditures on salaries for health workers produced little output because of lack of resources for complementary inputs such as medicines. While fiscal discipline was adhered to, strategic prioritisation and value for money were undermined.

3.2  **The PEM system**

The PEM system refers to the structures and procedures through which decisions are made and implemented regarding the allocation and management of public resources. These decisions are made in the context of the annual budget process. However, they are influenced by the wider policy process and by the institutional and legal framework of government. Therefore, any analysis of the performance of the PEM system must take into account:

- The budget process (see section 3.2.1).
- Links between expenditure decisions and the wider policy process (see section 3.2.2).
- The political, legal and institutional context (see section 3.2.3).

3.2.1  **The budget process**

The budget plays a central role in the process of government, fulfilling economic, political, legal and managerial functions. A good budget process is a tool that enables government to channel expenditure towards those areas that make the greatest contribution to its objectives.

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3 See CAPE (2000) for more detail on the functions of the budget.
Six stages of the budget process

Budget processes differ between countries. However, most budget processes have six generic iterative stages (see Figure 3.1):¹

- **Policy review:** an annual evaluation of the results of public expenditure to inform the updating of policies and plans. This may take the form of an annual Public Expenditure Review (see Box 5.1) or a legislative process involving reports to Parliament, or it may be more ad hoc.

- **Strategic planning:** setting expenditure and deficit targets, on the basis of macroeconomic projections, ideally over 3 to 5 years. Within this framework, medium-term policy targets and expenditure priorities are specified: the building blocks of a medium-term expenditure framework (see section 11.1).

- **Budget preparation:** submission and negotiation of ministry expenditure bids within budget guidelines and expenditure limits circulated by the Ministry of Finance. This stage culminates in preparation of the budget by the Ministry of Finance and parliamentary review and legislative approval.⁵

- **Budget execution:** when the budget appropriations are approved, resources may be released to the spending agencies to implement expenditure programmes.⁶ Procedures for the release of funds differ from country to country. In many developing countries funds are released in equal instalments either monthly or quarterly.

- **Accounting and monitoring of expenditures and revenues:** tracking the composition and level of revenue and expenditure over the year and monitoring the outputs of expenditure.

- **Reporting and audit:** the Auditor General reviews compliance with the budget, reporting in detail to the Public Accounts Committee which advises Parliament and initiates corrective actions as necessary.

The time frame for budget preparation, execution and finalisation of accounts is typically three years. This leads to a staggering of budget cycles so that at any one point in time three or more budgets will be at various stages of preparation, approval, execution and auditing. Given that strategic planning and budget preparation typically begin before reporting on the previous year is complete, some ministries will base their proposals on previous budgets rather than actual results. This can lead to errors in expenditure planning being amplified over time.

¹ See figure 1 in CAPE (2000) for a more detailed breakdown of the stages of the budget process, including the stages of the process where donors or international organisations may be involved.

⁵ See Potter and Diamond (1999), pp 17-18 for a description of the generic budget preparation process.

⁶ See Potter and Diamond (1999), pp 35-40 for an explanation of the stages of budget execution including a comparison of different systems in Commonwealth, Francophone, Latin America and transition economies.
The cyclical aspect of the process is crucial to its effective operation. It is the quality of budget execution that gives meaning to the process of budget preparation. It is the strength of auditing which lends rigour to the process of execution and it is the quality of policy review that gives direction to strategic planning. A weak link in the cycle will undermine the system as a whole. For this reason it is important to look at the cycle in its entirety when attempting to diagnose strengths and weaknesses.

The players in the budget process

The precise organisational responsibilities will vary considerably. Nevertheless, three key relationships underpin the budget process:

- **Between the legislature and the executive.** In return for authority from the legislature to raise revenue and make expenditures, the executive is held responsible by Parliament for achieving the PEM objectives in Table 3.1. Therefore budgets must be passed by Parliament and audited accounts are typically scrutinised by a Parliamentary Select Committee (see section 11.5).

- **Between the executive or Cabinet and the Ministry of Finance.** The executive is responsible for developing a budget strategy and making the fiscal decisions that underpin the budget. The Ministry of Finance supports the executive in promoting the three PEM objectives by providing advice on revenue and expenditure decisions, challenging the programmes and budgets of spending ministries and monitoring the use of resources to ensure consistency with the executive’s budget.

- **Between the Ministry of Finance and spending ministries.** The Ministry of Finance takes on a “guardian role” in ensuring that overall expenditure of spending agencies is kept in line with the budget. It undertakes to provide a predictable flow of resources to spending

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7 See CAPE (2000), pp 8-14 for a description of the budget process that includes the roles of the main players

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PART II. DEFINING PEM

Most budget processes have six generic interactive stages

...between the executive and the Ministry of Finance...

...and between the Ministry of Finance and spending ministries

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ministries, who in return deliver specified services within a given budget, while consistently searching for ways to improve value for money.

### 3.2.2 Links with policy process

Contemporary PEM theory stresses that PEM is not just about applying the procedures of the budget process to share out available resources but about using public expenditure to best achieve policy goals.

Figure 3.2 illustrates the role of policy or strategy in providing a framework for expenditure allocation and management. It is a simplified schematic intended to emphasise key concepts. While ideally expenditure should be consistent with a medium-term strategy, the link between policy and expenditure is not as uni-directional as suggested by Figure 3.2. Budgeting and planning should be a process of continual learning with feedback from implementation and service delivery into the policy process.

The link between policy decisions and the budget process presented in Figure 3.2 is often weak. In most developing countries, budgets are very detailed listings of expenditure authorisations that are impossible to link to government policies and do not provide an appropriate basis for policy analysis and formulation. In the absence of a strategic instrument – such as an MTEF – for prioritising expenditures, policy decisions are likely to impact in a fragmented way (see section 6.2.2).
3.2.3 The institutional context for PEM

The outcomes of the PEM system will depend on the institutional environment in which the budget and policy process operates. The “institutional structure” is the framework of rules, customs, and incentives, which influence how expenditure decisions are made and people behave. Some of the rules are contained in formal laws or regulations. A well-performing public sector will have a clearly defined system of authority delegation. However, there are also usually many unwritten customs and habits that may, for example, dictate the extent to which the written rules are actually enforced.

Assessing a public expenditure management system, and developing solutions, should be informed by a good understanding of the informal rules by which the system actually operates, as well as the formal regulations that are supposed to apply. An expenditure management system will be more effective at promoting PEM objectives (see Table 3.1.) if it operates in a structure of incentives, roles and rules which encourage “good” behaviour. Part III provides a guide to diagnosing the institutional arrangements of the PEM system by assessing it in terms of six characteristics that promote good budget outcomes.

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8 See Schick (1998) for a discussion for the institutional rules, roles and information that contribute to the achievement of the three PEM objectives.
10 See World Bank (1998a), pp 96-98 for a checklist to evaluate a given country’s formal laws and rules.
PART III: Starting the change process: A guide to diagnosis

This section aims to give you:

• An approach to engaging with partner governments in understanding the strengths and weaknesses of their PEM systems.
• An awareness of the key issues that should be covered, or questions that should be asked, when involved in the diagnosis phase of PEM projects.
4  INTRODUCING DIAGNOSIS

CHAPTER PURPOSE
This chapter sets the scene for the remainder of part III by:
• Outlining why PEM projects must include a diagnosis phase.
• Introducing the three key steps in diagnosis.

4.1 WHY DIAGNOSIS IS IMPORTANT

It is vital to understand the factors driving poor budget outcomes before designing PEM reform projects. A lack of understanding of the underlying problems and key institutions in PEM systems has been the failure of many reform projects.

Time constraints may mean that analysis is preliminary or partial but diagnosis is an essential stage of any technical assistance project. As an adviser, you may want to undertake a preliminary analysis as a basis for the terms of reference for a more comprehensive diagnosis by consultants.

There are at least three reasons why any PEM reform must be based on a robust and consultative diagnosis:

• To distinguish symptoms from underlying causes. It can be tempting to tackle symptoms, as they are often amenable to technical solutions. For example, poor expenditure control is often confronted through new financial management systems. However, these systems will make little impact if weak control is really a symptom of a lack of political will to enforce adherence to the budget. Policies and projects that only address symptoms are not likely to bring sustainable improvements and may sometimes exacerbate weaknesses.

• To prevent jumping too quickly to solutions. There is always a temptation to see the latest fad as the answer to all problems. Performance budgeting (see section 11.2), integrated financial management information systems (see section 11.4), and more recently medium term expenditure frameworks (see section 11.1) are examples. These approaches can work, but only where they focus on the real problems and where they are aligned to administrative capacities and institutional constraints. In many cases, more simplified versions of these approaches stand a much better chance of success.

• To build a shared understanding of key problems. The process of diagnosis provides an opportunity to build a shared understanding of the problems. There are always opportunities for key stakeholders to frustrate the intent of reform and this is particularly likely if they do not understand the need for reform. Gaining support for reforms involves building the confidence of both politicians and public servants that the changes will solve the real problems they face. Therefore, not only is it important for PEM reforms to be based on a robust diagnosis, the process of diagnosis must build some consensus on what these problems are.
4.2 A diagnostic approach

The following chapters will take you through the steps needed to build a shared understanding and analysis of a PEM system:

- **Step 1**: Collect information from people and materials to shed light on how the PEM system works (chapter 5).

- **Step 2**: Use the matrix of characteristics of PEM systems to guide the collection and structuring of information, to ensure that you have not missed any important dimensions of the problem (chapter 6).

- **Step 3**: Work with key stakeholders within government to build consensus on the underlying problems (chapter 7). The diagnostic matrix may be helpful in doing this.

In reality, these steps will overlap and need to be iterative. For example, the PEM characteristics should be kept in mind when collecting information and when you are completing the matrix the need for additional information is likely to emerge.

The International Financial Institutions (IFIs) have developed a number of assessment tools, checklists and guidelines to assist in evaluating PEM systems. Donors and IFIs want to move towards common processes of diagnosis, in which governments commit to reforms designed to address the weaknesses revealed by the diagnosis and donors and IFIs use the results of the diagnosis for their individual assessments of:

- The extent to which they may be prepared to rely on the PEM systems (e.g. when considering providing budgetary support or sector support through government systems)

- The extent to which and ways in which they may be prepared to help government in improving the systems.

Initial attempts to move towards this, based around use of the World Bank’s Country Financial Accountability Assessment (CFAA) are planned. There are also initiatives to develop further the existing assessment mechanisms.

You should aim to make as much use as possible of work done by others and, in carrying out new work, including diagnosis, you should seek, where possible, to work with others. The guidelines may be applied in reviewing what has already been done, or in carrying out new work. The diagnostic matrix presented in the guidelines is a conceptual framework to guide diagnosis at an overview level.
CHAPTER PURPOSE

Read this chapter to:

- Understand the challenges in collecting information on PEM in developing countries.
- Identify the key types of information to collect.

Information gathering is required throughout the reform of PEM systems, but particularly during the diagnostic phase. Information can be found in materials or gleaned from talking to stakeholders.

5.1 CHALLENGES IN COLLECTING INFORMATION

Information gathering will, inevitably, be only a partially successful exercise in most developing countries due to:

- Limits on the availability and quality of economic and fiscal data. Indeed the availability and quality of data is in itself an important indicator of the health of the PEM system. However, in all systems it should be possible to gather enough information to at least make a start at PEM analysis. If, in the worst case scenario, no information whatsoever is available, the first step should be to gather expenditure data. Be aware that 'lack of data' can also be used as an excuse to delay the painful analysis of what data currently exists.

- Stakeholders often contradicting each other in descriptions of the way the system actually works (in contrast to formal rules). However, even these different perceptions of how the existing system works can shed light on where the problems are.

5.2 SOURCES OF INFORMATION

Look for diagnostic work already completed. In particular, the wealth of country-specific information on the World Bank and IMF websites provides a useful starting point. For example, these sites will often include Public Expenditure Reviews (PERs), which can highlight key problems in public expenditure management (see Box 5.1).
Public Expenditure Reviews (PERs) are analyses of the allocation and management of government expenditure. They may cover all government expenditure or focus on one sector. Insights gained in PERs can inform strategic planning and budget preparation to identify ways to improve strategic allocation and value for money (see 3.1.). PERs are also increasingly explicitly analysing PEM systems and institutions. However, even those that only focus on the effectiveness and efficiency of expenditure are likely to highlight potential weaknesses in PEM systems. Therefore, they provide a useful source of information for diagnosis of PEM systems. As reports to the international community on how the government has been using its resources, they will become increasingly important in the context of the PRSP process.

The ability of PERs to inform expenditure decisions has been undermined by the perception of many governments that they are simply a tool used to impose World Bank-driven expenditure reforms. This reflects the fact that PERs have traditionally been driven by multilateral and bilateral donors and are at the heart of many lending processes.

However, the World Bank has been attempting to increase domestic ownership of the PER process. Increasingly, the Bank’s strategy is to support borrower countries to lead the process. Therefore, in addition to participating in PERs, DFID and other donors can also make a contribution through supporting the development of expenditure analysis capacity within countries.

Other sources of information include:

- Budget speech and documents.
- Final government accounts.
- Audit reports.
- IMF Fiscal Transparency Assessments.
- Internal manuals for preparation of the budget, medium-term expenditure framework and final accounts.

### 5.3 Key information

As an adviser you will often contract out detailed information collection and analysis. However, you will need to do some preliminary information collection and analysis to enable you to engage with government in identifying appropriate support and to write terms of reference. To avoid getting overwhelmed with detail, you should focus on collecting and analysing two main types of information:

- Performance against the PEM objectives identified in Table 3.1: The World Bank

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Box 5.1 **Public Expenditure Reviews (PERs)**

Public Expenditure Reviews (PERs) are analyses of the allocation and management of government expenditure. They may cover all government expenditure or focus on one sector. Insights gained in PERs can inform strategic planning and budget preparation to identify ways to improve strategic allocation and value for money (see 3.1.). PERs are also increasingly explicitly analysing PEM systems and institutions. However, even those that only focus on the effectiveness and efficiency of expenditure are likely to highlight potential weaknesses in PEM systems. Therefore, they provide a useful source of information for diagnosis of PEM systems.

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- Final government accounts.
- Audit reports.
- IMF Fiscal Transparency Assessments.
- Internal manuals for preparation of the budget, medium-term expenditure framework and final accounts.

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**Public Expenditure Reviews can inform strategic planning and budget preparation...**

...and provide a useful source of information for diagnosis of PEM systems...

...but government ownership is critical if results are to be fed into decision-making processes
Focus on information that relates to the three PEM objectives in chapter 3...

...and the six characteristics in chapter 6

Table 5.1 Performance indicators for PEM objectives

<table>
<thead>
<tr>
<th>Objective:</th>
<th>Performance indicator:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal discipline</td>
<td>Trends in aggregate fiscal indicators such as overall expenditure levels, the deficit and debt levels. Remember to distinguish between budgeted and actual expenditure data. Information on extra budgetary funds.</td>
</tr>
<tr>
<td>Strategic prioritisation</td>
<td>Compare government’s stated priorities with expenditure allocations. Assess progress in achieving objectives, such as reducing poverty.</td>
</tr>
<tr>
<td>Value for money</td>
<td>Compare budgeted and actual levels of expenditure as a measure of predictability (see section 6.2.3). Check for availability of data on trends in unit costs over time or in comparison to other countries in the region.</td>
</tr>
</tbody>
</table>

Source: Oxford Policy Management

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6 Step 2: Completing the diagnostic matrix

Chapter purpose

Read this chapter to understand:

- The generic characteristics that serve as benchmarks for judging PEM systems.
- A diagnostic framework for analysing PEM systems.

6.1 Summary of key characteristics

There is no one-size-fits-all PEM system. PEM approaches will depend on the economic, social and administrative realities of the specific country. However, international experience highlights six generic characteristics of PEM systems, which appear to be universally important in generating good budgetary outcomes with respect to the three objectives in Table 3.1.

These are:

- Constructive political engagement
- Policy clarity, consistency and affordability
- Predictability
- Transparency
- Comprehensiveness and integration
- Accountability

The extent to which these characteristics are present may be taken as a benchmark of the quality of the system. Thus they provide a useful framework for judging or diagnosing PEM systems.

6.2 Understanding the six generic characteristics

6.2.1 Constructive political engagement

What is political engagement?

A PEM process that promotes political engagement provides a framework in which political intentions are reflected in stated policies and in the budget. This builds political commitment to follow the budget, reinforced by an effective process of parliamentary scrutiny.

Box 6.1: Engaging politicians in Nepal

Politicians in Nepal have little contact with the formal budget process and only influence budget allocations informally through sponsoring projects. These projects are often aimed at meeting the narrow constituency demands of individual members of Parliament and are not compared against alternative uses of resources within overall revenue limits. As a consequence, there are only tenuous links between public spending and the government’s key objective of eradicating widespread poverty in Nepal. Despite public expenditure consuming a greater share of GDP over the last ten years, little progress has been made in reducing poverty rates.
PART III: STARTING THE CHANGE PROCESS

Why is political engagement important?

The allocation and management of public funds is, first and foremost, a political matter. Without this engagement, politicians can escape responsibility for the expenditure decisions reflected in the budget. A good PEM system will create pressures for Cabinet to work as a team to identify an expenditure strategy, and expenditure trade-offs within that strategy, rather than attempting to squeeze resources for their pet sectors or projects on an ad hoc basis (see Box 6.1). Political engagement in the budget process helps to temper unrealistic demands and adds credibility to budget enforcement.

How do you measure political engagement?

While there is no objective measure, the extent to which political energies are constructively channelled through the budget can be assessed by:

- The existence of, and adherence to, a budget strategy at Cabinet level. Ad hoc political decisions with expenditure implications are a signal of poor quality political engagement.

- Parliamentary committees playing an effective “watchdog” role by reviewing public expenditure. To play this role the legislature needs to be supported by an auditor reporting directly to them, transparent voting systems and well-defined opportunities to input into the budget process.

6.2.2 Policy clarity, consistency and affordability

What is policy clarity?

This characteristic refers to the quality of policy analysis and formulation. Effective expenditure management is not feasible without well-defined expenditure policies, whose costs are properly identified in budget appropriations and are consistent with available resources.

Why is policy clarity important?

“Failure to link policy, planning and budgeting may be the single most important factor contributing to poor budgeting outcomes in developing countries”.¹³

Policy decisions in developing countries are often made without considering expenditure implications and cuts in funding are enforced without changing the policies that drive expenditure. This leads to a mismatch between what is promised through government policies and what is affordable (see Box 6.2). The annual budget process becomes more about scrambling to keep things afloat than about allocating resources to achieve strategic objectives. A medium-term approach that encompasses all expenditure, within an overall expenditure limit, facilitates the management of policies and budget realities (see section 11.1).

¹³ See World Bank (1998a), chapter 3 for a discussion about linking policy, planning and budgeting.
Box 6.2: Linking policy and spending in Ukraine

As in many emerging economies, the policy-defined social service and protection norms, which provide the basis for Ukraine’s budget requests, are unaffordable by a very wide margin. However, there is no effective process for revising these norms. This is complicated by the fact that many service delivery responsibilities are specified in the Constitution. As a result, too many activities are being pursued in relation to the resources available, resulting in ad hoc in-year expenditure cuts and many under-funded activities. As priority services are not clearly defined by policy, they are not protected from within-year budget cuts.

This situation highlights the need to make difficult political decisions about which services government should continue to finance and at what level of service quality.

How do you measure policy clarity?

Figure 6.1 poses some questions to assess policy clarity, consistency and affordability.

While the link between policy and expenditure is critical for governments to direct resources towards achieving their objectives, relating budgets to objectives is very difficult. A particular challenge is identifying what government activities will make the greatest contribution to the achievement of its objectives (see section 11.2).

Figure 6.1: Questions to assess policy clarity, consistency and affordability

Source: Oxford Policy Management
6.2.3 **Predictability**

What is predictability?

Predictability refers to the extent to which the budget provides a dependable guide to public sector managers as to where and when resources will be made available.

Poor predictability often reflects over-optimistic economic and revenue forecasting during budget preparation (see Box 6.3). However, there are other sources of revenue instability such as donor flows, external shocks due to changes in commodity prices or interest rates, drought and other natural disasters. While the reliability of forecasting can be improved, these types of shocks are difficult to predict. However, the use of contingency reserves or borrowing instruments can prevent the need for in-year expenditure cuts due to revenue shortfalls. In addition, donors can help reduce unpredictability by offsetting rather than amplifying shocks to revenue levels.

In addition to revenue shortfalls, predictability can be undermined by within year expenditure reallocations and non-budgeted expenditures.

Why is predictability important?

If the flow of funds is erratic, public sector managers cannot plan their activities or commence a process that extends over several months. This makes it difficult to deliver services efficiently. In particular, personnel costs are generally a high percent of total recurrent costs and can not be reduced quickly. As a consequence, the impact of unpredictable revenue flows on non-personnel costs, and thus service delivery, is magnified.

Public sector managers are also likely to respond to unpredictability by “stacking” expenditures at the start of the budget year in case resources run out or building up arrears with suppliers. These coping mechanisms lead to inefficient expenditures and increased costs.
The tendency to overestimate revenue in many countries reflects not so much technical shortcomings as the incentives operating in the system. For example, in the Philippines strong political pressures are imposed on analysts to produce optimistic projections for the annual budget and medium-term expenditure framework. This allows politicians to appear to meet their fiscal targets without making hard decisions about expenditure reductions. Instead cuts in expenditure allocation are made during budget execution due to “unforeseen circumstances”.

Building capacity in forecasting would not improve predictability in the Philippines. Developing more sophisticated revenue estimation capabilities in the Department of Finance would not change the political incentives to over-estimate revenues in the budget. The solution lies in institutional reform that makes it more difficult for politicians to influence revenue forecasting. One approach is for Cabinet to agree and publish revenue and macroeconomic forecasts before considering expenditure options. This happens in Mozambique through the approval of the medium term fiscal framework before expenditure negotiations.

**How to measure predictability?**

The simplest way to measure predictability is to compare budgeted and actual expenditures. A consistent gap between budgeted and actual expenditures is likely to be an indication of poor predictability. The effect is likely to be most pronounced in the case of non-salary expenditure. It is also important to review the monthly or quarterly pattern of expenditure (and revenue) through the fiscal year – money that is not released until late in the fiscal year is hard to spend effectively.

The span of the planning process is also key. Ministries need to know what funds may be available beyond the current year, particularly if they are to invest in longer-term strategies for promoting the government’s objectives.

To make an ex ante assessment of whether a budget will deliver predictability requires a judgement about whether the budget is based on a realistic macroeconomic framework and whether sufficient contingency reserves exist. When making this judgement consider not only how economic and revenue projections are made, but by whom and against which set of incentives (see Box 6.3).

### 6.2.4 TRANSPARENCY IN PLANNING AND REPORTING

**What is transparency?**

A transparent budget system provides a readily understandable guide as to how resources are planned to be used and what results are expected to be achieved. Reporting should also enable easy monitoring of actual expenditures against the government’s stated intentions.

Transparency is important to promote certainty, reduce corruption and empower civil society.

Box 6.4: Fiscal Responsibility in New Zealand

One approach to embedding transparency in a PEM system is to legislate for it. New Zealand passed the Fiscal Responsibility Act in June 1994 in response to concerns that:

- Short-term political pressures often over-rode the need for a sound medium-term financial strategy.
- The public had not always been fully informed about the fiscal outlook, especially during election campaigns.

The Fiscal Responsibility Act focuses on the public availability of information as key to encouraging government to use this information to inform decision-making. The Act:

- Requires the Government to be explicit about its long-term and short-term objectives, to reconcile the two and to explain any changes to them over time.
- Ensures the provision of comprehensive financial information for informed and focused debate about fiscal policy.
- Establishes 5 principles for responsible fiscal management. These are not binding but the government is required to explain any departures from them.
- Legislates regular fiscal reporting and the use of private sector accounting principles (accrual accounting).
- Requires the government to be explicit about the policy and economic assumptions underpinning the budget.

Legislating reporting requirements may be risky for developing countries if they lack the financial information systems necessary to produce the information. Moving to the use of accrual accounting is also not a priority for developing countries struggling to keep their cash under control. However, approaches that push information into the public domain are critical to deriving benefits from any improvements in reporting capacity within government.

Why is transparency important?

Transparency promotes certainty and confidence over budget plans and reduces the opportunity for corruption. Clear communication of the government’s strategy also helps public sector managers to ensure that their budget plans are consistent with the strategy. Managers can only be held accountable, if expectations are clearly specified ex ante.

The provision of information to the public also:

- Enables civil society to challenge the government to improve the effectiveness and efficiency of expenditure.
- Increases awareness of service users as to what services they are entitled to and provides channels for complaint and redress if they are not satisfied.
How is transparency measured?

A useful framework for assessing transparency is the IMF Code of Good Practices on Fiscal Transparency. The code defines good practices with regard to:

- Clarity of roles and responsibilities.
- Public availability of information.
- Open budget preparation, execution and reporting.
- Independent assurances of integrity.

The extent to which there is a transparent relationship between public expenditures and the resulting outputs is also an essential aspect of this characteristic. Figure 6.2 provides some questions to ask to allow you to assess this dimension of transparency. However, implementing output or outcome systems is not easy (see section 6.2) and it is more appropriate for developing countries to initially make broad links between spending, services and objectives, rather than get bogged down in specifying detailed outputs.

**Figure 6.2: Criteria for transparent links between expenditure and outputs.**

Source: Oxford Policy Management

6.2.5 Comprehensiveness and Integration

What are comprehensiveness and integration?

The budget should capture all activities of government. However, defining the government sector is not always straightforward. For example, to what extent should the budget capture activities of entities such as state-owned enterprises that are not part of central government? The IMF argues that the budget should cover the activities of all levels of government (central and state level), and the quasi-fiscal operations of nongovernment entities or extrabudgetary funds.

Getting the right mix of expenditure also requires expenditure decisions to be integrated: current and capital expenditure decisions need to be linked and assessed together.

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16 See Potter and Diamond (1999), pp 5-8 for a discussion of what government activities should be covered in the budget.
Why are comprehensiveness and integration important?

Comprehensiveness and integration are needed to ensure that all policy proposals with expenditure implications compete for resources in the context of overall government priorities. Major decisions about trade-offs in public expenditure need to be taken simultaneously rather than sequentially. Therefore, comprehensive coverage needs to be matched by a systematic budget calendar that ensures key decisions are made in the early stages of budget preparation. Comprehensive coverage implies that all Government activities and programmes are captured, including donor projects.\(^{17}\) Note that in using the word “capture”, we do not mean that all expenditures must necessarily pass through the same funding and accounting system. However, ideally there are two dimensions to capturing donor resources in PEM processes:

- **Ex ante**: incorporating aid resources into the planning and budget formulation process.
- **Ex post**: reporting on aid disbursements in the budget estimates presented to Parliament and in the reports of expenditure against these estimates.

How to measure comprehensiveness and integration?

To assess comprehensiveness requires checking that the budget conforms to appropriate norms of coverage, as well as acceptable standards of accuracy and consistency.\(^ {18}\) Watch out for whether the budget:

- Captures extra-budgetary funds (including donor funds), quasi-fiscal operations and contingent liabilities (see glossary).
- Reports expenditures on a net rather than a gross basis. For example, under gross reporting user fees are included as part of government revenue and spending, while under net reporting only the subsidy to the service is included. Net reporting can hide the scale of government operations.
- Misclassifies or excludes expenditures. There is often a confusion between expenditure and financing transactions with, for example, the incorrect inclusion of loan amortisation as expenditure.
- Ensures co-ordination and consistency between the operational and development budgets. The recurrent and development budgets are often prepared following different procedures. In this case, they may use inconsistent macroeconomic assumptions; overlap in coverage or investment projects may be included in the development budget without allowing for the corresponding current expenditure.\(^ {19}\)

6.2.6 Accountability

What is accountability?

Accountability requires that decision-makers be held responsible for the exercise of authority

\(^{17}\) See CAPE (2000).
\(^{19}\) See Potter and Diamond (1999), pp 20-21.
vested in them. Not only must budget officials and line ministries answer for the use of funds, but they must also face consequences for any misuse of funds (see Box 6.5).

Three types of accountability or control systems are summarised in Table 6.1. Countries typically go through these stages of accountability as their budget system evolves, with more discretion provided to public sector managers as systems move from external financial accountability to internal financial accountability to managerial accountability.

These different types of accountability systems can also be distinguished by the extent to which they focus on financial accountability (for use of funds) or performance accountability (for delivery of services or achievement of results).

**Table 6.1: Types of Accountability**

<table>
<thead>
<tr>
<th>Type of accountability</th>
<th>Exercised by</th>
<th>What is controlled</th>
<th>Mode of accountability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>External</td>
<td>Central agencies: provide approval for each discrete transaction or group of expenditures.</td>
<td>Inputs: specific items of expenditure.</td>
<td>Compliance with itemised Budget and government-wide rules Pre-audit of transactions: control is imposed before any expenditure of funds.</td>
</tr>
<tr>
<td>Internal</td>
<td>Spending departments: those who spend the funds have first-instance responsibility for ensuring the legality and propriety of their actions.</td>
<td>Inputs: classes of expenditure.</td>
<td>Department systems comply with Government wide standards. Post-audit of transactions: managers do not have to obtain outside approval before they act.</td>
</tr>
<tr>
<td>Managerial</td>
<td>Spending managers: given discretion to spend appropriated resources in exchange for being held accountable for performance.</td>
<td>Outputs and total running costs: focus on what managers are producing rather than what they are buying.</td>
<td>Accountability for performance. Ex ante specification of performance targets. Ex post audit of results.</td>
</tr>
</tbody>
</table>

Source: Schick (1998)

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20 See Schick (1998), pp 113-127 for more discussion of these different types of accountability systems.
Many developing countries focus on financial accountability: holding agencies responsible for keeping spending in line with budgets. While this is important, ideally public sector managers should also be required to justify their budgets, and be assessed, in terms of the results to be achieved. The move to managerial systems of accountability involves holding public sector managers responsible for results in return for greater discretion in the way in which they achieve results. However, the rate at which developing countries are able to move towards managerial systems of accountability is likely to be slow (see section 11.2).

**Box 6.5: Enforcing the budget in Namibia**

The Namibian 1991 State Finance Act establishes clear accountability for unauthorised expenditure and gives Treasury the power to impose personal liability on public sector managers. However, sanctions are rarely imposed despite consistent unauthorised expenditure by Ministries. As a consequence, ministries face little incentive to ensure budget estimates are accurate or to maintain spending within budget. This lack of accountability is not only undermining fiscal discipline, but also inhibiting the direction of resources to the government’s priorities.

**Why is accountability important?**

Without accountability the stakeholders have no incentive to take the PEM process seriously and budgets can become meaningless. Accountability is important to ensure that:

- Actual expenditures are consistent with plans: that spending is supported by appropriate documentation and complies with financial and accounting regulations (financial accountability).

- Spending contributes to the achievement of the government and community’s objectives (managerial accountability).

Traditionally accountability has been seen in terms of accountability of spending agencies to senior managers and politicians. However, these mechanisms are often far removed from the actual delivery of services to the public and there is an increasing awareness of the need for decision-makers to be directly accountable to the public. Greater involvement of the public in the budget process increases the pressure on public service providers to better meet the needs of communities and lift the quality of services, while making communities more aware of their rights and channels for redress (see Box 6.6).21

**How can you measure accountability?**

Assessing the extent to which a PEM system is embodied with accountability requires answering several key questions:

- Are there clear lines of accountability? Are the roles and responsibilities of key players clearly defined?22

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21 See Cape (2000) for a discussion of different mechanisms for involving users of public services in the budget process.

• Is information on execution of the budget available on a timely, reliable and accurate basis?23
• Is the PEM system reinforcing discipline through the enforcement of control and compliance regulations?
• Are the outputs and/or outcomes of expenditure reported upon (half-yearly or annually) and considered in assessing future budget requests?
• Are there any efforts to involve the public in decision-making processes or to assess public satisfaction with the quality of public services?
• Is there independent audit and verification of performance and financial reporting (see section 11.5)?

Box 6.6 Uganda: accountability to the public24

One way to increase the accountability of service providers to the community is simply through the provision of information.

This approach has been tried in Uganda’s education system to increase the accountability of schools to parents. There is now a requirement to publish the details of all fund releases and how they are spent at all levels down to the school. A June 1998 survey found that over 90% of schools and districts display this information. Government also publishes details of releases, the schools they are intended for, and the use to be made of them, in the national and local media.

This type of information can potentially support parents in challenging schools for not delivering services they have been funded for and in reducing corruption. For example, while 10% of parents are still paying fees for education that should be free, the education service has the lowest level and incidence of bribes. Increasing information will not solve all performance and corruption problems but it does create an environment that increases the pressure on service providers to lift their game.

In particular, the legislature’s role and capacity is fundamental in holding the executive accountable for the allocation and use of funds in line with policy. Strengthening the legislature’s oversight and enforcement capacity is likely to be a key element of any successful PEM reform programme.

6.3 The diagnostic matrix

The previous sections have outlined six generic characteristics that can be used to identify the strengths and weaknesses of a PEM system. Table 6.2 brings these characteristics together with the stages of the budget process. It also summarises the type of questions that need to be answered in order to complete the matrix. The matrix effectively summarises key features of a PEM system and can be used as a framework for ensuring that all the potential dimensions of PEM problems have been captured.

23 See Potter and Diamond (1999), p 44 for examples of questions to consider when judging the adequacy of information available for control purposes.
24 From CAPE (2000)
This matrix is just one approach to understanding the strengths and weaknesses of PEM systems. It provides a conceptual framework rather than a detailed diagnostic checklist. It will help you develop a ‘big picture’ perspective of the key issues. Therefore, it will help in evaluating diagnoses completed by others or in ensuring that consultants commissioned by DFID undertake a comprehensive diagnosis.
### Table 6.2: Collecting information on the PEM characteristics

<table>
<thead>
<tr>
<th>Political engagement</th>
<th>Policy clarity, affordability</th>
<th>Predictability</th>
<th>Transparency</th>
<th>Comprehensiveness</th>
<th>Accountability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget formulation:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy review</td>
<td>Indicators:</td>
<td>Indicator:</td>
<td>Indicators:</td>
<td>Indicators:</td>
<td>Indicator:</td>
</tr>
<tr>
<td>Strategic planning</td>
<td>- Is there existence of, and adherence to, a budget strategy at Cabinet level?</td>
<td>- Is the budget based on a realistic macroeconomic framework?</td>
<td>- Are the budget strategy and understandable budget estimates published?</td>
<td>- Does the budget capture extra-budgetary funds, quasi-fiscal operations and contingent liabilities?</td>
<td>- Are the roles and responsibilities of key players clearly defined?</td>
</tr>
<tr>
<td>Budget preparation</td>
<td>- Is the Ministry of Finance empowered to enforce budget aggregates in bilateral discussions with spending ministries?</td>
<td>- Do overall expenditure limits set the context for policy decisions?</td>
<td>- Are budget strategy and understandable budget estimates published?</td>
<td>- How useful and clear is the budget classification system?</td>
<td></td>
</tr>
<tr>
<td><strong>Budget Execution:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget execution</td>
<td>Indicators:</td>
<td>Indicator:</td>
<td>Indicators:</td>
<td>Indicators:</td>
<td>Indicator:</td>
</tr>
<tr>
<td>Accounting and monitoring</td>
<td>- Do parliamentary committees play an effective &quot;watchdog&quot; role by reviewing public expenditure?</td>
<td>- Are there any measures of performance in delivering goods and services?</td>
<td>- Is there a consistent, significant gap between actual and budgeted annual expenditures?</td>
<td>- Is there publication of actual expenditure and fiscal aggregates, in comparison to budget?</td>
<td>- Is audited information on execution of the budget available on a timely, reliable and accurate basis?</td>
</tr>
<tr>
<td>Reporting and audit</td>
<td>- Do ministers request information on the effectiveness of programmes?</td>
<td>- Is there any discussion of the contribution of spending to policy objectives?</td>
<td>- Is the phasing of fund releases to spending ministries consistent with plans?</td>
<td>- Is there an independent audit?</td>
<td>- Is Ministry of Finance enforcing budget limits &amp; processes?</td>
</tr>
<tr>
<td></td>
<td>- Is Ministry of Finance able to ensure spending is consistent with budget?</td>
<td>- Is there a consistent, significant gap between actual and budgeted annual expenditures?</td>
<td>- Is there an independent audit?</td>
<td>- To what extent is non-financial performance measured and reported upon?</td>
<td>- Are outputs or outcomes assessed in budget requests?</td>
</tr>
</tbody>
</table>
7 Step 3: Identifying the underlying problems

Chapter purpose

Read this chapter to learn how to use the diagnostic matrix to:
• Build a shared understanding of problems with partner governments.
• Identify the underlying causes of poor budget outcomes.

Completing the diagnostic matrix will highlight the strengths and weaknesses of a PEM system. The next step is to distinguish symptoms from underlying causes and to identify where reform actions are most likely to have an impact.

7.1 Building shared understanding of problems

If you intend to support projects to reform PEM, you will want to ensure that there is a common understanding of the need for reform amongst the government stakeholders who can impact on the success of the project. Therefore, you will want to ensure that any project you agree to support includes a process for building consensus on underlying problems and solutions to these problems.

The matrix in Table 6.2 can be used as a tool for discussing these issues with key government stakeholders. In particular, involving key stakeholders in the process of completing the matrix in a workshop environment helps to identify areas of disagreement and can be a crucial first step in building consensus on problems (see Box 7.1). While this type of workshop may be financially supported by DFID, it needs the backing and commitment of change champions within government (see section 10.2).

7.2 Distinguishing symptoms and underlying problems

7.2.1 Technical or wider governance problems?

After completion of the matrix, it is useful for stakeholders to focus on understanding what is driving poor performance in any of the characteristics. This typically reflects either a deficiency in the:

• Technical competence of the public service. This refers to both the technical capacity and institutional structures and processes to support expenditure management.

• Wider quality of governance: the clarity and openness of the relationship between the executive and the legislature and between politicians and the public service.
Box 7.1: Building problem consensus in Malawi

In response to its failure to lift the quality of budgetary outcomes in Malawi, DFID financed an institutional review of the MTEF. A review team was established comprising consultants and government officers from central agencies and from 6 spending ministries. The team used the PEM diagnostic matrix as an organisational and analytical framework for the review.

An orientation workshop produced an initial listing of the operational problems with the MTEF in terms of the 6 characteristics of the matrix (refined to enhance their relevance to the Malawi context). Working groups then produced a “problem tree” for each area, distinguishing symptoms from causes and proposing broad solutions. The outputs of the working groups were reviewed in a larger stakeholder workshop, which also considered prioritisation and cross-cutting management issues.

The final outcome was a review document that enjoyed a remarkable degree of consensus on problems and their inter-linkages. The areas identified for immediate attention were strengthening of expenditure control and compliance to improve accountability and improvements in forecasting and risk management to raise predictability.

7.2.2 An example

Table 7.1 presents a sample diagnosis of a PEM system based on the matrix outlined in Table 6.2. The example is artificially brief but it highlights many common weaknesses of PEM systems. However, it requires more reflection from stakeholders to identify the key factors critical to enhancing these characteristics. For example, poor control of expenditure is a key issue emerging from Table 7.1. This is partly a technical problem as the lack of an integrated financial management system limits the ability of the Ministry of Finance to control commitments of line ministries. But ministries face little incentive to contain their own spending, as they know that sanctions for overspending relative to budget are never enforced.

The lack of enforcement signals a lack of credibility of the budget, which is at least partly due to the lack of links between the policy and budget process. In particular, the growing pressure of personnel costs on the budget signals a need to review the activities that government undertakes and the mix of personnel and other inputs needed to deliver priority activities.

The lack of explicit engagement of politicians with the budget process means that the process is incremental and unable to address these fundamental policy trade-offs. Instead ministries simply juggle their budget estimates to fit the budget ceiling imposed by the Ministry of Finance. They need not be too concerned about the realism of these budgets, as they know they will not be binding. This creates a vicious cycle (see Figure 7.1) where the combination of a lack of political engagement, of links to policy and of enforcement of sanctions leads to unrealistic budgets and overspending.
This is a simplified example for the purpose of illustration. However, it does show the need to look beyond obvious causes of poor budget outcomes, such as overspending. In this situation, introduction of a technical solution, such as an integrated financial management system, may help tighten control of budget implementation and achievement of the government's aggregate fiscal targets. However, if this control is not matched with the development of more realistic budgets through the prioritisation of activities, progress towards the government's other strategic objectives is likely to be undermined. The key appears to lie in engaging politicians to make policy decisions consistent with available resources.

### 7.3 Common PEM weaknesses

Weaknesses in the six characteristics outlined in chapter 6 result in a number of common problems in developing and transition economies. Awareness of these common problems, several of which are outlined in Table 7.2, will help you in diagnosing weaknesses in the PEM system of your partner governments.
### Table 7.1: Example of Summary Diagnostic of a Public Expenditure Management System

<table>
<thead>
<tr>
<th></th>
<th>Political engagement</th>
<th>Policy clarity, affordability</th>
<th>Predictability</th>
<th>Transparency</th>
<th>Comprehensiveness</th>
<th>Accountability</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget formulation</strong>:</td>
<td>Cabinet has limited involvement in setting priorities: no tradeoffs made between programmes in the context of available resources. Cabinet does not review ministry or programme performance.</td>
<td>No provision of focused annual expenditure agenda by Cabinet: new programmes effectively chosen by sectors/line ministries. No link between budget and national plan.</td>
<td>No link between macro-framework and annual budget submissions.</td>
<td>Revenue and expenditure estimates are published. Could be improved by publication of budget strategy and explanation of budget figures and trends.</td>
<td>Donor funds not captured in budget. 3 components of expenditure (salaries, nonwage recurrent, development) planned separately. No consistent framework for management of financial assets and liabilities.</td>
<td>No performance targets specified for line ministries.</td>
<td>• Ineffective political involvement.</td>
</tr>
<tr>
<td><strong>Policy review</strong>:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Poor link between macro forecasts, policy and budget.</td>
</tr>
<tr>
<td><strong>Strategic planning</strong>:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Lack of performance orientation.</td>
</tr>
<tr>
<td><strong>Budget preparation</strong>:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Budget execution</strong>:</td>
<td>Delays in presentation of accounts to Parliament.</td>
<td>Wages are pushing up expenditure, squeezing out non-wage expenditure, but this is not linked to any clear strategy.</td>
<td>Spending agencies tend to receive at least budget amount. Unpredictable over-expenditure symptom of poor enforcement of accountability.</td>
<td>Financial accounts (actual expenditures) are not published.</td>
<td>No central database of donor expenditure. Significant unreported, off-budget expenditure.</td>
<td>10 different accounting systems which do not reconcile. Sanctions for extra budgetary expenditure are not enforced.</td>
<td>• Accountability not enforced.</td>
</tr>
<tr>
<td><strong>Accounting and monitoring</strong>:</td>
<td>Lack of capacity in parliamentary select committee to review accounts in a timely manner.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Coverage questionable.</td>
</tr>
<tr>
<td><strong>Reporting and audit</strong>:</td>
<td>Politicians not involved in either reviewing performance or setting priorities.</td>
<td>Lack of strategic direction: current policies appear unaffordable.</td>
<td>Atypical in the sense that over-expenditure (rather than within year expenditure cuts) is a problem.</td>
<td>Lack of sufficient information to compare budget plans and actual spending.</td>
<td>Uncontrolled off-budget expenditures are a problem. Poor integration of budget limits its effectiveness.</td>
<td>Accountability for spending or performance negligible. Limited Parliamentary oversight.</td>
<td>• Expenditure control poor.</td>
</tr>
<tr>
<td><strong>Summary</strong>:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Transparency could be improved.</td>
</tr>
</tbody>
</table>
## Table 7.2: Potential weaknesses in PEM

<table>
<thead>
<tr>
<th>Ideal situation</th>
<th>Common weakness</th>
<th>Resulting problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unified budget with full coverage</td>
<td>Dual budget (separate development and recurrent); many extra-budgetary funds.</td>
<td>Difficulty in developing a consolidated budget. More difficult to enforce expenditure limits.</td>
</tr>
<tr>
<td>Universality: all central government revenues go into one fund</td>
<td>Earmarked funds, especially common for financing extra-budgetary funds.</td>
<td>Rigidity in spending priorities. These types of funds often bypass expenditure control arrangements.</td>
</tr>
<tr>
<td>Use of macroeconomic framework in preparing budget</td>
<td>Inadequate knowledge (or incorporation) of macroeconomic constraints. Poor estimates of program costs.</td>
<td>Leads to a bottom-up approach where budget is determined by spending-agency requests: generally leads to overspending.</td>
</tr>
<tr>
<td>Multiyear planning</td>
<td>Focus on current year only; no anticipation of future circumstances.</td>
<td>Potential negative impact on future deficits: recurrent consequences of capital spending are often not foreseen.</td>
</tr>
<tr>
<td>Realistic budget provides predictability to spending agencies</td>
<td>Cash budget based on optimistic revenue projections leads to expenditure cuts during budget execution.</td>
<td>Undermines ability of managers to use resources effectively and efficiently. Incentives to spend budget as early as possible in year.</td>
</tr>
<tr>
<td>Procedures for resource prioritisation implemented early in budget preparation</td>
<td>No direction in priority setting, or attempt to prioritise, until too late in budget preparation process.</td>
<td>If priorities not communicated early in process, overspending relative to budget is likely and contribution of expenditure to government’s objectives is undermined.</td>
</tr>
<tr>
<td>Performance orientation</td>
<td>Almost exclusive focus on inputs, with performance largely judged in terms of spending rather than delivery of goods and services or contribution to the government’s objectives.</td>
<td>There is a lack of clarity between purpose and task and, therefore, poor information on the performance of policies, and service delivery. Spending agencies have little incentive to focus on using resources effectively and efficiently.</td>
</tr>
<tr>
<td>Managerial flexibility in the use of inputs</td>
<td>Cabinet and central agencies involved in detailed decision-making on the day-to-day operations of spending agencies.</td>
<td>Cabinet and central agencies usually lack information to make these operational decisions, undermining the effective and efficient use of resources.</td>
</tr>
</tbody>
</table>

Source: Potter and Diamond (1999)
PART IV: Designing PEM reform

This section will help you to:

• Identify ways in which DFID can support PEM reform.
8 DFID AND PEM REFORM

Chapter purpose
Read this chapter for some food for thought on identifying:
• A role for DFID in supporting PEM reform.
• Steps in providing advice on PEM reform to governments.

8.1 IDENTIFYING A ROLE FOR DFID

After diagnosis the next step is to identify what support to PEM reform is appropriate

Part III provided an approach to understanding the PEM system and perspectives of key stakeholders as a first step to engaging with partner governments in a PEM reform process. In addition to commitment and effort on the part of the partner government, most PEM reform programmes require high levels of technical expertise and financial resources.

If the diagnosis suggests that there is potential for DFID to contribute expertise and/or resources to the reform process, the next step is to decide what type of support is most appropriate. In identifying appropriate areas for support you will need to be pragmatic. The point within the budget cycle at which reforms are initiated will often depend on the motivation, commitment and influence of individuals, rather than a logical deduction of what should be done first.

However, while you may need to be opportunistic, it is important that you still take a comprehensive view of the overall reform process. This is necessary for two reasons:

• You need to be confident that any PEM projects have a reasonable expectation of contributing to improved budgetary outcomes, at least in the long term. This will at least partly depend on how the project fits with other reforms, including those supported by other donors.

• DFID may be well placed to help the partner government in the design of a wider reform strategy, of which the project forms a part, perhaps working in association with the World Bank or other development agencies.

8.2 ADVISING ON REFORM STRATEGIES

It is impossible to prescribe a sequence of reforms that is appropriate in all circumstances...

When advising on reform strategies, it is important to recognise that it is impossible to prescribe a sequence of reforms which is appropriate in all circumstances. While the characteristics in chapter 6 are a feature of any well-performing PEM system, this does not imply that there is only one approach to PEM. There are many different approaches to creating these characteristics depending on the economic, social and administrative capacity realities of the specific country. Therefore, while these guidelines are relatively prescriptive about the approach to analysing PEM systems, it is not possible to provide a blueprint for PEM that will work in all situations and at all times. Having said that, there are some basic principles that come up repeatedly and are worth stating from the outset. These are captured in Box 8.1.
**Box 8.1: Supporting PEM reform - 5 golden rules**

1. Governments must always lead PEM reforms. DFID should seek to work with the key government players in the PEM process, namely the Executive, the Legislature, the Ministry of Finance, Accountant General, Auditor General and the main spending ministries.

2. The reform of a PEM system is a large and complex undertaking: as far as possible, work with other donors, rather than in isolation.

3. Do not underestimate the complexity of the PEM system and the significance of the inter-linkages between its different elements: the system is only as strong as the weakest link.

4. Be sure to focus on where the real problems lie. Try to understand the underlying institutional, as well as technical, issues as fully as possible. Diagnosis should be the byword, not imported ideas.

5. Be prepared for a long haul. PEM reforms take time, as success usually depends on changing the political and managerial culture. Changes in culture take time. To see results, development agencies must be prepared to follow PEM reform through over many years.

Rather than look for blueprint solutions, you need to:

- Return to your, or other available, diagnoses as a basis for identifying what types of reforms are needed.
- Identify potential key drivers of reform and any ongoing efforts to improve PEM within government. Ongoing or recent reforms will help you identify potential champions of reform and, once diagnosis is complete, highlight the areas where DFID can provide support relative to other government or donor activities. Reform processes never start from a blank sheet and as a DFID adviser you should be aware of the need to co-operate with other donors to pull together fragmented efforts.
- Draw on stakeholder and institutional analysis to understand what types of reform may be politically realistic given the incentives facing stakeholders. It may also be possible to identify potential support or opposition to reform based on evidence of commitment to reform from prior actions. Learn from what has worked or failed in the past. While these guidelines touch on many of the institutional issues you will encounter in a PEM reform process, they do not provide a guide to undertaking stakeholder or institutional analysis. The techniques involved in these types of analysis are already well covered in other DFID publications.

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26 For example, see DFID Governance Department: Technical Note No: 14 Institutional Development (1995) and DFID Social Development Department: Guidance Note on How to do a Stakeholder Analysis of Aid Projects and Programmes (1995)
The following chapters consider some of the key issues for DFID when supporting or advising on PEM reform. In particular:

- What would be a realistic pace and sequencing of reform (chapter 9).
- The implications of the institutional environment for managing change (chapter 10).
9  PACE AND SEQUENCING OF REFORM

Read this chapter for:

• Some guidance on identifying the realistic pace of PEM reform.
• Some ideas about how to identify opportunities for reform.
• Application of these ideas to the example from chapter 7.

When advising partner governments on reform programmes or deciding what type of PEM reform to support, you need to consider the appropriate:

• Pace of reform (see section 9.1).
• Sequence of reform (see section 9.2)

9.1  PACE OF REFORM

Technical assistance projects should be in tune with a realistic pace of reform for the country. Governments face a choice between taking a “big bang” or a gradual approach to reform. The politically acceptable pace of reform will depend on where the country falls along the spectrum between a crisis and gradual development of pressure for reform.

9.1.1  REFORM DRIVEN BY CRISIS

The pace of reform is likely to be more rapid when governments are forced to take action by a macroeconomic or fiscal crisis. Reform pressures from a fiscal crisis are often compounded by heavy external pressure from multi-lateral agencies and donors.

In these situations, governments will be more receptive to technical assistance programmes that support wide-ranging reforms. However, beware of governments reforming only in response to pressure from international agencies. Reforms that are instigated from within are much more likely to succeed than those imposed from without.

In particular, there is a risk that reforms driven by crisis will try to move too quickly, perhaps choosing options that are quick over those that would take longer but deliver more sustainable benefits. Attempts to reform too rapidly could also lead to over reliance on external technical assistance, thereby sacrificing relevance and sustainability. It is important not to forget the inertia inherent in PEM. Even those reforms that may seem relatively straightforward, such as revising the budget classification, can take several years to implement. The new classifications are likely to take at least a year to design and approve, and possibly longer if legislation is required, and another year to apply in a first round of budget preparation. A further year will pass before they have been applied in budget execution and accounts, and then another year before the accounts have been audited. So after four years, the new classification system will have only been applied once throughout the cycle. Allowing scope for teething problems, it may take five or six years to fully implement a simple reclassification of the budget.
Box 9.1: Typical PEM reforms

This box categorises typical types of PEM reforms in terms of whether their key focus is on technical or wider governance issues. Note that the success of a reform that focuses primarily on one of these dimensions will depend upon complementary reforms in the other.

Technical:
- Debt management.
- Budget systems and procedures.
- Budget monitoring and review.
- Financial management information systems and controls.
- Cash management.
- Procurement.
- Payroll systems.

Wider quality of governance:
- Enhancing role of civil society.
- Macroeconomic and fiscal planning: defining role of government.

Technical and wider quality of governance:
- Medium term expenditure frameworks.
- Introducing performance dimensions to budgeting.
- Financial accountability and audit.
- Sector Wide Approaches (SWAps).

9.1.2 Gradual reform

The process of PEM reform will be even slower when government commitment to reform is limited. In the absence of crises, pressures for improvements may still build up in consistently under-performing public sectors. In these situations politicians are less likely to support radical reform. In an environment of lukewarm political support for reform, there are two options:

- Support advocacy, civil society or capacity building projects to boost public debate and political support.
- If political support is unlikely to be forthcoming in the short to medium term, there may be benefits in pursuing technical improvements, for example in information systems. However, be aware that the benefits from technical improvements will be limited if it is institutional problems that are really driving poor budget outcomes (see Box 9.2: Managing reform in Bangladesh).
PART IV: DEFINING REFORM

Box 9.2: Managing reform in Bangladesh

The Reforms in Budgeting and Expenditure Control (RIBEC) project in Bangladesh provides a good illustration of effective change in a constrained institutional environment. It also illustrates the relationship between technical solutions and improvements in the wider quality of governance and the dilemmas which this poses.

RIBEC began as a broad reform programme in 1992 but, after early problems, was re-designed to be narrower in scope, focusing on quality and timeliness of financial information, and more evolutionary in approach. From 1996 to 2000, the project has made good progress, improving the presentation and classification of the budget and the timeliness of the accounts. As a result of these technical improvements, the quality, reliability and timeliness of financial information has improved greatly.

The success of the project to date has helped to develop momentum for change and change management capability. The technical improvements have built a basis for achieving better linkages between policies and resources and better budgetary outcomes. The surest way of achieving these improved outcomes would be through improvements in the wider quality of governance, including enhancing the role of Parliament. An easier way forward would be further technical improvements, such as more computerisation. The dilemma is over commitment and sequencing; can commitment to wider governance reforms be secured; can further technical improvements help to secure it and how much more investment in technical improvements is worthwhile without wider reforms?

9.2 Sequencing of reform

9.2.1 Technical or wider governance?

Chapter 7 suggested that a useful first step to identifying what types of reform may be appropriate is to identify whether deficiencies in the generic characteristics are driven by technical problems or problems with the wider quality of governance (see Figure 9.1).

Figure 9.1: PEM intervention matrix

A useful approach to identifying what types of reforms are appropriate...

...is to distinguish between technical and wider governance problems
The dilemma for developing countries

In reality, most developing countries will face a combination of technical problems and wider governance problems. This creates a tension in designing PEM reform strategies. The capacity and administrative realities of most governments mean it is very difficult to make significant progress on both fronts simultaneously.

However, there are limits to the extent to which reform can be advanced on one of the axes in Figure 9.1 to the exclusion of the other. Weaknesses in different parts of the PEM system usually reinforce each other. For example, increased information on what services public expenditure is buying will be limited in value if it is not used to increase the engagement of politicians in the budget process. On the other hand, intentions to increase the quality of information provided to Parliament will come to nothing if the public service does not have the competence to produce meaningful information.

Box 9.3: Getting the basics right

It's very tempting to see the latest fads in PEM as the answer to all a country's problems. But effective PEM reform, is a long and incremental process. Before undertaking more sophisticated reforms, such as MTEFs, governments need to ensure that they have some of the more fundamental technical and governance elements of budgeting in place. Allen Schick has described this as "Getting the Basics Right". In elaborating his argument he states:

- Foster an environment that supports and demands performance before introducing performance or outcome budgeting (see section 11.2).
- Control inputs before seeking to control outputs (see section 6.2.6).
- Account for cash before accounting for accruals (see glossary).
- Establish external controls before introducing internal control (see section 6.2.6).
- Establish internal control before introducing managerial accountability (see section 6.2.6).
- Operate a reliable accounting system before installing an integrated financial management system (see section 11.4).
- Budget for work to be done (outputs) before budgeting for results to be achieved (outcomes) (see section 11.2).
- Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
- Have effective financial auditing before moving to performance auditing (see section 11.5).
- Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them (see section 6.2.3).
As a consequence, it is usually necessary to take a step approach to PEM reform. You will need to work with change champions or managers within government to identify where support can fit into the sequencing of a wider reform programme. Whether the initial focus is on technical matters or wider governance issues requires a balance of:

- Addressing the problem areas identified by diagnosis, ideally tackling the weakest areas and getting basics right first.
- Recognising the constraints and barriers to PEM reform arising from the political and institutional environment. This will often require you to be opportunistic and look for early gains.

**Box 9.4 Getting the basics right in Uganda**

In Uganda an action plan for budgetary reform has been adopted which is focused on getting the basics right first by:

- Improving fiscal discipline through reforms at the centre to improve the control of expenditure and predictability of resource flows.
- Starting the process of better strategic prioritisation through an annual budget framework paper, which reviews and sets sectoral and programme allocations.
- Starting the process of generating performance information at the ministry level and building demand for a stronger performance orientation from implementing agencies.

Therefore, Uganda is focusing on establishing clear lines of control and accountability before introducing performance dimensions to PEM. In particular, they have attempted to establish financial accountability before introducing managerial accountability systems (see Table 6.1), while fostering an environment that supports and demands performance as a basis for the future introduction of more sophisticated performance systems.

**Addressing the problem areas**

In a sense, designing a sequence of reforms requires balancing the demands for reforms with the supply of appropriate techniques. Where possible, it makes sense to tackle the weakest areas first. The PEM system is only as strong as its weakest link: significant improvements in budgetary outcomes are unlikely while major gaps remain in the system. To assess how feasible it is to tackle the weakness links in the chain ask:

- Are technical fixes available in the weaker areas, or are political decisions required?
- If political decisions are required, is there strong Cabinet support for reforms as a whole, and for addressing the weakest areas? Can political support be developed?
- If technical solutions are sufficient, and/or political support is in place, is the motivation and capacity available in the relevant organisation to implement the technical solutions?

When prioritising weaknesses to be addressed, remember that it is important to “get the basics right”. Developing countries must establish the foundations of budget management before...
moving to more sophisticated reforms. There are a number of “basics” (see Box 9.3), but at the most basic level, they can be captured in the question: “does the budget and its implementation reflect the government’s true expenditure intentions?” If the answer is no, then the basics are not being met and must be addressed first. Box 9.4 illustrates how in Uganda, the budgetary reform plan focussed first on the basics.

**Taking into account political realities**

Unfortunately, the areas where there are opportunities for reform are unlikely to be amongst the weakest. It is often necessary to be opportunistic in identifying entry points for PEM reform. Getting reforms started often depends on finding an area where an individual or organisation is interested, motivated and empowered to initiate reforms. However, once the momentum for change has been established the weakest areas identified by the diagnosis should become priorities.

Maintaining momentum of reform is an ongoing challenge. This is particularly difficult given the long-term nature of PEM reform programmes. As these programmes involve institutional, technical and cultural change, they take a long time. It is unlikely that significant progress will be made within two years; a more reasonable time frame may be five to ten years.

Maintaining momentum in this situation depends on delivering visible benefits, which build confidence and support for further reforms. It is important that the initial components of reform include areas that create an impetus for further reform.

In some cases, lack of political support limits reforms to technical approaches, such as improved financial information systems. Yet this style of reform can often lead to an increasing level of sophistication in the technical solutions chosen without movement along the wider governance axis. While reforms that promote improved governance tend to create a demand for technical improvements, the reverse is rarely true.

If possible, PEM reforms should tackle governance issues at an early stage. If support for this type of reform is weak, DFID may consider supporting civil society organisations, to enable them to monitor government expenditures, even at a very rudimentary level, or at least to start to demand information. This may in turn act as a catalyst for further improvements in governance.

### 9.2.2 Technical vs. wider governance solutions in our example

We can use the technical/wider governance distinction to approach the problems diagnosed in our example in Table 7.1. In this example the most critical problems relate to the quality of governance, in particular the lack of political engagement in the budget process. Addressing this problem requires making improvements in the ability of the executive to use the budget as a development tool and ability of Parliament to play the role of watchdog over the executive.

It may be difficult initially for politicians to see the benefits from playing a greater role in the...
budget process. The best approach to reform may therefore be to begin with measures to enhance transparency. In this area, presentation is as important as content. Politicians don't respond well to detailed budgets. However, where aggregate information is presented and linked to programmes that politicians can identify, including some performance information, the level of involvement and critical review increases. Certainly, this is the experience of studies in USA and Europe, and borne out by anecdotal accounts in Africa.

Providing this type of information to politicians will:

- Encourage the executive to think more carefully about objectives for the budget and expenditure trade-offs. As they begin to see the budget as a tool to promote their objectives they may begin to push for improvements in the links between expenditure and the delivery of goods and services.

- Provide Parliament with the information to understand the budget. As their understanding deepens, they may feel empowered to push for greater opportunity to scrutinise the budget and for the refinement of performance measures that allow them to monitor implementation.

Transparency is often a good starting point for PEM reform. The provision of information to the executive, legislature and the public creates demand for further reforms through highlighting the current problems and the opportunities to improve budget outcomes. For example, the establishment of an independent Auditor-General can lead to a better-informed legislature (see section 11.5). Press and advocacy groups play a particularly important role in encouraging reform as a well-informed public will put pressure on government to be more responsive to its concerns. Politicians will show more interest in the budget where they can influence outcomes through open voting systems and where the press is interested in budget issues.

Greater transparency will also encourage technical reforms by putting pressure on the public sector to improve its collection and analysis of information. This may lead to reforms of macroeconomic planning and improvements in accounting systems. In our example, as the executive recognises the scope of the budget to promote their objectives, they will begin to demand better policy advice and budget analysis from ministries to support their decision-making. A starting point might be to strengthen the policy function in one key sector so as to demonstrate what might be achieved with better-targeted resources. If better policies and plans translate into an improvement in expenditure allocation and improved outputs and outcomes, then interest will be generated in other sectors. In this way the demand for more comprehensive PEM reforms might be created.

In our example, jumping to a full-scale Medium Term Expenditure Framework (MTEF) is unlikely to be appropriate. Given that the country has relatively low levels of both technical capacity and quality of wider governance, introducing an MTEF would require pushing out reform on both axes of Figure 9.1 at once. However, there would be advantages to embedding some of the basic elements of MTEFs – particularly focusing on strengthening the clarity of national and sector objectives in the allocation of expenditure (see section 11.1).
Identifying opportunities for PEM reform and building momentum for ongoing reform requires a good understanding of the formal and informal rules and relationships that influence decision-making. In addition, when advising on PEM reform strategies, or designing a PEM project, you will need to keep in mind the basic lessons of change management highlighted by international experience. These include the need for:

- A problem focus.
- Leadership.
- An emphasis on ownership and internal linkages.
- People based incentives.
- Management of risks.

10.1 Keeping focused on the problem

The problems identified in the diagnosis of a PEM system should provide the focus of any support to PEM reform. Reforming PEM is a long haul and it is important not to lose sight of these key problems throughout the change process. Solving real problems helps maintain the momentum of change. For example, political support for budgetary reform was built in New Zealand when rough forms of early output based budget information were used to help ministers set priorities for expenditure in putting together an extremely difficult budget in 1990. However, the nature of the problems, and therefore of the reform programme, will evolve over time. This will require flexibility and a process approach when providing support.

10.2 Leadership

Leadership is an essential ingredient to effective change. Instigating and maintaining the momentum of reform requires both:

- Change champions or political sponsors who demand and support change and help build constituencies for change.
- Change managers (e.g. senior civil servants, in central and spending ministries), who lead the management of the reform programme.

If you cannot identify a change champion and change managers sufficiently empowered to provide effective leadership, you should be conservative in expectations from any programme of PEM reform.

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10.3 Ownership and internal linkages

Reforms with wide ownership are more likely to succeed than those which have a narrow organisational base. In particular, reforms instigated and owned by external advisers are unlikely to be sustained. This is particularly true of PEM reforms.

The reform team needs to build support for the purpose and philosophy of the changes, as well as for the technicalities, by developing broad networks throughout government. In particular:

- Address concerns and incentives of politicians in Cabinet and in the legislature.
- Involve line ministries as much as possible and recognise the importance of the relationship between central and line ministries.
- Provide for effective co-ordination with other public service reforms.
- Seek to co-ordinate and achieve ‘economy of management’ within a coherent government-owned overall strategy (eg avoid the same senior government staff having to sit on steering committees of different donor support projects).
- Address potential barriers to reform, including political, legal/constitutional, institutional or technical/capacity constraints.

10.4 People based incentives

Sustaining reform requires building the commitment of stakeholders in the budgetary process. This involves providing people with the incentive to change. There are essentially three categories of incentives for individuals and organisations to improve budgetary performance:

- Increased accountability derived from control systems.
- Personal reward.
- Professional pride and community pressure.

The stick approach of increased accountability has had limited success and there are resource constraints on increasing financial rewards. Incentive pay systems are also vulnerable to failure if they do not take account of constraints on time use arising from the livelihood strategies of civil servants in low-wage systems. However, there is growing evidence that non-pecuniary rewards can be effective. In particular:

- Giving managers greater freedom to manage and make choices.
- Allowing managers to be seen to be responding to national and local priorities and to achieve greater community regard as a result.

\[\text{\textsuperscript{11} See Mokoro (2000) for a discussion of the different dimensions of ownership.}\]

\[\text{\textsuperscript{12} See Schiavo-Campo and D Tommasi (1999). See also CAPE (2000) for guidance on the design of sector programmes.}\]

\[\text{\textsuperscript{13} See Oxford Policy Management (28-30 July 1999) for the example of Uganda, which accelerated pay increases to those critical to reform.}\]

\[\text{\textsuperscript{14} See Brooke (1999).}\]
• Peer pressure or competition between managers and personal pride.
• Indirect incentives such as personal development through access to training.

However, these types of incentives will only change behaviour if there is a “culture of performance”: if poor performance is criticised and good performance is praised.35

10.5 Managing risks

Close attention must be given to risks, in both the design and implementation of PEM reforms. Anticipating difficulties and dealing with problems quickly avoids them getting out of control and reduces opportunities for those opposed to reform to make capital from them. For example, there is often a risk associated with the relaxation of central input controls. However, risks can be minimised if managed sensibly and in a measured way.36 Successful examples include Ghana’s health sector and New Zealand where the relaxation of central controls was earned, by demonstration of capacity, rather than as a right.

36 See Oxford Policy Management (28-30) July 1999), p 31 and Box 5.7
PART V:
Debates and Issues in PEM

This section will:
• Build your awareness of some key debates and issues in PEM.
Debates and key issues in PEM

Read this chapter to build your awareness of debates or issues relating to:

- Medium Term Expenditure Frameworks.
- Performance budgeting.
- Decentralised decision-making.
- Building auditing capacity.

Good practice in PEM is evolving. Views on the design, pace and sequencing of reforms differ. This chapter highlights debates or key issues in five areas that are of particular relevance to reform of PEM systems in developing countries. Those new to PEM may benefit from reading the rest of this manual before turning to this chapter. The aim is to ensure that DFID advisers are aware of these debates and to realise that there is no single right answer to complex PEM problems.

11.1 MTEFs

Issue: Are MTEFs a useful unifying framework or a distraction from the real problems?

In essence, the MTEF consists of a “top-down” resource envelope consistent with macroeconomic stability, a “bottom-up” estimate of the current and medium term cost of existing national priorities, and a framework which matches these costs with available resources through an iterative decision making process. There are three key components to MTEFs:

- A statement of fiscal policy objectives or targets, for example for total expenditure, the fiscal deficit and debt levels, based on medium term macroeconomic projections (referred to by the IMF as a Medium Term Fiscal Framework).

- Medium-term expenditure estimates for individual spending agencies based on clearly defined sector policies. The objective is to allocate resources towards strategic national objectives within constraints implied by overall fiscal targets.

- Elements of activity and output budgeting that seek to improve strategic prioritisation and the efficiency of public expenditures.

Box 11.1 Lessons from South Africa’s MTEF

While still evolving, South Africa’s MTEF is generally recognised as supporting a more strategic approach to balancing priorities within revenue limits. One study identified the following factors as key to its success:

- Political commitment from Cabinet and strong principal leadership from the Minister and Department of Finance.
- Simplicity. The MTEF runs on a simple framework of integrated three year spending plans, with annual changes made on a rolling basis. The published MTEF only added to existing budget formats one page per department detailing spending over three years.
- Comprehensive implementation rather than pilots in one or two departments or provinces. This enables the integrated assessment of policies and spending plans.
- The MTEF did not run parallel to an existing budget process, but became the only process for the allocation and management of expenditure. This was backed up by the delivery of predictable funding by the Ministry of Finance.
- Demonstrating quick wins. Acceptance was enhanced by a rapid turnaround in provincial finances. The ability of the executive to spread the pain of lower than expected economic growth between 1998-2000 over the medium term, rather than imposing severe spending disruptions in one year, also built support for the system.
- Good budget support and new systems. The central treasury provided budget support to build capacity at provincial level. Considerable effort was also expended to establish new management information systems.

Perhaps, most importantly, the MTEF has been a living process. The inception MTEF operated on poor information; low capacity and weak intergovernmental co-ordination. The second year saw the addition of sectoral review teams to improve policy co-ordination and the third year saw new financial management legislation. Improvements are continuing with plans including clearer linkages of service delivery information and financial data and a more comprehensive assessment of wider public sector fiscal activities. It is doubtful whether these developments would have come about without the demands created by the medium term budget process.38

These three elements describe the full-scale MTEF. Many expenditure management systems referred to as MTEFs do not include all of these components. In fact, you will find that it is the first two elements that are crucial. While ultimately a good thing, activity or output budgeting can be an extra complication which diverts attention from the critical steps of defining sector policies that are consistent with the target for total government spending.

38 This box is drawn from Mokoro (2000)
In CEE and FSU countries, MTEFs have been used to integrate the analysis of fiscal trends and issues into the budget process and to introduce the concept of the Budget as a strategic policy tool. As overall reform of budget systems and procedures is still only at the initial stages in these countries, the approach in the more successful MTEFs has been to focus initially on establishing a realistic aggregate fiscal framework and a summary analysis of issues relating to the main economic and functional categories of expenditure. In some countries the MTEF has been used to develop an agenda for public expenditure reforms including new budget systems, moving away from the inflexible norm-driven approach that characterised centrally planned economies.

Technical assistance support for introducing MTEFs in these countries has tended initially to be quite limited. It should aim to establish government ownership and commitment to the MTEF. Thereafter, more extensive support is likely to be needed both in strengthening institutional capacities within Budget Departments, and in supporting policy-based budget analysis in line ministries. More detailed analysis of “efficiency” issues and the relationship between budget inputs and outputs can be considered as a third stage that involves moving away from the rigid norms and line item budgeting that inhibit the restructuring of sub-sector budgets.

Experience suggests that the most successful MTEFs are those that are used as a strategic tool to make broad allocation decisions, rather than get bogged down in detail (see Box 11.1 and Box 11.2). The first step is for line ministries to be required to prepare more systematic justification for their budgets bids and defend them in budget hearings. This can develop into more sophisticated approaches as capacity is strengthened. For example, technical support in Uganda has helped the Ugandans to move from initial basic approaches to reviewing the consistency of sector budgets with stated priorities to beginning to cost out development goals more systematically. By showing the expenditure implications of current policies for future budgets, medium term expenditure projections can highlight whether the government is undertaking more than it can afford. Therefore, the benefits are particularly significant when there is a large gap between stated policies and actual resources.

The clearest message from the contrasting experiences of different countries is that clarity of national and sector objectives is crucial. Start with the following priorities, which are summarised in Figure 11.1:

- At the political level, MTEFs need to be driven by a clear policy framework and fiscal strategy. Only then can gains be made from attempts to link budget outcomes to policy objectives. This strategy will be undermined if ad hoc expenditure reallocations and inconsistent macroeconomic management occur.
- At the central level, building the capacity of the Ministry of Finance to reduce the gap between forecast and actual revenues and expenditures is crucial, as a means of improving budget predictability and the credibility of the MTEF process. Sector ministries cannot be expected to improve their performance if the Ministry of Finance cannot ensure a predictable level of funding.

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This box was provided by Mokoro.
MTEFs may not be a universal panacea but can promote strategic thinking

• At the sector level, clear, consistent and realistic sector policies need to be established before trying to achieve transparency in the allocation of resources to specific activities. The central agencies, such as the Ministry of Finance, should ideally play a “challenge function” by questioning ministries’ definitions of sector priorities.

It will also be important to reflect aid in the budget. Where the volume of aid is significant and the bulk of aid is not incorporated into the budget formulation process, integrating the recurrent budget with the domestically financed component of the development budget will not provide a comprehensive approach to public expenditure management (see section 6.2.5).

**Figure 11.1: Priorities in MTEFs**

Source: Oxford Policy Management

It is not surprising that MTEFs should receive near universal support. They can be an effective tool for introducing strategic thinking into the budget process. However, MTEFs are not the universal panacea that many have taken them to be. There are in fact few well-established MTEFs in developing countries. Those that do exist have only been recently introduced and are still evolving. MTEFs can work if they embed the basic elements of strategic thinking, before introducing more sophisticated budgeting tools that divert attention and resources away from the key changes essential for success.

### 11.2 Performance budgeting

**Issue: Is performance budgeting the answer to poor performance?**

Many developing countries focus on holding agencies responsible for keeping spending in line with budgets. While this is important, public sector managers should also be required to justify their budgets, and be assessed, in terms of the results to be achieved. This is because:

• The lack of a link between budget allocations and expected results makes it difficult for the legislature or civil society to be clear about the implications of the budget for the quality and nature of government services.
• If spending agencies are not assessed on results it makes it difficult to judge ex-post whether actual outcomes are those that were intended or whether better value for money could have been achieved. In particular, spending agencies will have no incentive to ensure that they deliver high-quality services or that their activities contribute to the government’s objectives.

Performance budgeting goes one step further than simply holding managers accountable for performance. It also links budget allocations with the intended results of expenditure through either:

• Outputs: the goods and services they have produced or provided, e.g. delivery of a defined minimum package of health interventions to a specified proportion of the population.

• Outcomes: the extent to which spending agencies have contributed to achieving the government’s objectives; e.g. infant mortality targets.

The term performance budgeting in essence describes this shift from measuring inputs to outputs and outcomes. Performance budgeting typically goes hand in hand with increasing managerial discretion in the use of inputs. Without this discretion managers can not be held accountable for results. However, there are debates about how appropriate performance budgeting is for developing or transitional countries. Alan Schick argues that developing and transition countries should first establish reliable external controls, then internal control systems before moving to performance or managerial accountability (see Table 6.1). These systems create the habits and practices of managing according to the rules that are essential preconditions to creating the performance oriented management culture within the civil service that is critical to systems of performance management.

In addition, the data requirements and techniques of performance budgeting are very demanding. For example, it usually requires significant improvements in accounting and reporting systems to allow costs to be better attributed to particular activities. Indeed, there are very few examples of operationally effective performance budgeting systems in developing countries though many have tried to implement them, often with the enthusiastic support of donors and consultants. In Asia; the Philippines, India, Malaysia, Singapore and Sri Lanka have all adopted types of performance budgeting with uneven results. Much the same has happened in Latin America and elsewhere. Typically, where performance budgeting has been introduced, its role has been scaled down from what was originally intended.

However, while developing countries may not want to rush into performance budgeting, particularly in terms of increased flexibility in the use of inputs, they can introduce elements of performance management. In particular, they can bring discussion of objectives and activities into the debate about expenditure allocations at the time of budget preparation. “First generation” performance management systems can establish performance targets at a broad level (ministry or department) and encourage spending agencies to strive towards improved performance. This provides the basis for the development of performance budgeting, through the definition of outputs or outcomes, as capacity is strengthened.

\[^{40}\] See Schick (1998)
Decentralising decision-making

Issue: Does increased operational flexibility improve the delivery of public services?

In almost every developing country, government and development agencies are talking about the need to decentralise. In very broad terms, this refers to the shift of spending and, to a lesser extent, revenue-raising responsibilities to sub-national levels of government. It reflects, at least in part, an untested assumption that local-level decision making will improve political accountability, ensure that publicly provided goods and services are more relevant to the preferences of recipients and improve the efficiency with which public services are provided.

While decentralising spending responsibilities can bring about these benefits, this is not automatically the case. Weak sub-national institutions can undermine benefits from decentralisation. Overstaffing, poor technical skills, corruption and a lack of transparency beset sub-national levels of government as much as they do central governments. Therefore, studies to assess the institutional capacity of sub-national levels of government, and programmes of improvement (such as training in financial management, councillor training programmes, etc) may be necessary forerunners of devolved responsibilities.

It may be advisable for the pace of decentralisation to vary between sub-national governments, depending on capacity. A number of countries (e.g. Uganda, Thailand, Ghana) and aid agencies (e.g. UNCDF) are experimenting with ‘hurdle criteria’ (particularly in financial management and accountability mechanisms) which must be met before responsibilities and resources are devolved.

Some analysts feel that decentralisation will exacerbate inequality in countries with high regional income disparities, and advocate that additional funds should be given to sub-national governments to equalise capacities and resources. Even where provinces have similar resources, they can differ in their responsiveness to the needs of the poor. A recent review of an Argentine social programme funded by central government but implemented by provinces found that poverty targeting varied substantially across provinces. 41

Nonetheless, recent studies suggest that local officials and community groups can be well placed to identify and reach the poor, in some cases more so than central authorities. 42 The extent to which decentralisation does lead to more efficient and responsive services will depend upon the extent to which local governments are accountable to their constituents. This requires electoral rules that encourage participation and representation and consultation with civil society. In Bolivia it was only when decentralisation gave communities more power to influence their local governments that the composition of local public expenditures shifted in favour of the poor. 43

It is also important to decentralise functions and access to the necessary resources simultaneously. Failure to transfer resources with new expenditure responsibilities can cripple local government’s ability to perform new functions. Many African countries have decentralised functions without providing the necessary revenues, leading to sharp declines in the quality of services. Other countries have done the opposite and created fiscal problems at the centre by decentralising revenues without the associated responsibilities.

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41 World Bank (1999/2000)
43 World Bank (1999/2000)
Countries have had mixed results from decentralisation and there is not, as yet, overwhelming evidence that it delivers benefits in responsiveness and efficiency of service delivery. The extent to which decentralisation does improve access and quality of public services will depend upon the way it is designed and implemented. In particular, the success of decentralisation will depend upon developing institutions that promote accountability and transparency at the local level and co-ordination between the layers of government.

11.4 FMIS

Issue: Can technological innovation improve accountability in the absence of the right political and institutional support?

Most countries that are designing PEM reforms will consider the issue of computerised financial management information systems (FMIS). A comprehensive FMIS covers many functions. However, the most critical are the core budgeting and accounting system and the payroll system. Therefore, typically the FMIS will aim to build these foundations first. Few countries really consider fully integrated FMIS. The favoured approach is to build the core components separately but using consistent coding so that they can be integrated in the future.

A good FMIS makes an essential contribution to the achievement of the six characteristics in chapter 6 and so to the achievement of good budgetary outcomes. An FMIS can potentially deliver two benefits:

- **Improved information** at all levels of management and administration. An FMIS should improve the timeliness, accuracy and variety of expenditure information. An FMIS should have controls that prevent most data entry errors, automate the transfer of data within the system, and ensure a full audit trail.

- **Better expenditure controls.** The direct effect of an FMIS is to reduce the opportunities for diversion of funds away from the priorities reflected in the budget, both at a strategic level and at an operational level. For example, if the payments process is automated, it can provide the information needed to ensure that payments do not exceed the budget for any given item of expenditure. However, whether this control is exercised will ultimately depend on the existence of political will to enforce discipline.

Therefore, an FMIS provides the information that government, Parliament and the public require to hold public managers to account, and to make better decisions about the allocation of resources in the future. Donors, who are providing some form of budgetary support to a government, are often particularly interested in FMIS since they impact significantly on controls over expenditure. Developing country governments will typically need donor support to develop FMIS as the costs are significant, in terms of financial outlay, effort and disruption and the risk of failure is high.

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44 See World Bank (1998a) and CAPE (2000) for a detailed description of the components of an FMIS.
45 A modern payroll system will typically aim to integrate with personnel, pension and control systems, and so is referred to here as a Personnel, Pensions and Payroll System.
46 Subsequent reference to FMIS therefore applies to the introduction of a core budgeting and accounting systems, or core budgeting and accounting system together with Personnel, Pensions and Payroll System.
47 There is huge variation in the potential cost of a core budgeting and accounting system; taking into account the consultancy inputs as well as software and hardware. It is likely to be at least $10 million and may rise to $20 million. Implementation across government of a core budgeting and accounting system or a personnel, pensions and payroll system can be expected to take at least five years.
Box 11.3: **Key lessons from FMIS projects**

DFID’s experience in developing FMIS has highlighted some key lessons for project design, resources and management arrangements:

- Always use an Information System Adviser to advise DFID and the Government, if they are willing, throughout the whole of the project cycle (make use of DFID’s panel of information systems experts).
- Ensure that everyone accepts that implementing an FMIS will be a long process and that benefits will not be instant.
- Consider the underlying design of the system, particularly whether it should comprise one system or several stand-alone systems.
- Ensure a very clear separation between the consultants advising the government on systems requirements and supervision of contractors, and the contractors implementing the systems.
- Avoid bespoke systems development if possible.
- Advise government to contract one supplier to deliver the working system (with sub-contracts as necessary) to ensure that government is not involved in disputes over the allocation of blame if things go wrong.
- Encourage government to develop the capacity to manage and maintain the system and consider the organisational changes that the new system requires. Restructuring is often necessary (firstly within the Ministry of Finance/Accountant General’s Department, but also in spending ministries and agencies) to reflect changes in roles and responsibilities.
- Consider sustainability – in terms of local support for hardware and software, availability of sufficient qualified staff in government – also related recurrent cost implications.

International experience suggests that there is a real risk of failure in the introduction of large management information systems. It is normal for a Government to sub-contract a firm to supply a system, but the effective management of that contract by Government is critical. This will require skills and dedicated personnel within the Government, but it is very likely that this will need to be complemented by substantial external support from those who have direct experience of managing these types of projects. Key lessons from experience of FMIS projects are summarised in Box 11.3. Reference should also be made to DFID’s guidelines on Good Practice in Developing Sustainable Information Systems (DFID 1997).

Given these costs, decisions to develop FMIS systems should not be taken lightly. When are they worth it? The contribution of FMIS to budgetary outcomes depends on the political and institutional framework in which they work. The value of information produced by the FMIS depends on it being used, for example, to inform expenditure allocation decisions or to control over-expenditure.

It may not be worth developing an FMIS if there is a lack of political or bureaucratic will to use the budget as the authoritative tool in resource allocation or to use the output of the FMIS to hold people to account. At an absolute minimum, the Ministry of Finance/Accountant...
General’s Department must be willing and able to substantially influence the accounting operations of spending ministries.

However, it is important to remember that in the absence of the information provided by an FMIS, transparency and accountability is impossible. It may be useful to think of FMIS development as an important complement to institutional reforms that encourage information to be published and used to inform decision-making. But be wary of the temptation to continually support technical improvements in the quality of information, without addressing the institutional constraints that prevent that information being used to promote better budget outcomes. The benefits from FMIS depend on people making use of the information to improve decisions about the allocation of funds, to hold public managers accountable for their use of funds and to make government more transparent to its citizens.

11.5 Auditing

Issue: Improving audit processes – is there any benefit?

External audit of the Executive undertaken by a Supreme Audit Institution (Office of the Auditor General in many countries) is a key requirement for achieving transparency about how public funds have been used and a critical component of PEM.

In almost all instances, external audit deserves the moral support of the international community, given its vital contribution to transparency. The importance of preserving the independence of the Auditor General and of taking action on audit findings should be an important theme in multi-lateral and bi-lateral relations. It is less clear-cut, however, whether technical and other assistance should be provided to develop the capacity of the Office of the Auditor General. This is because the benefits of external audit depend on both the quality of the audit and the extent to which follow-up action is taken on audit findings. If assistance is to be provided there are two important lessons to bear in mind:

- Achieving substantive organisational change in an Office of the Auditor General is no easier than achieving it in other public organisations. Improving the operational independence of the office, in terms of staffing and financing, can help remove some of the constraints and can help ensure that the Executive doesn’t deliberately undermine audit work. However, even if independence is gained, and skills and training provided, this will not necessarily lead to better performance if the office is not held accountable for better audit performance. The Auditor General is typically a servant of the Parliament/National Assembly and pressure for performance needs to come from this source.
In designing an audit project, consideration should be given to how audit findings are followed up. Whilst the quality of audit may be variable,\textsuperscript{48} it is unfortunately the case that follow-up by Parliament/National Assembly and the Executive is depressingly and consistently poor. In these circumstances, you may want to consider what support could be provided, for example to the Public Accounts Committee of Parliament/National Assembly and the Ministry of Finance, to strengthen the follow up procedures and practices.

However, even when the government is not responsive to the findings of the audit, it may still be worth supporting the independence and capacity of the Auditor General’s Office. The placing of the audit report in the public domain means that some information is reaching citizens about government activities and puts at least some pressure on the government to follow-up, either now or in the future.

\textsuperscript{48} On the one hand, it is common for the most basic of audit practices and working papers to be incompete; on the other hand many offices of the Auditor General have special units devoted to performance/value-for-money audit. This diversity may exist in the same Office of the Auditor General.
Glossary and References

This section will help you to:

• Understand PEM jargon.
• Find additional sources of information on PEM issues.
This short glossary explains key terminology used in the guidelines. More extensive glossaries are recommended at the end of this section.

**Accountability**: is one of the characteristics of a robust PEM system. Accountability requires that decision-makers be held responsible for the exercise of authority invested in them. Not only must budget officials and line ministries answer for the use of funds, but also face consequences for any misuse of funds.

**Accounting and monitoring**: this is the stage of the budget cycle where ministries and other spending agencies are required to report their expenditures and revenues (and perhaps performance) for the budget year to the Ministry of Finance. Note that year-to-date accounting and monitoring will also usually occur on a regular basis during budget execution.

**Accounting officers**: officials who have the ultimate responsibility or accountability for a vote.

**Accountant General**: an official, usually within the Ministry of Finance who is responsible for ensuring that the budget is implemented as passed by parliament, the setting of accounting standards and for the consolidation of the government’s accounts.

**Accrual Accounting Systems and Cash Accounting Systems**: accrual accounting systems recognise transactions or events at the time economic value is created, transformed, exchanged, transferred, or extinguished - and all economic flows (not just cash) are recorded. Cash accounting systems recognise transactions and events when cash is received or paid. Unlike accrual accounting, they do not recognise non-cash events. A key difference is that cash accounting systems have no record of asset values, which has a significant impact on incentives concerning the use and maintenance of capital.

**Appropriation**: The budget as approved by the legislature for line item of spending. The budget law gives the executive branch the authority to incur obligations, which become due during the budget year up to a specified amount for specified purposes within a financial year (usually one fiscal year).

**Auditor General**: reports to Parliament and to select committees on whether departments have conducted their business in accordance with the intention and authority of Parliament. The role of the Auditor General is essentially to provide Parliament with an independent assurance that all expenditure of public money has been properly authorised and accounted for, and that the information presented to Parliament is fair and correct.

**Below-the-line items**: There are below the line drawn to establish the deficit between revenues and expenditures; correspondingly above the line items comprise expenditure and revenues. “Below the line” thus normally relates to the financing of deficits.

**Budget**: The annual document in which the government presents its expenditure and taxation plans for the coming year.

**Budget execution**: stage of budget process where the government’s expenditure programmes are implemented.

**Budget preparation**: stage of budget process involving the submission and negotiation of ministry expenditure bids. The process concludes with parliamentary review and legislative approval.

**Budget process**: is the vehicle by which the government sets its overall budget plans and within which decisions are made on the allocation of funds.

**Cash budgeting**: a situation in which there is no cash borrowing to fund expenditure so spending is limited to cash receipts. In this environment, any fall in revenue relative to forecast immediately feeds though into cuts in within-year expenditure.
Central agencies: organisations at the “centre” of the public service which are responsible for providing the executive with advice and support for overall policy and processes. Central agencies include Ministry of Finance, Auditor General, Civil Service Departments and Office of the Prime Minister. These agencies are less likely to be influenced by narrow sectoral interests and their role is to challenge the advice of sector ministries from the perspective of overall national welfare.

Commitment: The placement of a purchase order or signing of a contract or other agreement for the provision of goods or services.

Comprehensiveness: is one of the characteristics of a robust PEM system. The budget should capture all activities of government. Effective resource allocation through the budget process requires current and capital expenditure decisions to be linked and assessed together.

Contingency reserve: a small portion of the total budget that is set aside for expenditures on unexpected needs or emergencies, not appropriated in other budget lines.

Contingent liabilities: represent a potential future draw on government resources. Contingent liabilities are not a certainty, but a type of risk. For example, potential damages from the loss of a court case.

Country Financial Accountability Assessment: a World Bank diagnostic tool designed to enhance knowledge of financial accountability arrangements in the public and private sectors. It serves two purposes: a fiduciary purpose, by identifying weaknesses in accountability arrangements in the public sector and the risks that these may pose to the use of Bank (and other donor) funds; and a developmental purpose, by facilitating a common understanding of the problems, and the development of plans to rectify them, including use of technical assistants where appropriate. There is a strong interest in developing the CFAA as a tool to be relied upon by donors collectively. The World Bank also has a separate tool for assessing public procurement arrangements – the Country Procurement Assessment Review (CPAR).

Development budget: public investments brought together in one plan intended to develop the economic and social potential of the whole economy or a specific area. They often include both capital and current spending on investment projects. In developing countries they are often mainly, but not exclusively, financed externally.

Dual budgeting: when the central government budget is not unified. Instead there are separate recurrent and development budgets that may be based on inconsistent macroeconomic assumptions, budget classifications, or accounting rules. Dual budgets increase the risk that projects and programmes do not compete equally and simultaneously for available resources. This undermines the ability of the government to choose the most effective and efficient expenditures.

Effectiveness (of public expenditure): the contribution of public expenditure to advancing the government’s objectives.

Efficiency (of public expenditure): public spending is efficient when goods or services are delivered at minimum cost.

Entitlement: Any spending programme where expenditure is open-ended (usually transfer/grant payments) and where recipients must be paid or given transfers/grants, if they meet certain criteria. Some common examples are found in social security programs, unemployment programs, and poverty programs.

Estimates: forecasts of revenue and vote Ministers’ requests for authority from Parliament to incur expenditure and liabilities; i.e. the ‘estimate’ of what revenue will be raised and expenditure incurred during the coming fiscal year.

Extra-budgetary funds: Accounts held by government bodies but not included in the governmental budget. Earmarked revenues or user fees and charges often finance expenditures from such accounts.
**Financial Management Information Systems**: a set of tools to support the achievement of PEM objectives. Ideally, a set of linked systems that provide vertical integration – through the planning, budget preparation, budget execution and accounting and monitoring phases of the budget cycle – and horizontal integration – across different units of government.

**Fiscal discipline**: maintaining spending within limits created by the ability to raise revenue and maintain debt at levels that are not prohibitively expensive to service.

**Fiscal policy**: government policies with respect to taxes, spending, and debt management that affect macroeconomic outcomes, particularly with respect to employment, the size of the economy, price level stability, and equilibrium in balance of payments. The budget process is a major vehicle for determining and implementing fiscal policy.

**Fiscal year**: is the government’s accounting period and is often referred to by the year in which it ends.

**Inputs**: the resources used to produce goods and services.

**Institutional structure**: the framework of rules, customs and incentives, which determine how decisions are made. These include formal rules and regulations and unwritten customs and habits. The outcomes of PEM will depend on the institutional environment in which the budget process operates.

**Legislature**: elected representatives who have responsibility for passing legislation, including the appropriation act, which gives the executive authority to make expenditures according to the budget.

**Line ministries**: ministries responsible for providing policy advice on, and implementing activities, in a particular sector, such as Education or Agriculture.

**Macroeconomic framework**: macroeconomic assumptions underpinning the budget. It is prepared in the strategic planning phase and provides a forecast of the overall resource envelope for the upcoming budget.

**Medium Term Expenditure Framework**: There are three key components to an MTEF: a statement of fiscal policy objectives and a set of integrated medium term macroeconomic and fiscal projections; medium term budget estimates for individual spending agencies based on sectoral objectives and priorities and elements of activity and output budgeting. However, many budgetary approaches that exclude the last element are still referred to as MTEFs.

**Outcomes**: the impact of public expenditure on the community or in advancing the government’s objectives.

**Outputs**: the goods and services produced with public money.

**Outturn**: actual revenues and expenditure.

**Parliamentary or Public Accounts Committee**: is the common name for the Parliamentary Select Committee that reviews the budget and is most directly involved in the public expenditure management (PEM) system.

**Policy clarity, consistency and affordability**: is one of the characteristics of a robust PEM system. Effective expenditure management requires well-defined expenditure policies, which are properly costed and consistent with available resources.

**Policy review**: the first stage of the budget process. The budget process is kicked off by an annual evaluation of the results of public expenditure to inform the updating of policies and plans.

**Political engagement**: is one of the characteristics of a robust PEM system. A PEM process that promotes political engagement provides a framework in which political intentions are reflected in stated policies and in the budget.

**Predictability**: is one of the characteristics of a robust PEM system. It refers to the extent to which the budget provides a dependable guide to public sector managers as to where and when resources will be made available.
Programme budgeting: a programme budget is specified in terms of programmes rather than along organisational lines. A programme is a public policy objective along with the steps necessary to achieve it.

Provisional appropriation: Legislation that permits an expenditure to get under way before the actual budget appropriation, without any further authorisation procedures. This is most commonly used at the start of the fiscal year; e.g. when the legislature has not yet finalised the budget.

Public expenditure management: the way in which public money is allocated to alternative uses and in which these decisions are implemented. It is broader than the traditional budget process through its focus on the link between expenditure and policy and its recognition of the importance of a broad range of institutional and management arrangements.

Public expenditure reviews: are analyses of the allocation and management of government expenditure. They may cover all government expenditure or focus on one sector. They can inform strategic planning and budget preparation by identifying ways to improve strategic allocation and value for money.

Quasi-fiscal operations: Activities of the central bank (or other state-owned financial or non-financial enterprises) that are similar to fiscal actions pursued by the government. Although undertaken at the direction of the government, they are usually financed by the banks or state enterprises but not included in the budget. Examples include credit to commodity boards (or other entities) at below-market interest rates, and central bank expenditures on the bailout of failing banks.

Recurrent budget: expenditures on wages and salaries, operations and maintenance that is not of an investment nature.

Reporting and audit: the final stage of the budget cycle, where the Auditor General reviews compliance, reporting in detail to the Public Accounts Committee which, in turn, advises Parliament and initiates corrective actions as necessary.

Resource envelope: the upper limit for expenditure for the upcoming budget based on expected revenues and deficit and debt targets. Ideally the resource envelope should be set during the strategic phase of the budget process so that expenditure is planned within a realistic constraint. In a good system resource envelopes will have a multi-year horizon.

Sequestration: within-year cuts to ministry expenditure allocations or budgets.

Special accounts: Accounts recording transactions of an “exceptional” character that are made outside the normal procedures for expenditure approval and recording; many refer to temporary accounts (such as advances), or to transactions whose authority is questionable or to the accounts of formal extra-budgetary funds or “below-the-line” accounts.

Strategic planning: the stage of budget process where Ministers determine their Budget strategy and objectives.

Supplementary appropriation: Legislation passed during budget year to provide for expenditures additional to original budget.

Transparency: is one of the characteristics of a robust PEM system. A transparent PEM system provides an understandable guide as to how resources are planned to be used and what results are expected to be achieved. Reporting should also enable easy monitoring of performance against government’s stated intentions.

Value for money: the achievement of economy, efficiency and effectiveness in the use of resources, in order to achieve desired outcomes at the lowest cost.

Virement: the process of transferring expenditure provision between expenditure classifications during the budget year. To prevent misuse of funds, spending agencies must normally go through administrative procedures to obtain permission to make such a transfer.

Vote: a group of appropriations. Each ministry or department will consist of one or more votes.

Warrant: A release of all, or more commonly a part, of the total annual appropriation that allows a line ministry or spending agency to incur commitments.
Other useful glossaries

The following glossaries may also be helpful:

2. The United States Senate, Committee on the Budget [The congressional budget process - an explanation
   http://www.senate.gov/~budget/republican/reference/cliff_notes/cliffc1.htm]
   [http://curricula.mit.edu/~nasbo/mod10/con01.html]
5. United Kingdom, HM Treasury, [www.hm-treasury.gov.uk/pub/html/budgetmore.html]
Useful sources of information on the “nuts and bolts” of PEM include:

Potter and Diamond (1999), *Guidelines for Public Expenditure Management*,
International Monetary Fund.

These guidelines are relatively brief and have been prepared for IMF economists reviewing the fiscal sector of the economy. The focus of the guidelines is on assessing the adequacy of budget preparation and execution systems.

www.worldbank.org/publicsector/pe/pehandbook.htm

This handbook provides a broad framework for thinking about PEM and reforming PEM systems. It includes a series of detailed checklists for diagnosing the weaknesses of budget and financial management systems in the public sector.

The World Bank also has a comprehensive website focused on public expenditure issues. See:
www.worldbank.org/publicsector/pe
A useful part of the web-site looks at how to undertake a Public Expenditure Review:
www1.worldbank.org/publicsector/pe/p1perhpw.htm

Centre for Aid and Public Expenditure Management (CAPE) in Overseas Development Institute (2000), Economists Manual on Aid and Public Expenditure Management. Available on the DFID Intranet and at:
wwwodi.org.uk/ppg/cape/capepapers.html
The manual covers the budget cycle in detail as well as providing sections linking poverty and donor support to public expenditure issues.

www.adb.org/documents/manuals/govt_expenditure/

This comprehensive manual covers the entire PEM cycle – from multi-year expenditure programming and budget formulation through budget execution, audit and evaluation. However, the manual is quite large and takes a long time to download.

Centre for Budgets and Policy Priorities (CBPP) (September 1999) *Guide to Budget Work*.
www.internationalbudget.org/resources/index.htm

CBPP is an US-based independent research organisation. The US International Budget Project website has a comprehensive list of international websites on budget issues.

www.oecd.org/puma/budget

PUMA is the Public Management Programme at the OECD. It undertakes reviews, comparative analysis and evaluative benchmarking of OECD member countries’ PEM systems.
REFERENCES

OTHER USEFUL TEXTS REFERRED TO IN THESE GUIDELINES INCLUDE:

Brooke (1999), Creating budget incentives for better performance and better budgetary control, Case Study for the Good Practice in Public Expenditure Management Workshop. Available from DFID Governance Department and Oxford Policy Management (see below)


DFID *Good Practice in Developing Sustainable Information Systems* (May 1997) supporting guide (March 1998)


Scott (October 1996), *Government Reform in New Zealand*, International Monetary Fund.


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<td>Diamond and Potter (1999), chapters 1 &amp; 2.</td>
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<tr>
<td>Historical overview and problems with traditional</td>
<td>CAPE (2000), chapter 5.</td>
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<td>Institutional context</td>
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<td>World Bank, civil service institutional assessment:</td>
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<td>Diamond and Potter (1999), chapter 2, box 2, pp 14-16.</td>
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<td>Accountability and governance</td>
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<td>www1.worldbank.org/wbiep/decentralization/orgnet/decentralization.htm</td>
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<td><a href="http://www.oecd.org/puma/sigmaweb/index.htm">www.oecd.org/puma/sigmaweb/index.htm</a></td>
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<td>Diamond and Potter (1999), Glossary.</td>
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Source: Oxford Policy Management
The Department for International Development (DFID) is the UK government department responsible for promoting development and the reduction of poverty. The government elected in May 1997 increased its commitment to development by strengthening the department and increasing its budget.

The central focus of the government’s policy, set out in its first White Paper on International Development in 1997, is a commitment to the internationally agreed target to halve the proportion of people living in extreme poverty by 2015, together with the associated targets including basic health care provision and universal access to primary education by the same date. The government’s second White Paper on International Development, published in December 2000, reaffirmed this commitment, while focusing specifically on how to manage the process of globalisation to benefit poor people.

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We are also contributing to poverty elimination and sustainable development in middle income countries, and helping the transition countries in Central and Eastern Europe to try to ensure that the widest number of people benefit from the process of change.

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