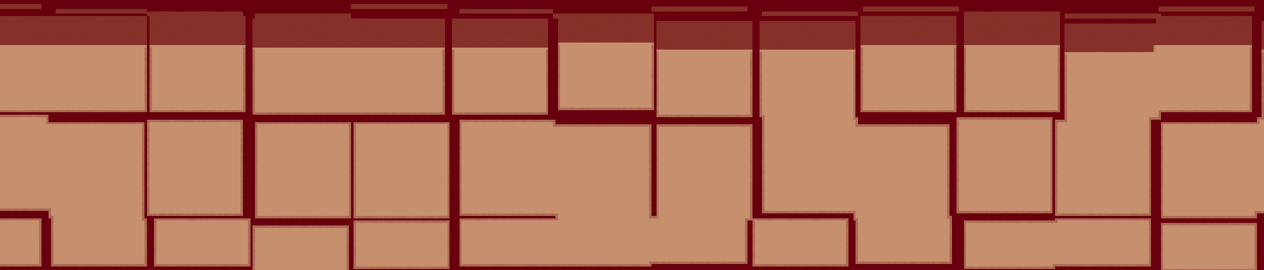
BUDGET REFORM SEMINAR

30 November – 2 December Maputo, Mozambique

MANAGING COMPLEXITY

From fragmentation to co-ordination



Budget Reform Seminar

Managing complexity: From fragmentation to co-ordination

30 NOVEMBER – 2 DECEMBER 2005 MAPUTO, MOZAMBIQUE

This publication was compiled by the CABRI Secretariat. It contains research papers presented at the CABRI Budget Reform Seminar in November/December 2005, and which have subsequently been edited.

All errors are those of the authors and editors, and the text does not constitute a shared opinion of or representation by any of the ministries to which the authors are affiliated.

For information on the Collaborative Africa Budget Reform Initiative, including the two Budget Reform Seminars, or to obtain copies of this publication, please contact:

CABRI Secretariat
Budget Office
National Treasury
Private Bag X115
Pretoria 0001
South Africa
Email: cabri@sentechsa.com
www.africa-sbo.org

Edited by Alta Fölscher
Copy-editing by Laurie Rose-Innes
Design and lay-out by Compress

This document has been financed by the Swedish International Development Cooperation Agency, Sida. Sida does not necessarily share the views expressed in this material. Responsibility for its contents rests entirely with the author.

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Acknowledgements

The success of the 2nd Budget Reform Seminar is attributable to the inputs of many individuals and institutions.

Thank you to the Ministry of Development and Planning, Mozambique for hosting the 2nd Budget Reform Seminar.

This resource book is an outcome of the knowledge and expertise of the presenters at the seminar, who came from finance ministries and regional and international bodies. The management support provided by GTZ and funding from various donors – DCI, SIDA, USAID and US Treasury Office of Technical Assistance (OTA) – contributed to the success of the seminar.

The management committee of CABRI is acknowledged for its leadership and guidance in realising the network's objectives.

Acronyms

BFP	Budget Framework Paper
BGC	Budget Guidelines Committee
CABRI	Collaborative Africa Budget Reform Initiative
COFOG	Classification of the Functions of Government
CSO	civil society organisation
DBS	direct budget support
DEPD	Department of Economic Planning and Development
DFID	Department for International Development
DP	development partner
GBS	general budget support
GECC	Government Expenditure Ceiling Committee
GFS	Government Finance Statistics
HIPC	heavily indebted poor countries
IFIs	international financial institutions
IFMAP	Integrated Financial Management Accountability Project
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
MEPD	Ministry of Economic Planning and Development
MFPED	Ministry of Finance, Planning and Economic Development
MoF	Ministry of Finance
MoFED	Ministry of Finance and Economic Development
MTEF	Medium Term Expenditure Framework
MTP	Medium Term Plan
NBFP	National Budget Framework Paper
NSGRP	National Strategy for Growth and Reduction of Poverty
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PAF	Performance Assessment Framework
PBA	programme-based approach
PEAP	Poverty Eradication Action Plan
PER	Public Expenditure Review
PFM	public finance management
PFMRP	Public Finance Management Reform Programme
PGBS	partnership general budget support
POPP	President's Office, Planning and Privatisation

PRGF	Poverty Reduction Growth Facility
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
PSIP	Public Sector Investment Programme
RPFB	Rolling Plan and Forward Budget
SBAS	Strategic Budget Allocation System
SBS	sector budget support
SCOA	Standard Chart of Accounts
SDPRSP	Sustainable Development and Poverty Reduction Strategy Paper
SNA	System of National Accounts
SWAp	sector-wide approach
TA	technical assistance

Background

The Collaborative Africa Budget Reform Initiative (CABRI) is proud to present its second publication, based on the 2nd Budget Reform Seminar that was held from 30 November to 2 December 2005 in Maputo, Mozambique. Sixteen countries from across the continent were represented at the seminar, which is an achievement that builds on the success of the previous seminar held in Pretoria in December 2004. The theme of the Maputo seminar, *Managing complexity: From fragmentation to co-ordination*, dealt with the critical challenges that face African senior budget officials.

This book reflects discussions at the seminar, outlining good practice, lessons learnt and the progress made across countries. The topics covered include the nature of co-ordination, management of aid flows, comprehensiveness of budget frameworks, the good as well as the bad of de-concentrating public functions, and the role of legislatures.

The format of the seminar allowed for formal inputs, while providing sufficient space for discussion and focused forward thinking. Both types of contribution are captured in this volume. Valuable inputs were obtained not only from country representatives but also from international experts, the participants sharing their experience and understanding, and challenging common concepts. This is very much in line with CABRI members' commitment to critical thinking in reforming and developing their country systems.

The Maputo seminar and this post-seminar publication are further steps towards the CABRI objective of *contributing towards the efficacy of public financial management reforms on the African continent*. Together, these are a resource for officials engaged in budget reforms and for development partners. CABRI strives to grow a robust network of budget officials on the continent through repeated engagement and exchange of ideas. As such, the network is a response to the interest of senior budget and planning officials in learning from their peers.

This conceptualisation of CABRI as a self-regulating, learning network was echoed in the opening address at the Mozambique seminar, delivered by the National Director Planning Dr José Sulemane, who stressed the importance of the network as an African initiative to solve African problems in the areas of public finance and budget management, and to build a body of practical experiences and lessons, rather than theories that fall short in the real world. The aim of the network and of this volume is to provide senior practitioners with effective tools and to alert them to comparative experiences in their task of translating development goals into specific policies and effective programmes.

1

Introduction

1.1 Managing complexity: from fragmentation to co-ordination

Budgeting in the public sector is an inherently complex and fragmented exercise. In even the most straightforward system, where the budget is primarily a financial plan for a centralised government, funded from predictable own resources and paying for public goods and services delivered by a civil service in government line departments, managing the government budget is not a straightforward exercise. It still involves the combination of multiple information sources, different perspectives and diverse interest groups, all influencing complex decisions. Fragmentation is inevitable between the centre and the line, between planners and financial managers, between budgeting and implementation and between different types of spending.

As government service delivery and financing modalities have grown more complex, so the demands on budget management tools and processes have increased. A modern budget management system now has to cope with multiple layers of government and their complex financing arrangements, sophisticated financing instruments, multiple delivery modalities and an environment where the distinction between public and private is increasingly blurred. At the same time, the

demands on the budget in terms of public management have increased. From being seen primarily as the tool to deliver on government's financial objectives and ensure accountability, the budget is now at the centre of translating a country's development goals into results.

Budget managers in developing countries typically have to deal with a number of additional sources of complexity, often in a less favourable human resources environment and under much greater policy and financing uncertainty than in developed nations.

The 2005 CABRI seminar theme, *Managing complexity: From fragmentation to co-ordination*, was the result of a survey of members a year earlier as to which topics would be of interest to them in future seminars. It is significant that the topics most commonly identified are the key drivers of complexity in developing country budget management: co-ordinating recurrent and capital spending and planning for investment; off-budget revenues and expenditures; the impact of debt-relief and aid-management trends; devolution, decentralisation and de-concentration; the separation and/or integration of planning and budgeting functions; and political involvement in the budget.

The seminar programme was designed to look at these key drivers of complexity, how they play out in CABRI member countries and what solutions are in place to de-fragment budget planning and execution. While the emphasis of the seminar was on sharing experience among CABRI members, several inputs were designed to bring relevant experience from elsewhere to the debate.

This introduction to the seminar resource materials seeks to highlight the important issues raised in the seminar presentations and discussions. It refers to the main themes of the papers reproduced in this volume. In addition, it picks up on arguments raised and experience shared in further presentations during the seminar for which papers were not provided.

The seminar programme flowed from an introduction of the theme, to discussion of system-wide institutional and technical mechanisms for managing budgeting complexity, through to discussion around four specific issues that contribute to complexity. The introductory session, which set the context for the discussions, was followed by sessions on:

- *System-wide institutional and technical mechanisms*
  - Co-ordination at the centre: structures, institutions and legal frameworks
  - Aggregation and disaggregation: comprehensiveness, budget frameworks and classification

- *Specific co-ordination issues*
  - Managing aid flows
  - Co-ordinating recurrent and investment spending
  - Decentralising public functions to public agencies, entities and bodies: benefits, pitfalls and management
  - Policy, budgeting and oversight: the role of the legislature

1.1.1 Session snapshots

Aspects of the new public finance

The opening session is captured in the paper, 'Aspects of the new public finance' (see section 1.2 below). The session framed the seminar by discussing the emerging developing country public finance context. It identified two particular driving forces behind increased complexity: the exploration of the policy space between the public and the private within countries, and between countries and institutions in the international arena. States are no longer singular constructs with simple lines of authority and straightforward rules and procedures for a limited set of transactions; they have become complex institutions with multiple roles engaging in multidimensional agreements and partnerships.

The session drew attention to the concept of the intermediary state and its role in negotiating with interests outside of national boundaries, as well as to the role of intermediary institutions – including CABRI – in reducing the risks and transaction costs of international co-operation. The session also highlighted the importance of understanding that international co-operation happens not as much across national borders as at a national level influenced by international agreements. Progress in building common approaches to partnerships, prioritisation and budgeting – supported through initiatives like CABRI – is important for the efficient mobilisation of resources, even when not pooled or collectively managed.

Finally, the session turned to discussing the need for more direct co-operation between states, particularly in a regional developing context, and the role of ministries of finance and budget offices in ensuring the growth of such co-operation. The session highlighted the potential for co-operation regarding infrastructure development, shared-interest policy areas like tourism, high-cost tertiary health and education services and economic regulation. In setting up the institutions to deal with all these developments in public finance management, the session emphasised the need for simplicity and streamlining requirements to the essential – budgeting institutions become ineffective when unnecessarily congested.

Complementing the introductory theme presentation in the first session, the

Nigeria case study illustrated well how modern dynamics play out at a country level. In recent years, Nigeria has faced various challenges (political, technical and economic) that arose due to the transition from a military regime to a democratic state. This coincided with the introduction of a number of institutions in the public finance management sphere, including fiscal rules that sought to save revenue windfalls from oil, fix the budget deficit and restrict sub-national borrowing. Despite these efforts, core difficulties with budget management remain, including the lack of a disciplined timetable, unsatisfactory co-ordination between the executive and the legislature in agreeing to a budget, unclear roles and responsibilities for planning and budgeting, and complex donor partnerships.

Co-ordination at the centre: institutions, and co-ordinating development and recurrent spending

In the second session, the costs and benefits of separating national responsibility for planning and budgeting between two ministries or amalgamating them into one ministry were discussed. The Malawi presentation (see Chapter 2) mirrored the experience of several other countries, including Kenya and Mozambique, where both joined-up and separate ministries have been in place. While the benefits of a merged institution are better co-ordination and easier linkage between planning and budgeting, the costs include scant attention to long-term strategic planning and investment issues. In either case, amalgamation or separation is often driven by political purposes with little, or even dysfunctional, change in the underlying allocation of roles and responsibilities.

As also highlighted in the Senegal presentation, the issue is not so much about one or two ministries, but rather about whether the budget process ensures that co-ordination between the planning and budgeting functions is maximised. The Senegal presentation emphasised the need for a robust legal framework to underlie procedures, rules and systems. As in other countries, the management of budgets has been undermined by lack of capacity in line ministries to link planning and budgeting (e.g. through proper costing practices), fragmentation between the systems that manage donor resources and domestic resources and lack of discipline in budget execution. Recent reforms regarding donor co-ordination and alignment, and budget and finance management systems, have sought to address these problems. The Malawian experience of the role of a robust medium-term expenditure process in maximising co-ordination was echoed by other countries during discussion.

A parallel issue is the co-ordination of recurrent and investment spending, the second theme addressed at the seminar. The Tanzania case study (see Chapter 2), together with the Malawi case study, on central planning and budgeting institutions,

illustrated well how a single budget process anchored in clear policy directives and a single classification system can overcome some of the difficulties posed by having separate investment and recurrent budgets.

The Mozambique presentation offered a view of the difficulties associated with large development partner involvement. Since 1997, with the passing of the law on the budget, there has been a single budget in Mozambique. Although recurrent spending is the responsibility of the Ministry of Finance and investment projects fall under the Ministry of Planning and Development, the two are brought together in a single budget, which is prepared within a single directorate.

However, matters are complicated by sectors where significant off-budget development partner expenditure occurs. Here, different classification systems generate problems; it is difficult to get a transparent view of what investment is required in a sector when a comprehensive picture of existing spending is not available. Development partners can play a role in lack of co-ordination. Their interests are often negotiated at a sector level, without reference to a national set of priorities. At the central level, however, donor commitment to co-ordination and alignment has brought some consistency and transparency into policy planning and budgeting. The lack of an amalgamated investment budget (or a clear perspective on the total number of projects undertaken) still means that as the number of projects increases, co-ordination between them becomes more complex and it is difficult to ascertain whether they are sustainable in aggregate. Investment spending is not always based on medium- to long-term resource availability. The introduction of decentralisation of spending to provincial and local governments is likely to add to this complexity.

The Mozambique presentation also emphasised the importance of having an explicit, national policy framework within which sectoral policies can be defined and against which the desirability of individual spending demands can be judged.

Aggregation and disaggregation: comprehensiveness, budget frameworks and classification

The third theme addressed at the seminar was that of the purposes and requirements of a classification system (see Chapter 3). The theme presentation included a case study of the reform of the South African system.

The purposes of a good classification system include linking different information sets and phases of the budget process together, ultimately to improve service delivery. Good data is crucial for policy-making processes, as it is for control and accountability purposes. A classification system should also be designed with international standardisation in mind to allow country compliance with data dissemination standards and international comparisons. However, the presentation emphasised the need to put

local requirements first. Several requirements for classification systems were discussed, including the need to have a multidimensional system, coverage of the full general government account, and linked information across the full accountability cycle.

The South African case study was clear that the design of a good architecture is not sufficient; it needs to be combined with a process of change management to migrate all institutions of government across to the new system. Important lessons from the South African experience include the following. System designers must first understand the information demands of country-specific decision-making processes, and these should determine the structure of the system. There is often a mismatch between what accountants require on the financial management side and what economists require on the budgeting side; both need to be included in the chart of accounts. Care should be taken to strike a balance between necessary detail and appropriately aggregated information in developing the system. Finally, it takes a few years of implementation and capacity-building work before a new chart of accounts will produce quality information. Similarly, the introduction of a financial management information system will not solve budget execution problems unless it is backed by reforms in business processes.

The seminar devoted a session to reporting on the CABRI pilot questionnaire. Questionnaires are potentially powerful research instruments for the network to draw out commonalities and differences between member countries. The pilot questionnaire focused on budget comprehensiveness, budget structures and classification issues, complemented by a short section on budgeting institutions and budget documentation. A total of nine member countries submitted completed questionnaires, pointing towards interesting trends in country practices. A summary of these trends and more detailed information on country responses regarding budget structure and classification appears in Chapter 3. The responses show that in most countries the classification systems have undergone reforms recently and are in good shape, although the budget structure and coverage of the classification system are not always comprehensive.

Donor co-ordination, harmonisation and alignment

The fourth major theme addressed at the seminar was that of donor co-ordination, harmonisation and alignment. The theme presentation and paper (see Chapter 4) examined the management of aid flows in the context of new approaches to aid delivery, including the move to programme-based approaches under partnership and budget support arrangements. The preliminary evidence from evaluations of these new aid modalities suggests that some of the expected benefits are occurring, including recipient governments being better able to manage their own budget

processes and a strengthening of aid co-ordination. However, the paper also finds some aspects of concern, such as evidence that conditionality related to general budget support can result in unpredictability of budget funding, which, in turn, affects fiscal discipline. It is noted, though, that such problems are not necessarily related to the aid instrument itself but may be caused by donor behaviour that cuts across other aid modalities as well.

The presentation emphasised that general budget support approaches are a relatively new innovation and, at present, constitute a mutual learning experience for donors and recipient governments. For the potential benefits of these approaches to be reaped, it is likely that there will need to be further adaptation and change in both donor and partner government approaches and practices in order to ensure that key objectives are met.

The Ethiopia case study (see Chapter 4) offers concise insights on the difficulties of implementing the new approaches at country level, highlighting the importance of strong country leadership backed by a clear policy framework. In the Ethiopian case, strong principles that emerged (and were formulated into a comprehensive aid policy) were as follows: ownership of the system (including reporting) should rest with the country; dialogue, co-ordination, harmonisation, alignment and information sharing should be used to enhance partnerships; external assistance should be focused on reducing poverty; capacity building must remain an integral part of external assistance; direct budget support should become the preferred mode of external assistance; and flows of donor aid should be predictable. Ethiopia also emphasised the need to partner with non-state internal stakeholders.

While providing a useful description of various country-level institutions employed to implement these principles, the Ethiopia case study is very clear that older practices persist and that the remaining conditionality and additional requirements present huge challenges. It is arguable that 'the global commitment to harmonisation and alignment does not easily translate into country-level action'.

Decentralising public functions to public agencies, entities and bodies: benefits, pitfalls and management

The fifth theme presentation (see Chapter 5) shared Organisation for Economic Co-operation and Development (OECD) experience in creating and managing arms-length agencies and outsourcing public services. Arguments in favour of agencies centre on expectations of increased efficiency, better focus and greater independence. Many OECD countries have gone down the agency route, and while some benefits have materialised there are also many concerns. One key concern is that agencies are often associated with a loss of transparency and a blurring of roles and respon-

sibilities, leading to a loss of accountability. Agencies can also place a burden on the central budget that is more difficult to control in periods of economic slowdown than is the case with the budgets of ordinary government departments, distorting the allocation of resources against priorities.

Outsourcing, through various modalities including public-private partnerships and the contracting of private parties through competition, is a way to introduce market principles into the public service. A voucher system, which places discretion in the hands of the client, is another instrument to improve competition. There is evidence to suggest that these modalities result in cost savings, but that various conditions such as capacity on the side of the state to negotiate contracts are critical, that desired outputs and outcomes should be described clearly, and that mechanisms for feedback from the public should be in place.

The Kenya case study (see Chapter 5) highlights that agencies are not created only for reasons of effectiveness and efficiency. Driving factors in Kenya were the need to employ more Kenyans and the aim of cost sharing, and agencies were often created to tap additional revenue sources, through the charging of fees or the creation of extra-budgetary levies. The ability of agencies to attract specialised skills is an important driver; human resources management frameworks that operate outside of public service restraints allow for better remuneration packages, but a perverse consequence of this is that agencies may drain the public sector of scarce human resources.

Over the years of managing such agencies in Kenya, several pitfalls have become apparent. Currently, approximately a fifth of the recurrent budget is transferred to agencies, but with far less control and oversight than would be in place for ordinary government ministries, which are answerable to central control agencies and Parliament. Even minimum levels of control lag behind because of delays in reporting. Many agencies also accumulate liabilities that ultimately become the responsibility of the central revenue fund when agencies default on payments. The duplication of activities of government ministries is also not uncommon, and the capacity within ministries to manage these agencies is often weak.

Overall, the Kenyan experience is that once these agencies have been created they are difficult to abolish. The existence of a clear legal framework, allowing for exit plans and/or effective sanctions should agencies no longer be required or should they fail, is an important precondition for deriving benefits from this modality of public service delivery.

Policy, budgeting and oversight: the role of the legislature

The final theme of the seminar concerned managing the complexity introduced by legislative oversight of budgeting (see the theme essay and the Uganda case study

in Chapter 6). The theme presentation emphasised the importance of having a functional role for Parliament in budget management. Parliament, with its mandate to approve allocations and its oversight of budget execution, should be seen as an important partner for central ministries of finance in budget management. Historically, however, the relationship between ministries of finance and legislatures has often been one of rivalry rather than co-operation. At the same time, parliaments have been instrumental in collapsing public finance systems rather than stabilising them. The key lesson from history has been that the institutional arrangements of the parliamentary budget process and the incentives that parliamentarians face count in determining whether the legislature's role is one of making budget policy or supporting policy accountability and performance.

The required institutional arrangements concern having a robust legal framework that demarcates: an effective role for the legislature as opposed to the executive; the establishment of co-operative arrangements with ministries of finance, including frequent information flows both before tabling budget proposals and during budget execution; and the establishment of sufficient analytical capacity in Parliament to facilitate good decision-making. However, the most important requirement is the establishment of a comprehensive, centralised budget process in Parliament that forces recognition by parliamentarians of the net social costs and benefits of their budget proposals (or amendments). Legislative budgeting rules are important further instruments in disciplining the legislature's role towards better budgetary outcomes, albeit by placing restrictions on the kind or number of proposals and amendments or by putting in place procedural limitations.

The Uganda case study is illustrative in setting out how these broad principles can be applied at country level to improve the quality of budgeting by allowing an effective role for Parliament. Since the enactment of Uganda's Budget Act in 2001, the budget-making process has become more open, transparent and consultative, involving a cross-section of stakeholders including Parliament, Cabinet, line ministries, local government and external, private sector, civil society and development partner stakeholders. These stakeholders have the opportunity of early and continuous involvement in setting priorities and in monitoring public expenditure for social and economic development through a series of consultative and supervisory mechanisms. The case study is unambiguous about the importance of putting in place the necessary structures (such as a budget office and a committee system in the legislature) and building capacity to undertake these processes.

Extra-programmatic contributions

Two further presentations, somewhat outside of the programmatic themes, contributed

to member countries' seminar experience.

An OECD presentation on aid flows into Africa provided CABRI member countries with valuable information on future aid flows and changes in aid-flow practices. The expectation is that between now and 2010, aid will rise rapidly, particularly into Africa, driven by increases in existing donors' budgets and by new countries contributing. Despite the potential benefits of additional resources, several concerns arise out of this projected increase: firstly, the impact on countries of such a large upscale in aid; and, secondly, the entrance of new actors who do not necessarily subscribe to the emerging multi-donor system and who may not have a strategic overview of what is happening at the aggregate level.

The presentation echoed earlier presentations at the seminar in highlighting predictability, aid dependence, absorptive capacity and political accountability as key issues for managing the upscale in aid. Work is currently in process to minimise uncertainty in the forward funding scenario for recipient countries, allowing multi-year fiscal and expenditure planning frameworks to operate better under circumstances of significant donor support.

Potential changes in how aid is reported by donor countries were considered, including different aid instruments and the possibility of establishing an accounting standard for aid, which would help donor harmonisation. Discussion finally turned to the strain that the upscale in aid will place on recipient countries' budgeting and financial management capacity, and the need to prepare for the shift through joint capacity-building efforts by existing donors and recipient countries was stressed.

The Angolan delegates voluntarily prepared a discussion paper on public finances in Angola, linked to the general experience of resource-rich African economies (see Chapter 7). During a lively, special evening session, the presentation highlighted changes in Angolan practices in line with generally accepted public finance principles, and demonstrated how these reforms occurred within a particular political economy and within sets of international financial, economic, trade and political relationships that influenced their design and implementation. The paper illustrates how economic structures and governance systems have been directly linked to the platform of natural resources and social relationships in Angola and in the general African context.

1.1.2 Conclusion

Complex structures affect all aspects of budget and public management, whether it is between institutions at the centre, between levels of government, between different types of government unit or in the interface with bilateral and multilateral agencies. The specifics of how institutions and budgets are structured are often not as impor-

tant as having in place the frameworks, disciplined processes and minimum information requirements for co-ordination.

The country case studies commonly highlighted the difficulty of translating new approaches into practice. Across the presentations and discussions, some shared principles and concerns for moving towards better co-ordination emerged.

Local requirements must be taken into account when adopting practices from elsewhere. While it is important to learn about standard international approaches and other countries' experiences with mechanisms to reduce complexity (e.g. medium-term expenditure frameworks and classification systems), CABRI member countries should apply their local understanding and knowledge, particularly of the informal systems that underlie local practices, when applying these solutions.

A recurring theme was the need to operate within clear legal frameworks and to keep it simple. Any additional institutional arrangement anywhere in the full budget cycle, whether it is a new structure, a new system or new documentation, must have a clear purpose that does not duplicate existing structures and for which the linkages to existing processes, structures and rules are made clear. If existing institutions are not functioning well, it is rarely a long-term solution to introduce additional or duplicate institutions. The complexity of the system needs to be kept in line with the commensurate development of capacity (another important theme throughout discussions). The role of legal frameworks in providing a clear foundation for even the most complex of practices was emphasised; in turn, this is determined by the quality of legal drafting and the engagement of skilled practitioners in the process of drafting.

A further thread emerging from discussions was the need for change management. Reform managers should take care that systemic changes, including the reasons for change, the rationale for the chosen route and the expected benefits, are communicated clearly. From design through to implementation and evaluation, stakeholder participation is important; and the design and implementation of reform should ensure that the right incentives are in place.

1.2 Aspects of the new public finance

Andrew R Donaldson

1.2.1 Introduction

Public finance, as an analytical discipline and as the practical arena of public policy design and implementation, has undergone two far-reaching reforms over the past two decades.

The first is the exploration of the 'policy space' between markets and government action – the evolution of public-private partnerships and pursuit of public policy purposes through the regulation and mobilisation of private sector activity and co-operation with civil society organisations.

The second is the growing role of international co-operation in public affairs, action to address global public goods and increasing attention to the dynamics and effectiveness of international collaboration in both policy and public service delivery.

These dimensions of public policy add considerable complexity to the discipline of public finance and to the practice of public policy making and implementation. The tidy division of the world into public and private sectors, and domestic and foreign affairs, has given way to much more complex institutional arrangements and hence

a more elaborate intellectual apparatus. At the same time, the 'new public economics' begins to give some order to what formerly appeared to be fragmented and disorderly – the diversity of divisions between public and private activity, and the great clutter of overlapping international agreements and institutions.

There is no sharp divide between the old and the new – globalisation and increasing interconnectedness of nations has been a long historical trajectory, and the interface between the public and private sectors has been a kaleidoscope in motion for as long as public affairs have been the subject of literate comment. However, the last few decades have seen great seismic shifts in both the discourse and the practice of public finance, and some commentators have seen fit to identify a 'new public economics 1' and a 'new public economics 2' in recent times: the first concerned with the public-private interface, the second with the international dimensions.[1]

The complexity of these shifts raises difficulties for public policy, because both public-private partnerships and international co-operation carry high transaction costs. For developing countries – and particularly for small, low-income nations – managing the complexity is a huge challenge. The great benefit of traditional government arrangements is that they are simple, lines of authority are clear, rules and procedures are documented and familiar and the annual budget process provides a transparent and unambiguous assignment of resources to public purposes. Resources are raised through taxes, which have the great advantage to the fiscus of being mandatory.

Co-operative or contractual arrangements with the private sector, and international collaboration in pursuit of common purposes, are fraught with negotiation difficulties, problems of trust, possible conflicts of interest, risk, uncertainty, asymmetric power and interminable frustration. It is easy enough to formulate rhetorical praise for the partnership idea; getting the agreements past the legal advisors, the financial analysts and the project steering committees is entirely another matter. Nevertheless, the complexity is with us, and we have to find a way through the barriers of misunderstanding and the legal and financial technicalities.

This creates rather a daunting agenda for CABRI for the next year or two. But it is also a wonderfully exciting opportunity, because there is so much to gain from getting these things right; there are immense benefits from improvements in the public-private sector interface and in the quality and focus of international partnerships.

Constructing the right agenda for research and co-operation over the next few years means thinking hard about what the most pressing and most promising areas of collaboration might be. CABRI's resources are limited, so it is important to make careful choices.

1.2.2 The new public finance

An intermediary state

Let me share a few ideas from the 'new public finance' literature that might be useful.

The first is the idea of an *intermediary* state. This is a concept developed in some detail by Inge Kaul of the UNDP Office of Development Studies as a way of thinking about how governments in a globalised world have to reach compromises and negotiate an appropriate balance between the demands of the outside world and their own domestic political and policy objectives. States that fail to negotiate workable compromises risk being marginalised in the global development race, and in extreme cases end up as 'rogue' or 'failed' states. Thus, it is one of the tasks of modern governments to intermediate between national and global interests, but it is not efficient to think of every small nation finding its own particular set of compromises with the rest of the world. Consequently, we have multilateral institutions that perform the intermediary role on a global or regional scale, in effect providing a forum for achieving collective solutions and developing 'templates' for international partnership – in trade matters, in managing global environmental issues, in dealing with international crime and money laundering, and in regulating financial affairs.

CABRI has an intermediary role to play, and it may be worth spending some time exploring what this means. Firstly, there is no need to reinvent standards of good practice in budget design and implementation, but there is a clear need to adapt from international practice simplified and standardised approaches that are suitable for countries with very limited resources, various degrees of aid-dependence and, perhaps, the particular kinds of relationships between the national fiscus and local or community development programmes that are characteristic of African economies. In all of this work, it is important to respect national sovereignty – country circumstances vary and sovereign governments will make their own choices – but there is a great deal of useful work that can be done collaboratively to assist governments in exploring options and finding a shared understanding, especially in those areas of public policy and financial management in which the external world has particular interests.

These interests of the rest of the world are very wide-ranging, and often uncomfortably intrusive. This is not just a First World-Third World thing: national sovereignty is subject to constraints, even in the richest and most powerful nations. Sovereignty is qualified by the rest of the world's interest in how property rights are protected, in how one country's tax laws impact on investments or trade relations, in how crime and fraud are combated, in how the environment is protected, and in how human rights are protected. Take the currently topical example of the concern, worldwide, about the prevalence and possible mutation of the bird flu virus. Because

birds migrate across boundaries, a country's interests cannot simply be secured by strict border controls and municipal health inspections – every nation has an interest in what every other nation does to control the internal transmission of bird flu. The 'new public economics' reminds us that many public goods are in fact 'global' public goods that require global co-operation and partnerships.

What has this got to do with budget reform? Shared interests need to be addressed through shared resource arrangements. Of course, the rest of the world can negotiate individual aid or budget assistance or joint financing arrangements with every individual country, but progress is likely to be faster and more efficient if collective vehicles are found. So it may be helpful to give further thought to the intermediary role that CABRI can play, helping shape more streamlined arrangements for dealing with the external world's interest in financial management and resourcing both of development and of the global or regional public goods that need to be collectively addressed.

Subsidiarity

There is a second concept in the 'new public finance' literature that is helpful in managing the complexity of things – it is the idea of *subsidiarity*. This is rather a ponderous word, but it captures the simple idea that globalisation is more about co-operation behind, rather than beyond, national borders. This gives recognition to the fact that international institutions do not have sovereign powers and international collective action is difficult and costly. Thus, many kinds of international co-operation happen, in effect, behind national boundaries – that is, they do not rely on multilateral institutions and global action, but take place within the context of national programmes and partnerships. This is a simple but very powerful insight.

It is not necessary – in fact, it is often impractical – to create an international pool of funds and directly spend or control programmes through multilateral institutions, in order to deal with global public goods or shared interests. In recent years, there have been new international funds and programmes created for particular purposes, but comparatively few permanent multilateral institutions have been created. Most action happens at the national level, influenced but not dictated by international agreements. It is precisely because this is where most of the action is that it is so very important for initiatives like CABRI to make progress in building a common understanding and consistent approaches to budgeting, planning, prioritisation and partnerships, so that resources can be efficiently mobilised, although neither pooled nor collectively managed.

Although there is a preference for national-level interventions, because institutions and decision processes are largely defined by national boundaries, we need to explore options for more direct collaboration as well. Many African countries are very

small, so there are scale economies in joint initiatives. Major infrastructure projects – transport, water supply, power generation – have natural network properties that cut across national boundaries. In areas such as higher education, production and supply of school books, tertiary referral hospitals, customs and trade administration, specialist agricultural support and industrial standards and certification, even tourism promotion, there are substantial scale economies and benefits of concentration of resources. CABRI might usefully give further consideration to how the planning, budgeting and management of joint infrastructure projects, and collaboration in improving the quality of public services, could be taken forward; these are perhaps matters for dedicated task teams to consider.

An interesting sub-component of this topic is the scope for contractual service-delivery agreements between governments, or 'trade' in public services. Many American states have cross-border agreements on access to and charges for higher education opportunities, for example. There are many areas of public service delivery where the normal principles of specialisation, comparative advantage and potential economies of scale argue for co-operative government-to-government agreements, and these can also involve private sector service providers. It does not make sense for every country to have its own mint, or to try to achieve a comprehensive portfolio of higher education and research programmes.

However, unless work is done on the terms and conditions of agreements between countries, and the appropriate financing or pricing arrangements, these kinds of co-operation will not happen.

Economic regulation is another area of considerable complexity, in which there is much to gain from cross-border co-operation. The last 20 years have seen phenomenal growth internationally in the number and variety of arms-length regulatory agencies, through which governments seek to provide expert and independent oversight of financial markets, industrial competition, public utilities, telecom suppliers, environmental protection, consumer protection, food safety and public health. It is not just that there would be scale economies and technical advantages from collaboration in building regulatory capacity; there is also the huge benefit for the development of the market economy that comes with standardisation and greater certainty in the regulatory environment.

This is a useful reminder that the central economic challenge facing African economies is to achieve more rapid economic growth, investment, broader participation and employment creation. Complex and elaborate public services that carry high investment requirements or significant increases in revenue requirements are unlikely to be affordable. Our budget offices have a huge responsibility to concentrate resources on those programmes and initiatives that have the greatest impact on

both economic development and poverty reduction. Of course, it does not help if the plans and analyses and programme designs for development and poverty reduction are so complex that nobody in the spending agencies actually knows what they are supposed to be doing. We need to build sound and simple monitoring and evaluation systems and continuously look for ways of achieving greater impact with the limited resources at our disposal – in association with spending departments and service delivery agencies.

International partnerships can help, and there is a great deal of work to do in simplifying and streamlining the allocation of international donor funds and ensuring that foreign technical assistance is more efficiently used. Partnerships with the private sector can help – both contractual arrangements for private sector service delivery and partnerships with local and international non-governmental organisations. Again, there is a great deal of work to be done in getting the design of these arrangements right and in building relationships of trust and effective co-operation.

In managing these and other kinds of partnership, and more generally in modernising our budget systems and financial management, it is important that we continuously guard against unnecessary complexity.

Complex loan structures and guarantees can be designed for infrastructure investments, but then you need to make sure you have lawyers and financial analysts on your side who are just as good as those hired by the banks. Multiple performance targets and objectives and outputs can be written up for a multitude of programmes and agencies, but you are much more likely to keep track of progress if you are monitoring a handful of reliable performance indicators. Modern accounting systems can be purchased as off-the-shelf computer packages, but traditional cash-management systems are more likely to give you effective expenditure control.

1.2.3 Conclusion

The modern world offers many opportunities for public finance innovation, and for new kinds of partnership with the private sector and across national boundaries. There are enormous benefits from getting these reforms right. However, getting them right means keeping them simple, so that as reforms proceed we have more control, know more about what is going on and have a better understanding of how the national budget complements international initiatives and contributes to growth of the market economy.

Endnote

1 See Kaul I & Conceição P (eds) (2005) *The new public finance*. Oxford: Oxford University Press. This paper draws strongly on the overview chapter in this volume.

2

Co-ordination at the centre

2.1 Introduction

A cornerstone of an effective budgeting process is good co-ordination at the centre towards an optimally structured budget decision-making process. In many CABRI member countries this includes not only the arrangements of different institutional structures, the allocation of decision-making powers and the sequencing of information flows that might affect budget policy cohesiveness, but also co-ordination between the recurrent and development budgets to ensure that both address the same national policy objectives.

The seminar debate addressed issues relating to co-ordination of policy, programming and budgeting under different scenarios relating to whether planning and budgeting functions are combined in one central ministry (or separated into a ministry of finance and a ministry of planning) and whether recurrent and investment spending are combined in a single budget (or appropriated separately).

Participants agreed that the issue is not so much which institutional or budget structure is best but rather how the disadvantages of either can be managed and the advantages maximised. For example, a unified budget compromises the visibility of allocations for project-type spending in an institution's allocation, making monitoring of project completion and the removal of allocations for investment projects from

an institution's baseline allocation more difficult. Similarly, the combination of planning and budgeting in one ministry can mean that the long-term perspective that comes with good planning plays second fiddle to short-term financing concerns. A separation of functions, on the other hand, can compromise the links between planning and budgeting, resulting in planning for resources that are unlikely to ever exist and a lack of a policy-strategic thrust in budgeting. Similarly, the separation of the budget into two appropriation vehicles breaks the link between investment and recurrent spending, perpetuates planning for external resources separately from domestic resources and makes it difficult to ascertain the full cost of any one policy initiative or sector.

Therefore, the emphasis should be more on what types of institution are required to achieve the best budgetary outcomes under any scenario. For example, if a development budget is appropriated separately from a recurrent budget, all expenditure should be classified consistently and the budget documentation should include a comprehensive view of spending by institution and of programme by policy objective. Thus, the steps that have been suggested to create a more effective system include: improving the legal framework of the structure; designing a sequenced budget process that brings relevant information to the table at relevant points; harmonising information management systems; and integrating the budgets through comprehensive fiscal frameworks and consistent classification systems and budget structures.

It was recognised that a serious danger prevails when institutional 'mergers' and 'divorces' occur only at the political level. Participants stressed that whatever structural changes are implemented, they need a deeper process of redesign to ensure optimal outcomes.

Two case studies were presented at the seminar. In the Tanzania case study, RSS Hamisi highlights how an integrated budget process, a sound budget structure, integrated classification systems and good information systems can assist in building effective links between separate development and recurrent budgets. In the Malawi case study, Chauncy Simwaka provides a perspective on how superficial structural change can undermine the building of long-term capacity for effective planning and budgeting.

2.2 Co-ordinating recurrent and investment spending: the case of Tanzania

Ramadhan Saidi Sampa Hamisi

2.2.1 Introduction

In Tanzania, the government budget is an important instrument for the implementation of policy decisions to achieve social, economic and political ends. The formulation of the budget requires a series of processes linked to a chain of interventions and legal regulatory mechanisms that involve a number of players and stakeholders. Since the budget is a public instrument, it is based on a legal framework, which gives it the necessary mandate. The budget formulation process is thus a legalised and formalised work cycle of preparing budget estimates, authorisation, implementation, control and accounting for it.

This paper outlines the key features of the government budget system – the legal base, budget structure and process. The paper briefly discusses budget management and co-ordination mechanisms, highlighting how the development and recurrent budgets

are co-ordinated throughout the system. It provides the highlights of budget-related reforms like performance budgeting, adoption of Government Finance Statistics (GFS) classification, the Public Finance Management Reform Programme (PFMRP), the Public Expenditure Review (PER), the Medium Term Expenditure Framework (MTEF) and the Strategic Budget Allocation System (SBAS). It also explains the co-ordination aspects encompassed in some of these reforms. The paper concludes with a narration of some budget management achievements and challenges faced by the government.

2.2.2 Budgeting system

The Tanzanian budget system is legally based, and is characterised by a budget structure and an elaborate budget process.

Legal base of the budget

The preparation and implementation of the government budget is based on legal requirements and structures. The legal base is that body of laws and administrative regulations that govern the budget format, timing and procedures as well as the allocation of formal powers, responsibilities and rights in the budget cycle or process. The instruments that provide the legality of the budget include the following:

- *The Constitution of Tanzania*. Chapter 7 of the Constitution outlines the provisions regarding the finances of the United Republic of Tanzania. It indicates who has the mandate to prepare the budget and submit it to Parliament, and the type of revenue receipts, accounts, authorisation of payments and so on.
- *The Public Finance Act of 2001*. This is a new instrument that also provides the legal framework of the budget system with regard to revenue, expenditure control and accountability. The Public Finance Act repealed the former Exchequer and Audit Ordinance of 1961.
- *The Annual Appropriation Act*. This Act provides powers to the Minister for Finance to draw money from the Consolidated Fund and allocate it to the various votes. It also provides powers for the reallocation of funds between votes.
- *The Annual Finance Act*. This Act grants powers to the Minister for Finance to raise funds by imposing taxes to finance the budget.

Structure of the government budget

There are two components to the government budget in Tanzania – revenue and expenditure.

The revenue budget includes:

- domestic resources –
  - tax revenue, and
  - non-tax revenue;
- foreign loans and grants, including Heavily Indebted Poor Country (HIPC) Initiative funds;
- sale of shares in public corporations; and
- drawdown of reserves, including domestic financing.

The expenditure part has the following structure:

- recurrent expenditure –
  - public debt,
  - ministries,
  - regions,
  - local government, and
  - special expenditure, including contingency; and
- development expenditure –
  - domestic resources, and
  - external resources.

At this stage, it is important to highlight the challenges of co-ordinating development and recurrent spending. The starting point is the fact that Tanzania has gone beyond the first generation of a programme review budgeting system (PRBS). We are now implementing the National Strategy for Growth and Reduction of Poverty (NSGRP), which recognises the existence of the Medium Term Plan (MTP) and sector strategic plans.

The government budget process

Budget preparation
The budget preparation process starts with the Budget Guidelines Committee (BGC), which proposes the budget structure. In co-ordinating recurrent and development spending, the BGC is guided by Vision 2025, the MTP, the NSGRP and inputs from the PER process. The BGC covers the following stages:

1. The committee begins with the macroeconomic and sectoral performance

reviews. PER working groups' outputs provide the basic data and information used in reviewing budget performance and in the preparation of the Budget Guidelines.

2. The second stage is the projection of economic growth and identification of key macroeconomic and sectoral policy commitments, with a view to determining the pool of resources (both external and internal inflows) expected to be available in the upcoming budget year and the two following outer years.

3. The third stage entails identifying ministry, department and agency (MDA), regional and Local Government Authority (LGA) strategic/medium-term plans and linking them to overall MTP objectives, NSGRP interventions and government policy commitments to ensure their consistency.

4. The fourth stage involves the costing of strategic sectoral planned activities that are consistent with NSGRP cluster interventions and then applying MTEF processes to integrate NSGRP cluster and budget activities and to link these activities with the resource allocation. This stage includes preparation of the annual budget by all MDAs. Prioritisation and sequencing of NSGRP activities is based on the following considerations: the ongoing programmes/activities that were initiated by the original Poverty Reduction Strategy (PRS); new strategies that build on ongoing activities; strategies that have multiple effects (i.e. strategies covering more people or larger or more issues); strategies that address more than one outcome; strategies that contribute to implementation and capacity development; strategies that address the regional imbalances; and strategies for mainstreaming cross-cutting themes. It is at this stage that the recurrent impact of development spending is factored into the budget.

Budget execution: revenue and flow of money from the centre

Tanzania still runs a cash-management system, where expenditures are determined by the level of available resources in a given month. At the centre of the system is the Government Expenditure Ceiling Committee (GECC), chaired by the Permanent Secretary to the Treasury, who is also the Paymaster General. Membership of the committee includes the Bank of Tanzania, the Tanzania Revenue Authority and representation from the government of Zanzibar.

Based on the level of available resources, both domestic and external, the GECC allocates funds to the various expenditure items using the following criteria: debt

service is the first charge against available resources, followed by personnel emoluments and then other charges and items that are provided for on a monthly basis.

To ensure the smooth execution of the development budget, the GECC also provides quarterly allocation of development funds.

Budget execution: expenditure controls

Once the GECC has finalised resource allocation at the national level, the Budget Division in the ministry then allocates the resources to the various actors, namely MDAs, regions and LGAs. To allocate resources, the division utilises cash-flow plans prepared by the institutions prior to the beginning of budget execution.

While cash-flow plans for recurrent expenditure are based on a monthly cycle, plans for development expenditure are on a quarterly basis. Unlike recurrent expenditure, funds for the development budget can only be disbursed upon receipt by the Treasury of the preceding quarter's progress report, which includes both financial and non-financial information (e.g. on progress in the physical implementation of projects).

Monitoring and control

Budget monitoring, control and evaluation are necessary for closer supervision of work programmes and projects. This involves a continuous monitoring of the plans and the budget in order to document achievements and identify bottlenecks. Monitoring, control and evaluation mainly focus on accountability, which aims to ascertain the appropriateness of expenditure and revenue, and conformity to authorisation, through financial reports. It also provides management with information on performance.

Mechanisms for control and monitoring are periodic reporting and follow-up using specified formats, and internal and external auditing. Others are parliamentary controls, budget reviews and adjustments, and project inspections.

2.2.3 Reform progress

Besides its primary role of managing public finances, the Ministry of Finance (MoF) has the challenge of having in place more efficient and effective government budget management processes and systems. In this endeavour, the MoF ensures that the government budget is properly managed and that budgetary reforms are efficiently implemented. The MoF also provides all necessary technical support to MDAs, regions and LGAs in the process of managing their budgets and in implementing the budget reforms.

Budget management reforms

The government of Tanzania has undertaken several interrelated reform initiatives and has introduced several instruments into budget planning and management, starting with the Rolling Plan and Forward Budget (RPFB) in the early 1990s, the implementation of the PFMRP, the performance budgeting initiative, the PER, the MTEF and adoption of GFS classification. These are briefly discussed below.

The Rolling Plan and Forward Budget (RPFB)

The RPFB was adopted in response to the need to introduce an effective medium-term framework for planning. It was noted that because there were insufficient resources to implement the programmes outlined in the five-year plans, the allocation of funds basically became an annual budgeting exercise. The RPFB introduced an element of forward planning in respect of resources and expenditure.

The Public Finance Management Reform Programme (PFMRP)

Phase 1 of the PFMRP was instituted in 1998, with programme components covering budget management, accounting, policy analysis and tax administration.

Among the projects implemented under the PFMRP is the Integrated Financial Management Accountability Project (IFMAP). This project is made up of two earlier projects, the Government Accounts Development Project and the Interim Budget Development Project.

Significant advances have been made under the first phase of PFMRP, and IFMAP in particular. Some of the achievements include the installation of a financial management system in ministries and regions, the introduction of a common chart of accounts for budgeting and accounting purposes, the Integrated Financial Management System (IFMS), and improved budget preparation through the PER process.

Performance budgeting

Performance budgeting was introduced in the government system to reorient the incremental input-based budgeting towards output or target-based budgeting.

This new approach was expected to improve budget performance, as measured by output indicators, unit costs and a measurable, deliverable quantity of service for a given allocation of budget resources. After the introduction of institutional strategic plans and a performance management system, which was results-oriented, performance budgeting provided the necessary supportive framework. Performance-related targets at institutional level were to be reflected in the budget process for effective implementation.

The objectives of performance budgeting were to:

- enhance efficiency in service delivery;
- enhance management accountability through performance monitoring and review;
- improve resource allocation by linking it to specific, quantitative and monitorable targets;
- ensure consistency of resource allocation with institutional perspectives in a strategic medium-term framework; and
- facilitate a holistic approach to budgeting that would enhance budget integration.

A Performance Budgeting Operations Manual was prepared to complement the achievements made in this area. This manual was intended to guide the process of performance planning and budgeting and to be the basis for all ministries, independent departments, regional administrations and local governments to prepare and submit performance budget estimates in subsequent years.

The Public Expenditure Review (PER)

The PER has been an ongoing process for several years. The traditional PER function has focused on the budget process in terms of management, control and accountability, and the underlying objective has been to evaluate budget performance against approved targets and procedures or processes and to identify shortcomings and corrective measures.

However, since 1998, the PER in Tanzania has been conducted on an annual basis, closely aligned with the government budget cycle and carried out under the direction of the PER Working Group, chaired by the MoF and including in its membership a wide range of stakeholders from the government, development partners and civil society. This approach has been consistent with the series of initiatives in Tanzania aimed at developing an open process of policy formulation and budget strategy.

There are two main PER objectives. The first is to facilitate and improve the implementation of a medium-term effort to strengthen budget management through improved predictability, efficiency and sustainability of the government budget. The second is to evaluate performance against approved budget frame and output targets, in order to ascertain whether funds have been spent for purposes agreed upon and whether the spending units have achieved the intended goals. An underlying concern is also to attain an increased shift in donor finance from projects to

broader budget support, in order to enhance flexibility of allocation across investment and recurrent expenditure items.

The Medium Term Expenditure Framework (MTEF)

The MTEF is built on past reform initiatives such as the RPFB, which focused on policy and strategic review and three-year ceilings, performance budgeting, which emphasised output- or results-oriented budgeting, and MTPs developed with support from the then Civil Service Department. All ministries, independent departments, regions and LGAs now prepare MTEF-based budgets.

In essence, the MTEF is a prioritised three-year integrated budget, based on performance budgeting within a strategic plan. The MTEF starts with a review of the previous and current year's budget performance, and an evaluation of the available resources; it goes on to establish the cost of implementing the activities to attain the set targets, and deals with the prioritisation of these targets. Ultimately, three-year integrated performance-based estimates are formulated, given the resource envelope in terms of local and donor funds. This approach enables the linking of resources to the attainment of specified objectives. The MTEF places greater emphasis on service delivery and meeting the needs of priority stakeholders. Indeed, it has strengthened performance budgeting at all levels and in all government institutions.

Adoption and application of Government Finance Statistics (GFS)

The need for reclassification was felt because of weaknesses in the coding system of the government budget. The structure of the old classification was inadequate to provide for meaningful economic analysis of a performance-based budget, which requires a consistent and unified classification to assess results at target level. Further to that, the government accounting system was being computerised and, consequently, it was seen as prudent to unify the system of budgeting and take advantage of the accounting reform initiative. There was also the need to adopt common international reporting standards.

GFS is an international classification method that attempts to group items of revenue and expenditure into economic clusters and thereby facilitate economic analysis of government transactions within the general government sector, and between the government sectors and the other sectors of the economy and the rest of the world. It is designed to provide statistics that enable decision makers to study developments in the financial operations and position of the public sector. GFS is a comprehensive coding system that covers revenue, and recurrent and development budgets.

Through GFS, development projects have been disaggregated into smaller items

of expenditure for coding and classification. Most importantly, though, GFS facilitates budget integration through a standard coding and classification system. It should be emphasised that, thanks to GFS, eventually we will have a single budget, as opposed to the current set-up where we have separate recurrent and development budgets.

Introduction of the Strategic Budget Allocation System (SBAS)

The adoption of the Poverty Reduction Strategy Paper (PRSP) in 2000 provided a new momentum for fighting poverty and offered guidance on strategic resource allocation. Under the PRSP, the government committed itself to according priority status in resource allocation to important PRS sectors – agriculture (research and extension), basic education, primary health, water, rural roads, the judiciary and HIV/AIDS.

The first-generation (HIPC-triggered) PRS, which covered three years, came to an end in 2002/2003. The next PRS (the NSGRP) was adopted and implemented in 2005/2006. The NSGRP, also known as MKUKUTA, addresses the need to become more outcome-oriented by adopting three clusters:

- Growth and income-poverty reduction;
- Improvement of quality of life and social well-being; and
- Government and accountability.

The cluster is the highest level; below it there are goals, followed by cluster strategies, which cut across sectors. There are also operational outcomes (or monitorable outcome indicators). The relevant actors, including MDAs, regions and LGAs, are linked to cluster strategies.

In order to implement the NSGRP and meet its requirements, a Microsoft Access software tool called the Strategic Budget Allocation System (SBAS) was developed to manage the complexity of the budget data on cross-cutting strategies. This tool enables MDAs to fill in their MTEF budget requests and to submit the same to the MoF. The standardised formats of inputs are used by the Plan and Budget Guidelines Committee to allocate resources in the Budget Frame to NSGRP cluster strategies and non-NSGRP strategies. Resource ceilings for the Plan and Budget Guidelines are issued at vote level, with a clear picture of how much has been allocated for use in financing NSGRP cluster strategies (MTEF targets).

Once ceilings have been approved for each target and, hence, for each of the MDAs, the MDAs are required to break down the targets into activity and input level for the annual budget and for the outer years of the MTEF.

2.2.4 Budget co-ordination mechanisms

Budget co-ordination is an important element in the budget process and is imbedded in the above outlined reforms at two levels – budget formulation and budget implementation. It also involves many actors and stakeholders, including development partners (donors).

Institutional arrangements for co-ordinating the recurrent and development budgets prior to 1997

The Budget Guidelines used to be prepared jointly by the MoF and the President's Office, Planning and Privatisation (POPP). However, the MoF had jurisdiction over the recurrent budget, while the POPP had jurisdiction over the development budget. This set-up meant having two divisions, one in each institution, dealing with a component of the government budget. Difficulties in co-ordination prompted the Tanzanian government to merge the co-ordination and monitoring division in the POPP with the budget division in the MoF. This was the first step towards budget integration.

Level one: budget formulation

MDAs are required to prepare their recurrent and investment requests for the three MTEF years using SBAS Micro. The MoF is required to assist the MDAs by providing them with the necessary technical support and general co-ordination.

The MTEF was introduced to bring a more strategic focus to expenditure planning. In this regard, the process of estimating recurrent cost implications of ongoing investment projects has been initiated.

The adoption of GFS classification has made the full integration of the recurrent and development budgets possible. GFS classifies all expenditure budgets, whether in the development or recurrent budget, in one consistent system as either recurrent or capital expenditures, and, within these, into different types of recurrent or capital spending. This allows for easy amalgamation of the budgets into a comprehensive view of the allocations to any one institution or programme.

Using SBAS Macro, allocations to cross-cutting cluster strategies (MTEF targets) are made in a co-ordinated manner. In this way, the share allocated to each of several ministries for such targets can be traced. The allocations for recurrent expenditure and investments for each vote are reflected in the Plan and Budget Guidelines.

Level two: budget implementation

The MoF is responsible for the overall monitoring and control of the government budget. It manages the budget through expenditure tracking and close monitoring of project implementation.

At vote level, accounting officers are responsible for following up the performance of departments, and are expected to provide quarterly reports on progress of performance to the MoF. On the basis of such reports, the MoF carries out the necessary adjustments to approved recurrent and investment budgets.

Public expenditure is now controlled largely through the IFMS, a computerised system that links up most of the government paying stations in Dar es Salaam. Therefore, most payments are centrally effected and monitored. Hardly any expenditure or commitment can be incurred without financial provision through the IFMS. In addition to the IFMS, sub-treasuries have been established for processing payments by decentralised government ministries and regions.

Audits are conducted by the National Audit Office on behalf of the National Assembly to ensure that representatives of the people maintain control over the revenues and recurrent and investment expenditures of the government.

As explained above, the PER process is led by the MoF and is a collaborative effort between the whole donor community, the government and civil society organisations. Through the Plan and Budget Guidelines, vital inputs from the PER process are fed into the budget process and are utilised in preparing the annual budget and sector MTEFs covering revenues and expenditures. Again, during implementation of the budget, some interventions from the PER process are taken into consideration to keep budget performance on track.

Donor co-ordination

The government of Tanzania and development partners (DPs) have been working together, especially through instruments such as bilateral agreements and signed memoranda of understanding. The memoranda set out the principles and terms of partnerships between the government and DPs. The Tanzania Assistance Strategy (TAS) and the Joint Assistance Strategy (JAS) also govern the relationships between the government and DPs. Budget support revolves around the participating parties' commitment to alleviate poverty. The dialogue and instruments used to achieve a successful implementation of budget support, therefore, combine a review of policies used to fight poverty, the development and maintenance of the environment necessary for those policies to be effective, and an assessment of the outcomes from interventions made. In this regard, Tanzania is fortunate to have a substantial amount of information on assistance from DPs.

2.2.5 Achievements and challenges

Significant achievements have been made in implementing the budget reforms and in co-ordinating recurrent and investment expenditure, in particular. Performance

budgeting has been successfully implemented in both central and local government institutions. With effect from the 2000/01 fiscal year, all ministries, independent departments and regions, including LGAs, have prepared performance/output-based budgets.

GFS economic classification based on the 1986 GFS Manual has been completed. All budget books, Volumes I–IV, are coded in line with GFS requirements. Thus, the framework for integration of recurrent and investment spending is in place.

Supporting systems for budget preparation and execution such as the IFMS are in place. The MoF carries out budget follow-up in terms of recurrent expenditure tracking and project inspection annually.

DPs are actively involved in the budget review process, and their views are taken into consideration in the formulation of future budgets. Adoption of the TAS and JAS is expected to strengthen donor co-ordination, as DPs are urged to use a common funding mechanism. This will also result in increased predictability of donor fund flows.

The main challenges include inadequate reporting for direct-to-project funds. A significant amount of donor assistance still falls outside the budget. Donors are encouraged to use the government budget system and, more particularly, the General Budget Support (GBS) funding mechanism. Another challenge concerns difficulties in getting timely information on physical performance. This is attributed to a number of factors including weak communications systems and low capacity within the institutions. However, use of the GFS coding system in the budget estimates and in the introduction of level two of the budget has alleviated the situation.

2.2.6 Conclusion

This paper has outlined the key features of the government budget system. It has highlighted budget management and co-ordination mechanisms and budget-related reform initiatives undertaken by the government in improving and enhancing efficiency in the management of public resources. Several budget management achievements and challenges have been outlined.

As a result of the steps taken to introduce and strengthen performance budgeting in the government budget system, recurrent and development budgets are now performance based.

The adoption of GFS economic classification has improved the coding of the budget estimates. The GFS coding system is a framework for the integration of recurrent and investment spending.

The government has introduced other initiatives to improve accountability and efficiency in the management of public resources, and has put in place an institutional

framework for stakeholder participation in the budget process. The PER process continues to be an important forum for public sector participation in expenditure management issues.

The MTEF, which came out of the PER process, is based on performance budgeting and focuses on enhancing predictability and efficiency in public expenditure management in the context of a three-year time frame. The recurrent cost implications of ongoing projects (investments) are reflected in the outer-year MTEF budgets.

The IFMS has been particularly useful in the control of expenditures and in providing information on financial performance to stakeholders including the government and DPs.

2.3 Structures, institutions and legal frameworks: the case of Malawi

Chauncy Simwaka

2.3.1 Introduction

Malawi is one of the countries in which the Ministry of Finance (MoF) and the Department of Economic Planning and Development (DEPD) have merged and then separated again. This paper looks at the drivers, history and sequencing of changing institutional structures, and the advantages and disadvantages of having the ministries separated or combined.

In 1997/1998, the Malawian MoF and DEPD were merged into one ministry on account of several factors. During the mid-1990s, it was observed that most development policies were not well implemented; in most cases, the policies were inadequately costed and were not included in the national budget. One of the events that triggered the ministry merger was the handling of Malawi Vision 2020, a national vision of where the country should be in 2020, formulated with the participation of all key players including civil society organisations. After spending substantial resources on developing the strategy, no mechanisms were put in place to implement

it. However, soon afterwards, the joined ministry was separated again into two bodies – the MoF and the Ministry of Economic Planning and Development (MEPD).

In order to asses the impact of merged and separate ministries on budgetary outcomes, this paper will discuss the budget process and explain the role of the MEPD and MoF, followed by an exploration of the impact of the respective arrangements of ministries on the budget process.

2.3.2 Structures and institutions

This section looks at key Malawian budgetary institutions that are relevant to whether planning and financing should be separated or merged into one ministry.

Activity-based, medium-term budgets

In order to improve transparency and accountability, the Malawian government opted for an output-based budget document as a key element in the Medium Term Expenditure Framework (MTEF) reforms. This underlines efforts to shift the budget emphasis from inputs to defined activities and outputs. Under this approach, the budget becomes a detailed cost estimate of priority activities that fit within a given resource ceiling, rather than an incremental list of inputs. In its very nature, it aims to address the pitfalls of incremental budgeting with elements of a zero-budget approach, in which all funds are allocated anew in each budget cycle (i.e. at the start of the cycle, all budgets are set to zero and the available funds are allocated according to priorities). The activity-based budget is a key instrument for translating development policies into financed government programmes; the activities identified in development plans to implement policies should appear as financed activities in the budget.

Macroeconomic forecasting and the budget framework

Another important tool in the budget preparation process is the macroeconomic framework, comprising the assumptions (exchange rate, interest rate and inflation) used for revenue, expenditure and financing projections. The macroeconomic framework translates into a budget framework, a link that facilitates the fit between macroeconomic policies for key variables and resource constraints. Realism is an important value in preparing a budget framework: it reduces the incidence of overestimating or underestimating the resource envelope or expenditures, which creates problems in the course of implementation and undermines planning discipline. However, technical and institutional deficiencies in resource forecasting have made it difficult to generate a reliable medium-term framework in Malawi. The forecasting of macroeconomic growth, a critical variable in the estimation of government revenue, especially from domestic sources, used to be a DEPD responsibility.

Dual budgeting system

The Malawi government budget has two parts – the revenue budget, covering the recurrent side of expenditure (expenditure necessary for maintaining the basic daily operation of projects and government services), and the development budget.

Recurrent expenditure is divided into personnel emoluments (salaries, wages, allowances and benefits for public servants) and other recurrent transactions (ORT, or operational funds), which include expenditures for the provision of goods and services to the public (e.g. medicines in the health sector, school books in the education sector and recurrent transfers to state and non-state bodies) and the maintenance of capital items. Not all expenditure on the revenue budget is recurrent in the economic or accounting sense: durables such as computers are also purchased under the revenue budget.

The development budget finances projects in the Public Sector Investment Programme (PSIP). This budget is funded from two sources – external resources in the form of loans or project grants and local or counterpart expenditure. Some projects are funded jointly, while others are funded wholly from local resources.

While expenditure on the revenue budget is mostly (but not wholly) consumption related, development expenditure involves mostly (but not wholly) fixed capital formation. This includes construction of roads and bridges, schools, hospitals, airports, and so on. Development expenditures are aimed at realising the government's development goals as stipulated in the Poverty Reduction Strategy Paper (PRSP), the PSIP and the Malawi Economic Growth Strategy (MEGS). Each project has its own specific goals, and the decision to implement it has to be in harmony with the government's overall fiscal objectives.

Development expenditures have a bearing on future levels of recurrent expenditure, because all investments eventually have to be maintained under the recurrent budget; for example, constructing a school is a development project but the subsequent recruitment of teachers and the purchase of books and teaching and learning materials and other running expenses will be recurrent expenditures. Thus, when formulating the development budget, a careful analysis is done to make sure that the recurrent budget can absorb all the recurrent costs in the year that a particular project is completed.

The Public Sector Investment Programme (PSIP)

The PSIP is a five-year rolling programme for guiding public investments. It provides a framework for planning and scheduling investment in line with long-term government objectives and short-term macroeconomic constraints. It is a comprehensive listing of government projects and, as such, contains all approved projects scheduled

to start within the defined period. It is also a screening mechanism for verifying that projects conform to government objectives and overarching policy and strategy. The DEPD was mandated to co-ordinate the formulation and implementation of the PSIP, while the MoF would provide resources only to projects that had been appraised and approved by the DEPD through the PSIP. The objectives of the PSIP include:

- to provide a screening mechanism and verification that projects conform to government priorities and that design standards are followed;
- to facilitate scheduling of investment so that there is consistency with overall expenditure ceilings and absorptive capacity within sectors; and
- to ensure that there is a balance of public resources invested in the social and economic sectors.

Clear PSIP project-approval principles are in place. Included are projects that:

- seek to alleviate poverty, especially in the rural areas (as stipulated in the Malawi PRSP);
- stimulate and encourage economic growth, for example those in agriculture and tourism (as stipulated in the MEGS);
- do not create a heavy burden and unsustainable recurrent expenditure; and
- encourage private sector participation.

Determining expenditure ceilings

Total government expenditure is determined by taking a particular percentage of Gross Domestic Product (GDP). The quality of expenditure reflects the government's main objectives, which currently are sustainable growth through poverty alleviation, and the provision of social services (health, education, etc.). Every year, the total available expenditure is allocated in the budget process to different expenditure objectives or sectors. This happens in the form of ceilings – the maximum amount of money that the government will spend in a given year against particular target sectors or expenditure categories

Hard budget ceilings are used in management to ensure the maintenance of balance between government expenditures and expected resource flows, thereby limiting financing operations to fiscally sustainable levels. This, in turn, supports macroeconomic and monetary policy and prevents crowding out of the private sector.

Under the current separate arrangement, the MoF allocates resources to ministries without the involvement of the MEPD.

Table 2.3.1: Stages in the budget process

	PREPARATION	
Step 1	Policy statements	Ministries and Departments, MoF, MEPD, Office of the President
Step 2	Review goals, objectives, outputs and activities	Ministries and Departments, MoF (MEPD not involved)
Step 3	Review prioritisation of programmes, sub-programmes and activities	Ministries and Departments, MoF (MEPD not involved)
Step 4	Review costing of agreed programmes/activities	Ministries and Departments, MoF (MEPD not involved)
Step 5	Presentation of goals, objectives, outputs and activities, their organisation into priority programmes and sub-programmes and indicative costing by Ministries/Departments to the MoF	Ministries and Departments, MoF (MEPD not involved)
Step 6	Consultation with donors on prioritisation and resource allocations	Ministries and Departments, MoF (MEPD not involved)
Step 7	Determination of sectoral ceiling/resource envelope	Ministries and Departments, MoF, MEPD
Step 8	Approval by Committee of Principal Secretaries and Cabinet	MoF (MEPD not involved)
Step 9	Advise Ministries of ceilings, issue circular on budget preparation, issue ceilings	MoF (MEPD not involved)
Step 10	Ministries/Departments prepare estimates	Ministries and Departments (MEPD and MoF not involved)
Step 11	Budget estimates discussion	Ministries and Departments, MoF and MEPD
Step 12	Presentation of budget to Parliament	MoF and MEPD
	IMPLEMENTATION AND MONITORING	
Step 13	Cash management, issue of warrant (provisional/general) and authority to spend	MoF (MEPD not involved)
Step 14	Monitoring and evaluation	MoF and MEPD (no co-ordination)

The budget process and responsibilities

The responsibility of coming up with a budget rests with line ministries and departments. The MoF co-ordinates and manages the process, which is guided by the Public Finance Act. On the basis of economic assumptions, currently provided by the MEPD, the MoF prepares a budget framework and provides line ministries and departments with expenditure ceilings and budget preparation guidelines within which their budgets are produced. After discussion between the MoF and line ministries, these allocations and their detailed use at line ministry level are compiled into

the annual budget and presented to Parliament. The inter-ministerial discussions are aimed at ensuring that line ministries and departments allocate their resources efficiently and in line with their mission and objective and the economy as a whole. Table 2.3.1 outlines the stages of budget preparation, implementation and monitoring, and current involvement of the MEPD.

2.3.3 To merge or not to merge

In 1997/1998, the then MoF and DEPD were merged to address specific shortcomings in links between policy-making, planning and budgeting.

The first assumption driving the merger was that once the MoF and DEPD were combined the government's development policies would be implemented easily through the budget, because there would be one Principal Secretary with responsibility for both development policy formulation and budgeting. Thus, the merging of the MoF and DEPD was aimed at ensuring that government development policy (through Malawi Vision 2020) would be translated into action through the budget.

The second driving factor for joining the MoF and DEPD was to strengthen capacity in the MoF, because of the need to integrate the recurrent and development budgets. The PER of 1990 recommended that the two budgets should be integrated since there were many recurrent expenses in the development budget and, likewise, there were capital expenses in the recurrent budget. The merger was expected to improve capacity, because personnel from the DEPD with skills in project planning and management would enhance capacity in the budget division in formulating the development budget based on the PSIP. It was further assumed that the marriage would strengthen monitoring and evaluation in the MoF with DEPD capacity in this regard.

The duration of the joined ministry was too short to produce any tangible results. However, a number of useful conclusions can be drawn from the Malawi experience.

A single ministry enhances co-ordination. During the merger, co-ordination improved as mutual consultation was easy and the different principles driving the work of the two partners were better understood. The war of words about who was responsible for the development budget died and the integration of policy planning, project identification and the inclusion of priority projects in budget appropriations improved. Co-ordination, especially in policy formulation, moved forward significantly: the PER of 2000 was successfully completed with many inputs from the former DEPD units.

A persistent issue between the MoF and the DEPD had been the allocation of resources to projects. In most cases, the DEPD was primarily interested in generating, evaluating and advocating new projects and, generally, was not as concerned about the adequacy of financial resources to cover the expense of completing such projects

in the future or about assessing the recurrent cost implications of those endeavours to ensure their long-term viability. With the merger, confusion about the allocation of resources began to subside.

These few benefits could have been greater if proper reporting systems and institutions had been created between former DEPD and MoF units. For example, a good start would have been moving the entities to a single building for easy contact; and the development division should have been part of the budget department, with full responsibility for formulating the development budget. However, when the MoF and DEPD were joined, the development division was not retained as a unit, but was merged into different parts of the MoF, while other former DEPD staff remained separate. This meant that during the time of the merger, the development division – the function of which was to plan, monitor and evaluate projects – was dormant. Had it been kept as a unit, but operating from the budget department, the development division could have been responsible for the monitoring and evaluation of development budget projects alongside monitoring the revenue budget.

Duplication of functions was not dealt with sufficiently in the merger. For example, the Economic Affairs section in the MoF should have been abolished in the merged ministry, since the former DEPD units could have taken over its functions. At present, there is still a duplication of duties between Economic Affairs and the MEPD, blurring accountability and undermining good budgetary outcomes.

Rationalisation of staff in the context of overall government effectiveness was also not satisfactory under the merged ministry. The merged ministry could have allowed for better utilisation of staff; excess staff could have been allocated to planning sections in line ministries, boosting line ministry planning and budgeting capacity and resulting in better budget presentations.

Before any of these shortfalls could have been addressed, however, the ministry was de-linked again in 1998/1999 due to a change in government policy and the influence of political and economic factors.

Perhaps the worst consequences of de-linking the merged ministry so soon have been the slow progress in integrating the recurrent and development budgets, and the loss of clearly delineated capacity for project monitoring and evaluation.

2.3.4 The way forward

Whether the responsibilities at the centre of government for policy planning and financing are separated between two ministries or not, the need remains for delivery on government policy priorities for growth and poverty reduction through effective linkage between policy, planning, budgeting and accounting. While separation of these functions at the centre of government puts at risk the link between policy

and budgeting, a merged institution often results in poorer attention to longer-term policy issues in the face of short-term financing and expenditure pressures.

In both cases, therefore, the need remains for a robust strategic expenditure planning process, where the allocation of available revenue is based on policy considerations and sound financial projections within a medium-term resource envelope. This requires the use of an MTEF, a comprehensive and programme-oriented budget structure and classification linked to the chart of accounts, and a process that ensures de-fragmentation of the budget, information sharing and effective participation by key agencies, competition between different expenditure proposals (whether development or recurrent) and clear accountability for advice provided and decisions taken.

3

Aggregation and disaggregation: comprehensiveness, budget frameworks and classification

3.1 Introduction

How financial information is presented in the budget process is a function of the classification system. Classification of spending information according to standardised categories first developed when government operations to be funded by legislatures became too numerous for legislatures to continue the practice of examining each spending proposal separately, on a proposed item-by-item basis, and maintain a comprehensive grasp of all proposed spending. Governments then aggregated spending information by spending agency according to standardised items in order to rationalise legislative budget processes and make the impact of spending more transparent to legislatures.

As budget management institutions developed, classification systems acquired additional functions beyond assisting legislatures in their oversight role. Their design now incorporates the need for international comparison; they are instruments of control and accountability; they provide technical tools for resource allocation and budget management; they assist in making explicit government's fiscal stance; and they contribute towards risk management. In short, a sound budget structure and classification system is the cornerstone of modern budgeting systems.

There are several requirements that a classification system should meet in order

to fulfil these functions. These include the following: organisational, economic, programmatic and functional perspectives on financial information in the classification structure; a comprehensive and properly sequenced budget structure; consistent and explicitly linked categories for budget and accounts classification; and consistent application of classification categories across all government spending and revenue and across time. There needs to be full coverage of the general government account for the classification system to support a complete accountability cycle.

A sound budget structure and classification system can aid in managing unique complexities arising from developing countries' public finance contexts. Defragmentation of budgets under dual budgeting systems and the existence of significant extra-budgetary external resources or extra-budgetary funds, and improved budget credibility and cash management in line with budget policy objectives in the context of revenue uncertainty during the spending year, are all contingent on the quality of budget structures and classification.

However, a sound classification system is not only about the architecture of budgets. It is also about building good human resources capacity for using the architecture every day, about adequate systems to capture and aggregate information in a timely manner, and about having clear rules and the capacity at the centre to enforce these rules.

This chapter presents the two main inputs at the seminar, both providing rich material on the practice in CABRI countries regarding budget comprehensiveness, budget structures and classification systems. The theme essay, by Mickie Schoch, Alta Fölscher, Hennie Swanepoel and Annelize Adendorff, provides CABRI members with an overview of the South African experience in reforming the classification system. It emphasises the practical difficulties in designing a system that meets the needs of both economists and accountants. It illustrates that a reform process comprises much more than the design of system architecture, a chart of accounts and the establishment of system hardware: implementing these new institutions and instruments requires a painstaking process of working with every government agency to implement the new system and building the capacity of users.

The final section of the chapter is an extract from the CABRI pilot questionnaire report presented at the seminar. The extract picks up on the questions that explored CABRI member-country practices regarding the main themes of the session.

3.2 Achieving co-ordination through the classification system: objectives, principles and experiences

Mickie Schoch & Alta Fölscher, with inputs by Hennie Swanepoel & Annelize Adendorff

3.2.1 Introduction

The relationship between good governance and improved economic and social outcomes is increasingly recognised. The national budget is the single most important policy document of government; it provides the vehicle through which policy objectives are reconciled and matched with available resources and are implemented in concrete terms. Good budget preparation, execution and monitoring processes enable a government to allocate scarce resources to those areas that will make the largest contribution to achieving its objectives. Quality data is a fundamental input and output for setting fiscal policy, co-ordinating decision-making on economic and

social policies and day-to-day budget management. Revenue and expenditure information should be collected and presented in such a fashion that it promotes transparency and accountability. In other words, a reliable stream of consistently classified and coded information throughout the budget process is an essential *technical tool to manage complexity*.

This paper considers classification as a technical tool to co-ordinate and link the different phases of the budget process. Because of time and space constraints, the focus is primarily on budget and expenditure classification, while recognising that budget managers require and use other types of financial information, such as information on revenues and borrowing. The paper starts by setting out the requirements and building blocks of a sound expenditure classification system, given its purposes in budget management. It then considers how a good classification system can impact on common arrangements in many developing countries. The final part of the paper offers some ideas on the design of a classification improvement programme, and includes a reflection on the relative success of the South African approach.

3.2.2 The purposes of a classification system

Classification of budget and accounting information is the systematic arrangement of complex multidimensional data into categories according to common properties, in order to make the information intelligible in standard formats. This exercise has several interdependent functions or purposes in the budget process.

Making good information available

A sound classification system is necessary to produce good information, which, in turn, is essential for budgetary analysis during budget preparation, budget approval, budget execution and audit and evaluation. A sound budget structure and classification assists in arranging complex financial information in intelligible formats for different parts of the public sector at different levels of the budget for use at different times in the budget process, while enabling linkages and comparison between these aspects. The classification system should serve the information needs of diverse groups of users: the executive, ministries, agencies and programme managers; legislative and other governing bodies; the public; investors and creditors; rating agencies; and international agencies. It should make clear who was, is or will be responsible for what types of expenditure and for what purpose.

Internally, a budget classification system that makes explicit relative allocations to, and uses of, funds for different policy objectives is necessary to improve spending effectiveness. If policy-linked financial information is simultaneously disaggregated according to the economic nature of spending, it assists policy-makers in assessing

the mix of inputs used or proposed to achieve policy objectives. This, in turn, would improve spending efficiency. In addition, good information about the balance of proposed or actual spending inputs and their economic nature across public sector institutions is also crucial to assess the broader economic impact of public spending, and as an aid in fiscal policy implementation.

At the same time, suitably aggregated and disaggregated information is a requisite for external budget transparency. A central objective of building a classification system would be to make proposals for spending, and the actual spending of public moneys, transparent to the legislature and external stakeholders.

A tool of budget management

A sound classification system not only ensures that good information is available on the results of budgetary decisions, it is also a technical tool towards the more strategic allocation and use of public resources. A key purpose of the classification system is to provide budget planners with suitable categories for allocation decisions. Posing budget ceilings is an important element of budget management: the budget structure and classification system determines how ceilings are sequenced and enables or constrains how robust and strategic these ceilings are, during both budget preparation and budget implementation.

If the classification system does not offer a strong link between allocations and policy priorities, it makes it more difficult for budget planners to translate policy priorities into financial programmes because they end up allocating to categories of which the policy relevance is not immediately obvious. Also, when in-year spending cuts are required and the only classification available is by budget institution and line item, a reduction in available resources results in cuts by institution or by line item across institutions (e.g. the instruction to cut travel expenses), rather than cutting all the expenses of lower-priority programmes within institutions. The quality of fiscal adjustment, albeit upwards or downwards, is compromised if the classification system does not offer suitable tools for deciding where spending increases or decreases should be effected and for implementing such choices. In short, the budget classification system assists in the strategic allocation and use of resources in line with policy objectives to consistent and understood sets of government activities across time, sectors and government units.

Also, a sound budget structure coupled with consistent budget classification assists in managing the use of funds from different sources towards the same purposes. If allocations under a development budget are classified according to the same structure used for the recurrent budget, it allows for easy aggregation into a joint budget. Similarly, if activities under a special fund, or through a separate entity set up by

an act of parliament, with an independent source of funding, contribute to a functional area of spending, a sound classification system will ensure that it shows up in the government financial statistics. Thus, a sound classification system: facilitates co-ordination between budgets arising from different sources of funding; assists in providing a more comprehensive view of government finances for policy purposes; ensures that the full cost of implementing a policy objective is made transparent, even when funded from different sources; and aids competition between policies by de-fragmenting their funding. The role of consistent classification in co-ordinating spending under a dual budgeting system is discussed further below.

Control and accountability

During budget implementation, the classification of spending is necessary for *ex-ante* internal control and *ex-post* external accountability. Central objectives of a classification system would be to enable day-to-day budget control and administration and to track compliance with legislative authorisation.

Internal control comprises checking proposed spending against the availability of budget across different spending categories; for example, whether the proposed spender has funds appropriated for the type of activity that is to be funded, albeit by programme or types of input depending on the financial regulations. The recording of spending in the accounting system is a further step towards accountability. If the classification system does not allow these different dimensions to be captured and made available through financial reporting, it compromises the ability of oversight authorities to track spending against plans. At the same time, managers in government require timely information on spending and revenue at different levels of aggregation according to organisation and responsibility. This is achieved through the financial reporting system, at the heart of which is the classification system. The strength of the financial reporting system determines the incentives for managers to properly perform their functions.

3.2.3 Requirements of a sound classification system

There are several core requirements that classification systems must fulfil if they are to perform the functions set out above.

Consistency and comprehensiveness

First among these is that they need to be consistent and comprehensive; in other words, classification rules must be applied consistently across all institutions of government and over time within institutions, notwithstanding the source of funds or purpose of expenditure. Common weaknesses in many countries' classification

systems, which compromise their ability to manage resources towards spending objectives, are inconsistent categorisation of data (i.e. unclear distinction between functional, economic and line-item classification), variable application of classification systems across government, the exclusion of some institutions of general government from the classification system and inconsistency in budget classification of spending under the development and recurrent budgets.

An important instance of consistency is the need for using the same categories between budget and accounting classifications. This requirement, which often is not in place, is critical to enable the classification system to make clear the linkages between different phases of the budget process. Budget and accounting financial information is derived from two different operations in the budget preparation and implementation process. Budget allocations in terms of standard budget classification are the result of allocating the available resources into the budget structure through the budget process according to their expected usage against policy objectives and spending demands. Accounts classification, on the other hand, involves recording every single transaction in detail by coding it along similar dimensions (including a time dimension) against the chart of accounts' prescribed codes. These can then be aggregated to higher levels corresponding to budgetary categories. The aggregation of information from thousands of classified transactions then allows for intelligent records of the use of funds against specific time periods. In a developed system, the budget classification classes and sub-classes will correspond to accounting classes along all the key dimensions, so as to operate as a check on whether spending plans have been implemented and to assess the soundness of the plans in the real world.

A comprehensive and clear budget structure

The classification of financial information in line with the structure of government, whether for budgeting or accounting purposes, results in suitably disaggregated budget frameworks. These frameworks are used within the fiscal policy and budget planning and implementation processes to manage the interface between economic and fiscal policy across the public sector.

The United Nations System of National Accounts (SNA) sets out a standard framework within which the different parts of government can be identified. This system has been taken over into the Government Finance Statistics (GFS) framework. The framework distinguishes between national and sub-national levels of government, and between different types of government operation at each level, as described below (and see Figure 3.2.1).

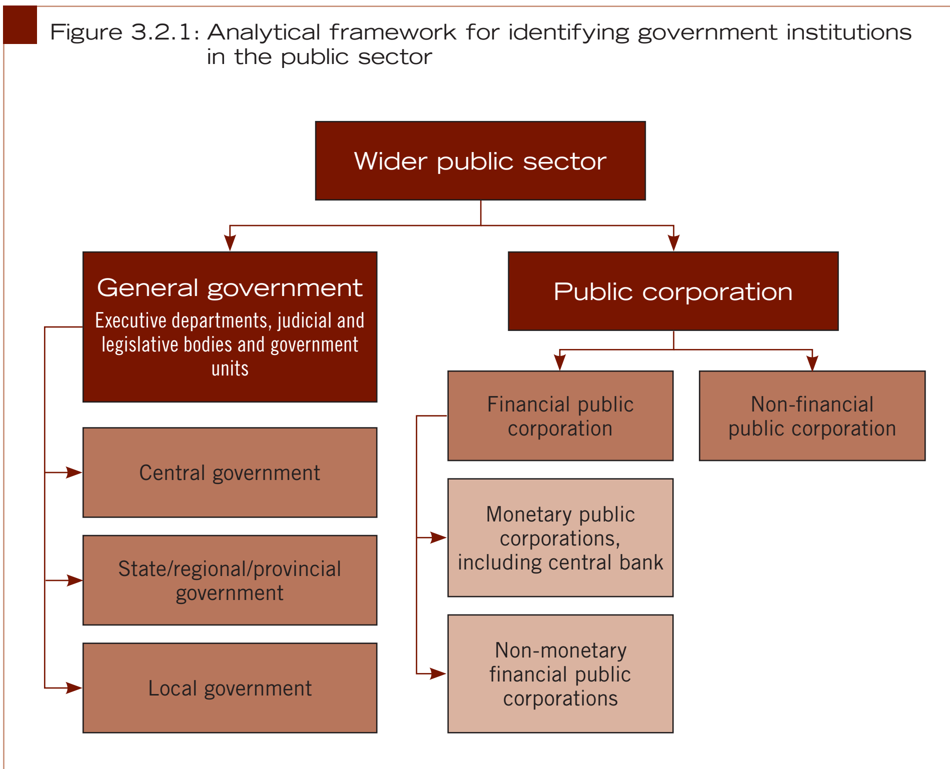
The public sector consists of all executive departments and government units of the general government sector (central government plus sub-national government)

and all public corporations that carry out the fiscal policies of the government. Public corporations are market producers fully or partially owned by the state, financing their productive activities by charging economically significant prices, whereas general government units are non-market producers.

General government (the compilation of central, regional and local governments) generally includes a central group of executive departments plus various judicial and legislative bodies and government units. These may be agencies, commissions, boards, operating authorities or other specially designated entities that are to some degree accountable to or controlled by a government, but operate with considerable independence.

A government unit is funded by raising taxes or levies separately from the main budget, by engaging in economic activities in its authority or by receiving transfers from the budget. Often, it is able to own assets and incur liabilities by borrowing on its own account, and it usually has the authority to disburse at least some of its funds in the pursuit of its policy objectives and to appoint its officers independently of external administrative control. Non-market, non-profit institutions should be

Figure 3.2.1: Analytical framework for identifying government institutions in the public sector



included in the general government sector, if the government determines the general policy and programme of the institution.

Executive departments are the core units of government tasked with policy and implementation functions. They are funded from the government budget, are staffed by civil servants and are administered in line with public service regulations.

A social security fund is a government unit that operates and manages a social security scheme. These social insurance schemes are imposed and controlled by the government and cover the community as a whole or a large section of it. Social security schemes involve compulsory contributions by employees and/or employers, and government units determine the terms on which benefits are paid. The schemes can cover benefits in cash or in kind for old age, disability, death, sickness, maternity, work injury, unemployment and health care.

Government's central budget framework should operate within a set of overall fiscal frameworks that indicate fund flows, liabilities and borrowing requirements for the wider public sector, for general government and for central government. A fiscal framework for the wider public sector would capture fund flows and borrowing requirements for general government and the public corporations. A comprehensive general government fiscal framework would show all revenue and all expenditure for central government and sub-national governments, whether the revenue and expenditure is extra-budgetary (i.e. not appropriated under the main budget) or not. This allows for a comprehensive view of government's fiscal operations.

The central (or main) budget framework would be a building block of the general government framework and would show fund flows in and out of the main government revenue fund. In turn, it would disaggregate into suitable categories across several dimensions.

Inclusion of relevant dimensions

The classification system must allow government to categorise funds across the dimensions dealt with below.

Organisation/administration (for accountability and responsibility). Firstly, for accountability purposes, it is important that expenditures are classified according to who is responsible. A sound administrative classification system will pinpoint which institution of government is responsible for a spending item. Therefore, this type of classification should be tailored to the organisational arrangements of government and to different levels of responsibility and accountability in budget management. This structure allows for the determination of who will be responsible for the spending of the funds and who will be accountable for the use of the funds. Several countries present expenditures by organisation, but not at the same level of aggregation

for all institutions in government. While this may be appropriate for administration and controls, it makes the assessment of running costs of the different entities a challenge.

Function (for historical analysis and policy formulation). A functional classification organises government activities according to their purpose (agriculture, defence, education, intergovernmental transfers, etc.) and is independent of the government's organisational structure. A functional classification provides for the analysis of the allocation of resources among sectors and is important for monitoring macro budget policy objectives (e.g. whether government is investing sufficiently in social spending objectives across various institutions of government). A stable functional classification is necessary to produce historical surveys of government spending and to compare data across several fiscal years. Many countries have implemented the United Nation's Classification of the Functions of Government (COFOG) as the standard functional classification, which facilitates international comparisons. The 2001 GFS, which is an International Monetary Fund (IMF) standardised framework, incorporates COFOG. Other governments have a mixed sectoral/functional and organisational classification, with the former operating as a top layer of the latter, but this has drawbacks in that it does not account for instances where activities in one ministry belong to a different functional classification or where, over time, ministries have been created that include parts of a ministry that belonged to a different sector in a previous dispensation.

Funding (source of financing). Expenditures should also be classified according to funding source, which allows for differentiating between diverse sources of funds and for tracking how funds from a specific source are used. This is particularly relevant for countries receiving significant external resources. For example, in South Africa, payments are financed according to voted funds, equitable share (transfers to other spheres of government), conditional grants, statutory commitments and donor funding; in Namibia, payments can be financed according to voted funds (recurrent or development budget), statutory commitments, general budget support or earmarked donor funds; in Kenya, the source of funds includes identification of which organisation's budget an expense is funded from, to allow for activities carried out by one agency but funded from the budget of another to be accurately recorded.

Economic (for statistical purposes) and *object* (for compliance, control and economic analysis). Classifying expenditures according to economic category is necessary for economic analysis; for example, economic classification allows for a determination of what proportion of government spending wages constitute, or the level of public capital investment, which is crucial for policy formulation. Most countries have adopted at least a GFS-consistent economic classification system. It is important

to keep in mind that the GFS is not an accounting or financial reporting standard but rather a standard framework for analytical reporting of fiscal statistics. In other words, GFS concerns economic, rather than the accounting entity's, performance. Nevertheless, government accounts classifications and reporting standards should be compatible for the generation of statistical reports, in order for one system to meet both accounting and fiscal reporting needs.

Object or line-item classification is associated with economic classification. This type of categorisation is important for budgetary control and monitoring, and ideally should be compatible with GFS economic classification. For budget management purposes, it is critical to closely track inputs, particularly in countries with a risk of arrears generation. Line-item classification is often linked with strict *ex-ante* controls and poor budgeting outcomes, primarily explained by the rigid management of appropriations and exclusive focus on inputs instead of outputs.

Programme and/or activity (for allocating and tracking particular spending objectives). Commonly, a programme is understood to be a set of activities with the same objective. Some countries have set up a classification of expenditures according to programmes and sub-programmes, indicating how expenditures would relate to key government spending objectives. In some cases, a programmatic classification has been set up in an attempt to implement elements of a more performance-based approach. In other cases, 'programmes' have been introduced to increase the readability of the budget. Not unrelated, a number of countries have introduced an activity-based classification. The primary objective of this method is to trace individual costs back to primary objectives. It involves identifying activities within an organisational unit or project, assigning resources to it, identifying outputs of the activities and, subsequently, assigning activity costs to the outputs through cost drivers. Part of the problem of 'programme budgeting' and activity-based costing is that on many occasions they have been introduced as an add-on category without direct linkages to the organisational arrangements of the government or the chart of accounts. This problem is exacerbated when programmes encompass several ministries. In practice, programme budgeting (and activity-based costing) implemented in this manner has resulted in a lack of ownership, loss of accountability and the addition of a layer of meaningless classification.

Mutually exclusive categories and a well-constructed chart of accounts

In order for the classification system to provide a single version of the truth, funding categories within these dimensions should be mutually exclusive to the lowest level of detail.

In capturing actual spending transactions from financial input documents, the

accounting system utilises a detailed chart of accounts. The structure of the chart of accounts normally has various levels of detail and analysis. The first few levels provide the high-level information necessary for budgeting and accounting purposes; no information is directly entered into these levels. The highest level of consolidation takes place in the first level of the chart and generally covers three broad areas: receipts; payments; and assets, liabilities and equity. Codes are used to identify types of transaction.

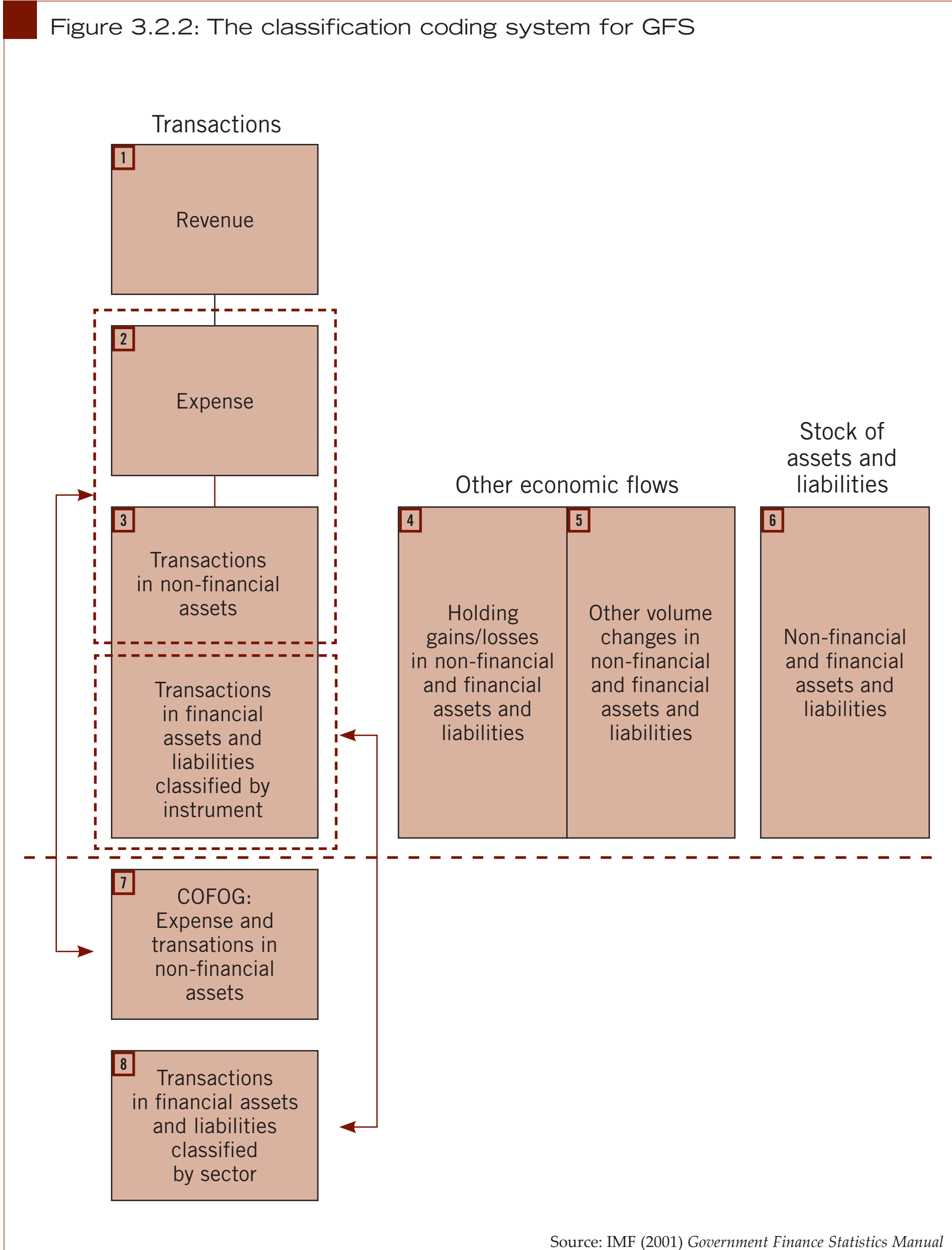
The GFS system uses six high-level codes: all transactions starting with 1 relate to revenue, 2 to expense, 3 to financial assets and liabilities classified by instrument, 4 and 5 to other economic flows, and 6 to stock of assets and liabilities. In addition, expense transactions and transactions in non-financial assets can also be classified using COFOG; code 7 would be used for such transactions and code 8 for classification by sector. Digits are added to signify a lower level of detail. The organisation of the GFS classification coding system is shown in Figure 3.2.2.

Reflection of gross allocations and transactions in the budget structure

Financial reports sometimes tend to use net items, rather than reporting the gross transactions that make up the netted items. While 'netted' items are usually sufficient for macroeconomic analysis, they are generally insufficient for budget formulation and management purposes. This is because certain inflows may offset outflows during consolidation; for example, the debt-to-GDP ratio is usually calculated on a gross basis and is not reduced by the amount owed to the government or by other assets held by it. Transparency may be compromised when transactions are recorded on a net rather than gross basis, as it is a possible method to 'disguise' certain operations and their impact on the economy. A country's budget structure and financial reporting, therefore, should provide information on gross revenue and allocations.

While a good classification structure with mutually exclusive categories and appropriate dimensions, which is applied consistently to all institutions of government, is necessary for the system of classification to fulfil its functions in budget management, it is clearly not sufficient by itself. Strong human resources capacity, clear rules, supportive budgeting and accounting processes and continuous support from the centre of government are also required to make and keep the system operational. A classification system is never stagnant, with users on the ground facing new challenges every day in classifying diverse transactions. A strong grasp of strategic issues, together with painstaking implementation and maintenance, is essential to continuously ensure quality information in the budget process.

Figure 3.2.2: The classification coding system for GFS



Source: IMF (2001) *Government Finance Statistics Manual*

3.2.4 Designing, implementing and managing a classification system

This section reflects on some issues that impact on the design, implementation and management of a classification system in the developing country context.

Classification as a possible tool to address the separation of capital and recurrent budgets

A distinction should be made between capital and recurrent spending for analytical purposes, transparency and policy-making. This distinction is necessary to determine the operating costs of government. Capital spending generates a stream of future costs and benefits and, therefore, is analytically different from expenditures, the effects of which are felt for only a short period of time. Therefore, many countries have developed a user-friendly practical guide to assist practitioners in deciding whether a transaction should be classified as recurrent or capital.

Several countries operate separate recurrent and capital budgets, which in some instances are not part of the same appropriation. When the process of budget preparation is the responsibility of different entities and/or results in two separate documents, it is referred to as dual budgeting. Dual budgeting makes an integrated review of recurrent and capital spending difficult. The separation of recurrent and capital budgets is commonly a feature in countries that are the recipients of substantial volumes of external resources. Even when containing a significant share of recurrent expenditures, donor projects are usually part of the capital budget, while domestically financed programmes are designated to the recurrent budget. In the CABRI pilot questionnaire on budget frameworks and classification, responding countries reported that it is not necessarily the nature of the spending (recurrent or capital) that determines whether an allocation is effected through the capital or recurrent budget. Some countries use the capital budget as a vehicle for development projects, or projects forming part of a longer-term development plan, or projects that are donor funded.

In many countries, donor-financed programmes and projects are off-budget completely and thus utilise very different classification and coding systems, making integration and consolidation a particular challenge. Furthermore, in several countries, the recurrent budget and the capital budget use a different budget classification – the recurrent budget is presented by line ministry, while the capital budget is shown by function, programme and project.

The classification system can be a useful tool in addressing the separation of the recurrent and the capital budget. When the recurrent and capital budget use the same classification and coding system, it should be possible to consolidate the data to get a unified information base. This has been done in Tanzania, where a recent classification and chart of accounts reform ensured that classification of expenditure is consistent between the capital and recurrent budgets, with only the source of funding classification distinguishing expenditures for the capital budget from expenditures for the recurrent budget. This, together with an increasingly integrated

process related to single policy and funding frameworks, is paving the way for better integration of the development and recurrent budgets, while retaining the possibility of planning and funding differently for different purposes.

Similarly, in South Africa problems of constraints on treating capital expenditures differently in the budget process – on account of having a unified budget without mechanisms to plan for projects separately – are being solved through the classification system. Large and important projects, particularly large infrastructure investments, may need to be monitored closely. Payments made may relate to different functions and organisational classifications or even funding sources. South Africa is introducing project identifier codes that allow managers to correctly report on total payments for specific, cross-cutting projects; and all related spending would be grouped as part of the project. Such coding enables transparency as it helps to prevent 'special projects' with a defined timeline from disappearing into the 'baseline' of budget allocations. Codes related to such projects are temporary in nature. A good information system should be able to integrate classification requirements that were not anticipated during the design phase. In the case of special projects, a budget manager could adopt an activity-based costing scheme to account for payments involved. Temporary classifications, such as project identifier codes, should be embedded in the chart of accounts and not be an additional stand-alone classification. A 'project' should also be clearly and consistently defined.

Cash versus accrual accounting

Several countries are considering moving towards an accrual basis of accounting, either completely or for a selection of public sector organisations. The central difference between the two accounting bases is the timing of the recording and coverage. In principle, an accrual system is deemed to be better because it accounts for resources, and not merely for cash. In a cash basis of accounting, transactions are recorded when cash is received or paid, and the accounting is restricted to monetary transactions only. In the accrual basis of accounting, flows of transactions are recorded at the time economic value is created, transformed, exchanged, transferred or extinguished. Accrual accounting results in the recognition of accounts receivable and accounts payable and accrued revenue and expenses.

Acquisitions of non-financial assets are recorded separately from expenses, and the expenses of using those assets in operating activities are matched with the period of their use rather than the period of their acquisition. In accrual accounting, all resources are recorded, which permits the integration of flows with changes in the balance sheet. Recording flows on the basis of accrual accounting will automatically capture obligations, whether for paying principal debt or interest or for goods

and services when the obligation accrues on account of the underlying activity or transaction, rather than when the payment is made. Accrual accounting provides the best estimate of the macroeconomic impact of government fiscal policy; with cash accounting, the time of recording may differ significantly from the time of the occurrence of economic activities and transactions. The use of different bases of accounting by individual entities within a level of government may involve different budgeting and monitoring regimes, which makes the preparation of consolidated financial statements difficult.

Robust classification for financial management information systems

The computerisation of public expenditure management processes should result in improved recording and processing of government financial transactions, allowing for prompt and efficient access to reliable financial data. It is not surprising, therefore, that many countries have introduced information systems to manage financial transactions in an effort to move from manual bookkeeping to automated processes.

A financial management information system should strengthen financial controls and thus facilitate a full and updated picture of commitments and expenditures on a continuous and timely basis. When formats and structures of financial reports are embedded in computerised systems, it is no longer necessary to manually draw up reports. In other words, a computerised financial management information system can be an effective tool for co-ordinating and integrating the financial data as it connects, accumulates, processes and provides information for budget management purposes.

However, while many countries have introduced financial management information systems, the envisaged benefits have frequently not materialised. Significant costs are involved in the design, implementation and maintenance of such a system. The introduction should be a component of a comprehensive public expenditure management system and not a stand-alone project. Furthermore, a financial management information system can only be effective if the underlying budgetary and accounting systems are robust and well managed. The introduction of a financial management information system makes it necessary to unify the codes and classifications (budget classification and chart of accounts). It should follow the full classification of the budget and link the budget classifications with the standard functional and economic classifications for the purposes of economic analysis.

3.2.5 Reform issues: getting from here to there

A good budget and expenditure classification system increases transparency and accountability, allowing for greater scrutiny of public finances. Therefore, a degree

of political will is a necessary condition for implementing and designing a budget and expenditure classification improvement programme. An improved classification system is unlikely to result in any significant benefits if the political principals are disinterested in making real improvements in economic governance and increasing the quality of service delivery. Public expenditure management reforms are a function of institutional change.

In deciding on a reform programme, it is important to consider what is desirable and what is realistically achievable. The design of reforms in the classification system should start with the identification and review of any administrative and technical constraints in the prevailing information structures and supporting systems. Inappropriately designed information systems can be an obstacle to reforming budget and expenditure classification. Many classification improvement programmes have suffered from the allocation of insufficient time to the design phase of the programme; once implementation commences it is difficult to engineer substantial changes. This is not to suggest that all eventualities can be foreseen early on; however, it does mean that an information system should be able to integrate classification requirements that had not been anticipated in the early design phase.

Classification system reform may take several years to implement, as it is an exercise in change management. Change management can be defined as the process of aligning an organisation's people and culture with changes in organisational strategy, structure, systems and processes. Embarking on a reform programme that is disruptive has a high chance of failure. The process of change must be managed by: ensuring that officials buy into the implementation of an improved system and understand why its adoption is necessary; effective communication of the benefits at all levels of government; adequate training throughout government; proper monitoring of implementation; and addressing conflicts between old and new systems in a timely fashion.

Implementing change: design and implementation of a new economic reporting format and a revised standard chart of accounts in South Africa

The Constitution of South Africa states that national legislation must establish a national treasury and prescribe measures to ensure both transparency and expenditure control in each sphere of government by introducing generally recognised accounting practice and a uniform expenditure classification. The South African public expenditure management system has undergone substantial reforms since the mid-1990s. A key aspect of the reform process was to systematically improve the timeliness, quality and usefulness of information on the allocation and use of funds, both internally and externally, to improve public policy and funding choices and to

strengthen accountability. At the same time, it was recognised from the start that, while it is important to get the technical information systems and tools right, successful implementation is as much about creating incentives for staff to implement and adhere to new practices and procedures.

Before the start of the reform efforts, the South African budget was classified on functional, line-item, administrative and programmatic lines. However, the quality of the information was dubious, with many inconsistencies in the application of standards. The line-item (standard item) classification was archaic and a hangover from the earlier incremental, input-based system. The relations between budgeting, accounting for funds spent, and reporting to the Auditor General were not clean-cut, disabling the link between policy and actual spending, and ultimately undermining the quality of oversight and accountability.

A key feature of the reforms has been the implementation support to line departments, which included working with departments to recode their transaction base correctly, providing training programmes to financial management personnel and a help-desk facility at the National Treasury. This was in recognition of the fact that while careful design of the budget structure and chart of accounts framework is a necessary input to improve the quality of the budget and financial information, it does not guarantee that the departments responsible for recording the transactions will apply these frameworks correctly.

In other words, change management was a key ingredient of the reforms and was considered to be a multi-year project. Table 3.2.1 sets out the sequencing of the reforms.

In the South African budget structure, expenditure information is first broken down by government unit (national or provincial), then by vote (usually coinciding with a main spending department at national or provincial level) and then by programmes and sub-programmes within a vote. The programmes relate to the

Table 3.2.1: Sequencing of the South African reforms

1998	Reclassification of existing expenditure items in line with GFS for compliance with Special Data Dissemination Standards (SDDS)
1999	Modernisation of accounts to align with international best practices
1999–2000	New economic classification based on GFS
	Roll-out from national budget through to provincial budgets
2000–2004	Development and implementation of the Standard Chart of Accounts to support the effectiveness of the new Economic Reporting Format
2005–	Rationalisation and refinement

objectives of the line departments. Four broad categories of functional classification are used in the budget structure – general government services, protection services, social services and economic services.

The new format is in line with the 2001 GFS standard, thus enabling improved international reporting. However, in order to take into account the specific nature of the South African environment, certain modifications to the structure of the account and the labelling of receipt and payment items have been made. The use of unclear terms such as 'other' and 'miscellaneous' is avoided, greater detail is included on various transfer categories, and items are labelled more clearly.

South Africa operates a modified cash-based accounting system, with entries for national budget data made in the period in which transactions are captured on the financial systems, rather than when the actual cash flow occurs. As it is the intention to move towards accrual-based accounting in the future, the system has been designed to cater for this.

There is direct alignment between the budget documentation and the financial system, as the format of the tables for the Economic Reporting Format is the same as for the Estimates of National Expenditure (detailed presentation of budget), tabled on the same day as the Appropriations Bill. A detailed Standard Chart of Accounts (SCOA), introduced in 2004, supports the new budget tables in the financial system. Existing accounting systems and the data warehouse were revised to record information in accordance with the new structure.

SCOA allows for information to be stored in such a structure and in such detail that, without the need for time-consuming adjustment or analysis, it can be used to report on the basis of approved programme areas for financial management purposes and for national and provincial treasuries, and it enables the South African Reserve Bank and Statistics South Africa to report in terms of the economic reporting format to meet the requirements of the IMF. Additionally, SCOA uses consistent codes for the same activities to aid analysis and transparency, and thus eliminates the need for reclassification. While government accounts continue to be on a cash basis, additional codes have been set up to enable SCOA to deal with accruals when introduced.

At the highest level, the chart reproduces the reporting tables exactly and is then broken down to detailed posting levels. The accounts use four main segments to identify transactions: fund, objective, responsibility and item. A fifth segment, project, has been added to identify and track various kinds of projects at the national and provincial level. This works on the basis of a project identifier that enables management to track payments on particular projects even though they may relate to a number of different items. SCOA is required to be used by all national and

provincial departments, together with the trading entities under their control. It is not directly applicable to other entities, but their financial results are consolidated for national statistics on the basis of SCOA and the GFS system of economic reporting that underpins it.

SCOA has up to 12 levels of detail and analysis. Levels 1 to 3 provide high-level information that is required for budging and accounting purposes; no information is posted to them directly. Level 4 provides further analysis for management purposes, but is also used for high-level postings. The definitions for the main posting levels (i.e. 5–12) are there to help classify the transactions within the new Economic Reporting Format levels (i.e. 1–3). The introduction of SCOA resulted in the two million posting items used by government departments in the past being condensed into several thousand items, by eliminating those items that were duplicated or no longer required. In the past, capital and recurrent expenditures were classified inconsistently; a decision tree has been developed to provide a practical guide for deciding on whether expenditure is recurrent or capital.

While the introduction of the new Economic Reporting Format has been considered a success so far, there are remaining challenges in going forward. Even though the number of items has been condensed significantly, there is a danger of the number spinning out of control again. Importantly, the benefits of the new system will fully materialise only when the information is interrogated, analysed and used as a serious input for decision-making. Nevertheless, a key reason for the successful roll-out is that the reform designers acknowledged that implementation is an exercise in change management and that disruptive change frequently results in failure. The process of change was and continues to be managed by a strategy of focusing on instilling a sense of ownership and commitment to change at all levels (from senior management down to data clerks), through communication about the benefits and training of 6 000 role-players to date, monitoring implementation closely and addressing conflicts between the old and new systems.

Improving the information base for tracking the uses of appropriations, presenting the budget to the legislature and managing the budget has been a central element in the South African public financial management reform programme. Its success can be explained by the considered and phased approach taken in implementation, a communication and training strategy that targeted all of those involved in recording, collating and analysing financial data, close monitoring of implementation and compliance. However, possibly the main reason for success has been that the design and implementation of the new Economic Reporting Format and SCOA was integrated with an overall strategy to make public finances more accountable, transparent and better targeted.

3.2.6 Conclusion

A robust classification system is an essential tool in fiscal and budget management. Many demands are made of budget and accounting classification systems. Domestically, they assist in the management of public moneys towards priority public goods and services by providing financial information in standardised, accessible and comparable formats linked to events in the real world. They are essential for effective economic and fiscal management (aggregating revenue and spending across the public sector in useful categories) and an effective budget preparation process (providing information on the proposed use of funds across several different cuts, including by institution, type of spending, economic impact of spending and object of spending). They enable budget control and management by ensuring that funding is used in line with the purposes for which it was appropriated by legislatures, and they enable the management of performance by standardising unit costs and linking spending to programmatic objectives. Internationally, when in compliance with international standardised systems of classification and accounting such as the SNA and GFS, they provide information on the fiscal operations of government in comparable formats, which can be used by rating agencies, capital markets and investors, for example.

Reforming classification systems and charts of accounts has become a standard item of budget reform programmes. Several lessons regarding successful design and implementation of classification reforms have been learnt.

Layers of classification should be integrated, should not duplicate existing systems and should be linked to the accounting system. For example, implementing a programme classification system that is not linked to actual budget appropriations through the system of accounts could result in meaningless compliance exercises by budget managers, rather than having a real impact on strategic budget management.

Reforming a classification system is not a quick process. Even if the design of the system can be achieved relatively quickly, implementing the new system requires significant training and refinement. If not all budget managers and recorders of financial information are properly trained in the classification of every transaction they encounter, even the best classification design will still produce low-quality information. Similarly, a financial management information system is a tool rather than the solution for improved financial management; it only functions well when supportive institutional arrangements are in place.

A demand for information should be stimulated. It is essential that the new and enhanced information that is generated by an improved system is comprehensively utilised, not only by government policy-makers and budget managers, but also by Parliament and outside stakeholders. Putting in place an improved system cannot

predominantly be a supply-driven exercise – quality information for better budget management and service delivery has to be demanded, continuously.

The domestic requirements of a classification system should not be outweighed by international standardisation. A robust classification system would mean that it is domestically appropriate, in the first place, rather than merely internationally standardised. Careful design of classification categories and charts of accounts can ensure compliance with international standards, by providing for mapping procedures at the appropriate posting levels.

Classification systems and charts of accounts should have the flexibility to comply with future demands. Space should be left when designing the frameworks for classification systems to accommodate future categorisation demands, whether on the revenue, expenditure or asset and liability sides.

Robust classification systems strike the right balance between detail and aggregation. A classification system should provide enough depth to describe sources and uses of funds in sufficient detail, but not in so much detail that the ability to aggregate information into sensible categories is lost. This balance should be struck at the outset, and maintained throughout the development of the system.

The institutional responsibility for classification system design and implementation should be clear, and mechanisms for co-ordination between the budgeting and accounting requirements of the system should be developed. Accountants place demands on a classification system that are different to the demands of budget managers. Efforts to reform classification systems should pay attention to decision-making responsibility and mechanisms for co-ordination, and trade-offs between these demands, to ensure that systems are consistent across different phases of the budget process.

Classification systems and charts of accounts should provide only for appropriate accounting and economic data. In many instances, classification systems are changed to cater for information demands that should not be included in financial systems (e.g. payroll information or project management information). Including such information in the classification system results in an unnecessary complication of transactions and leads to misclassification. Such information should be maintained in appropriate sub-systems with their own classification structures.

3.3 Member country practices: insights from the pilot questionnaire

Alta Fölscher & Mickie Schoch

During 2005, CABRI piloted the use of questionnaires to research member countries' budget practices. The pilot survey focused on budget institutions – budget frameworks, budget comprehensiveness, off-budget expenditure, revenue and expenditure classification and budget documentation – as possible technical mechanisms to manage budgeting complexity.

The pilot questionnaire borrowed from the OECD survey on budgeting practices and procedures, which assists in a comparison of practices and procedures in OECD and African countries. However, several questions were added that are specifically applicable to budget practices in Africa, given the presence of donors, greater macro-economic uncertainty and reforms.

A total of nine countries provided completed questionnaires: Angola, Ethiopia, Guinea, Kenya, Mauritius, Mozambique, Nigeria, Rwanda and South Africa. This summary of the questionnaire report provides a taste of the kind of information arising from the survey that is relevant to the theme of comprehensiveness and budget frameworks, revenue and expenditure classification and dual budgeting.

3.3.1 Budget comprehensiveness

A comprehensive fiscal framework, a clear budget structure and a sound revenue and expenditure classification system are all prerequisites for an effective budget planning and management system. Even if revenues are raised and spending done outside of the main budget framework (i.e. the framework that manages inflows and outflows of the main revenue fund), a comprehensive fiscal framework or set of fiscal frameworks draws together all sources of funding against all expenditure outlays to offer a comprehensive view of public finances. A comprehensive framework for budgeting will include all uses of public funds, notwithstanding source, flow or instrument of use of such funds. This allows for the overall effect of government fiscal operations on the macroeconomy to be considered in the fiscal policy process, and ensures that all competing claims on government revenues are considered on an equal footing in the expenditure policy process.

Three types of spending are often not captured or, if captured, not classified at a detailed level in line with main budget financial transactions: spending financed by extra-budgetary funds, spending that is financed by donor funds, and revenue and spending at sub-national levels. The questionnaire included questions that probed country practices in this regard.

Extra-budgetary funds, including donor funds

Most countries do not systematically include the projected impact of fiscal operations in the wider public sector in the budget process. At the same time, many types of extra-budgetary fund flows are not included and, specifically, in 50 per cent of the countries that reported receiving aid flows, less than 20 per cent of donor funds are reported on-budget (see Figure 3.3.1).

Of the nine countries, six replied that not all funds that are appropriated outside of the main budget for central and general government appear in the fiscal framework or set of fiscal frameworks (see Figure 3.3.2). Angola and Nigeria replied that even general budget support funds are not systematically included in the main fiscal framework.

Sub-national revenue and spending

All countries capture transfers to sub-national governments in their fiscal frameworks. Of the nine respondents, however, three provide only the total transfer, without any further information on the distribution across sub-national governments or whether the transfers are conditional or unconditional. On the other hand, two of the respondents, South Africa and Nigeria, reported that their sets of fiscal frameworks include information on the total transfers, the type of transfers and their distribution across sub-national governments. (See Figure 3.3.3)

Figure 3.3.1: What percentage of donor funds is on-budget?

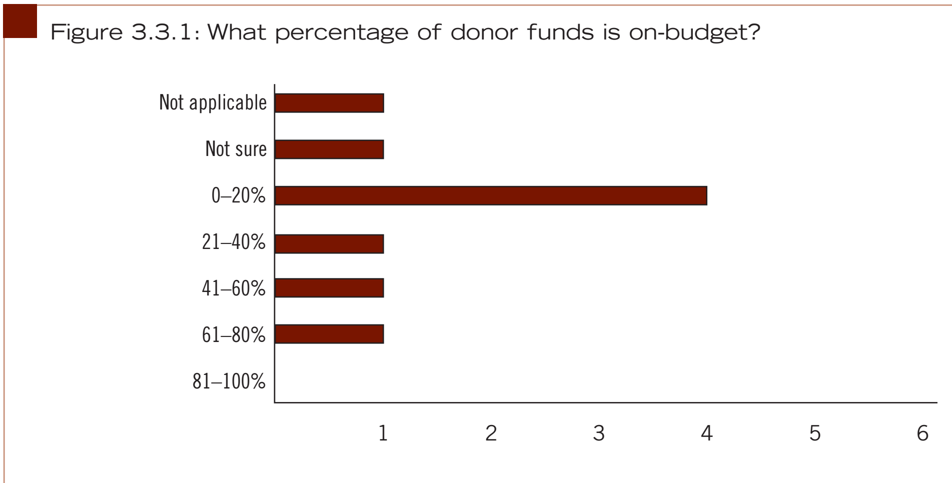
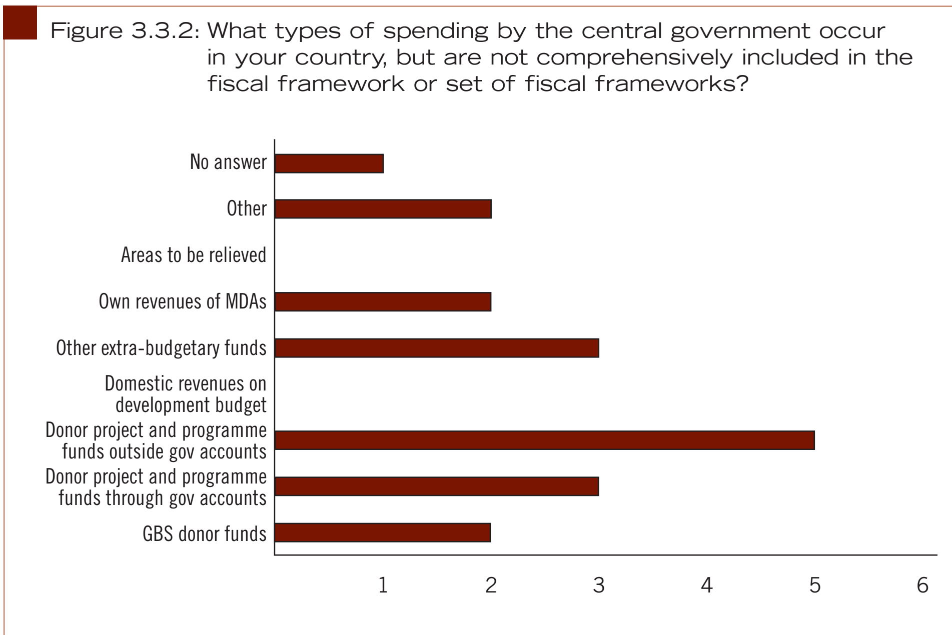


Figure 3.3.2: What types of spending by the central government occur in your country, but are not comprehensively included in the fiscal framework or set of fiscal frameworks?



Thus, although there is significant coverage of transfers to sub-national level, few countries include a view on general (national and sub-national) government spending and revenue in their sets of fiscal frameworks. Of the countries where sub-national governments have their own revenue sources, only half include these in a general government fiscal framework. (See Figure 3.3.4)

Figure 3.3.3: Does the budget framework break down to show what funds are transferred from the central revenue fund to sub-national governments?

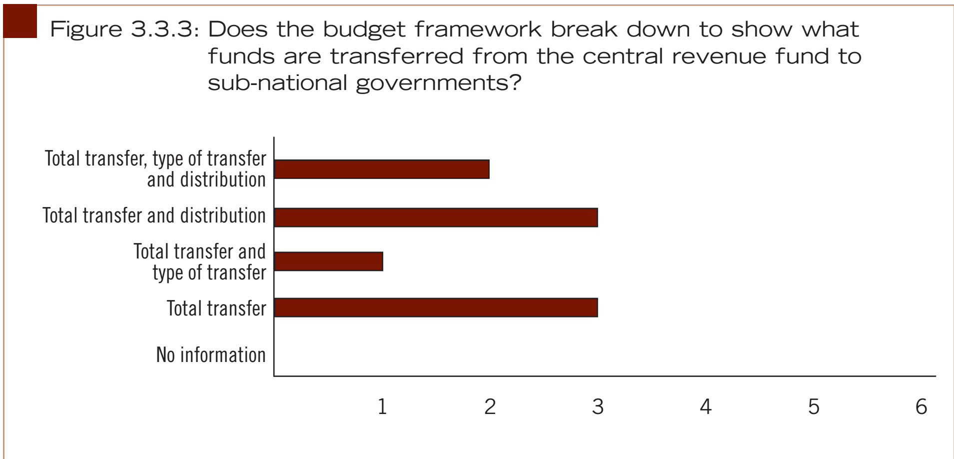
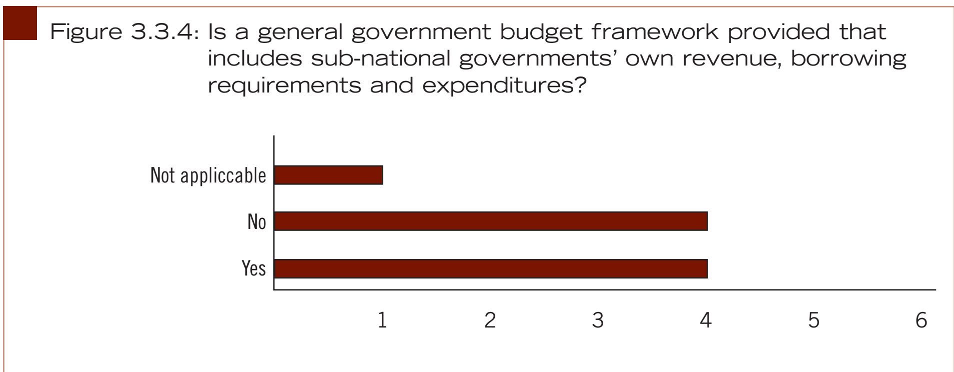


Figure 3.3.4: Is a general government budget framework provided that includes sub-national governments' own revenue, borrowing requirements and expenditures?



3.3.2 Budget classification

Budget transactions need to capable of being reviewed from the perspective of their economic impact, form of appropriation, administrative control and purpose. A recording and classification system that meets these needs is the foundation for the presentation of the budget, final accounts and fiscal reports and for tracking appropriations and their uses during each phase of the budget cycle.

A budget and expenditure classification system provides a framework for policy decision-making and accountability. Expenditures and revenues are classified for different purposes – the preparation of reports that respond to the needs of the report users, the administration of the budget and budgetary accounting and the presentation of the budget to the legislature.

The chart of accounts provides for the systematic coding of items used for classification, budgeting, recording and reporting of receipts and payments within the govern-

ment accounting system. It is a detailed framework that enables information to be captured on individual transactions and aggregated in a meaningful way for reporting purposes. The chart of accounts enables information to be stored in such a manner and in such detail that, without the need for time-consuming adjustments or analysis, it can be used to meet a number of management and reporting requirements.

The questionnaire probed countries' classification systems by asking questions about the structure of the classification system, linkages between budget and accounts classifications and the classification of on-budget and off-budget expenditure, and government financial statements.

Structure of classification

All countries classify their expenditures by administrative or organisational unit, and most categorise by function and economic classification as well, including a breakdown of capital and recurrent expenditure. (See Table 3.3.1)

The chart of accounts coding system reflects all of the classifications used in the budget process in seven out of the nine countries. All but one country reported using a decimal coding scheme to show the hierarchy of line ministry, general directorate and division responsible for budget expenditures.

In four of the countries, funds are voted according to administrative unit and line item. Two countries vote by administrative unit and programme and three use some other configuration (e.g. administrative unit, programme and line item). No country votes exclusively by programmes. Three countries also vote per programme unit, but none does so exclusively. The lowest level of classification for which funds can be shifted differs from country to country. (See Figure 3.3.5)

All countries reported that the basic concepts, classifications and definitions used are valid across all government entities. In the majority of countries, the chart of accounts allows for meaningful consolidation and a single 'version of truth'.

However, only five countries reported that receipts and payments included in the

Table 3.3.1: Classification of expenditures

Classification	Countries
Function classification	8
Economic classification	8
Line-item classification	6
Capital/recurrent expenditure breakdown	7
Administrative/organisational classification	9
Programme classification reflecting policy objectives	4
Activity classification	2

general government sector appear in the government account. (See Figure 3.3.6)

In the majority of countries, the government financial statement provides a complete account of all transactions of various entities in the government sector (see Figure 3.3.7). Rwanda reported that this was expected to improve as soon as a new software application had been implemented.

Figure 3.3.5: To what type of classification are funds voted in the budget process?

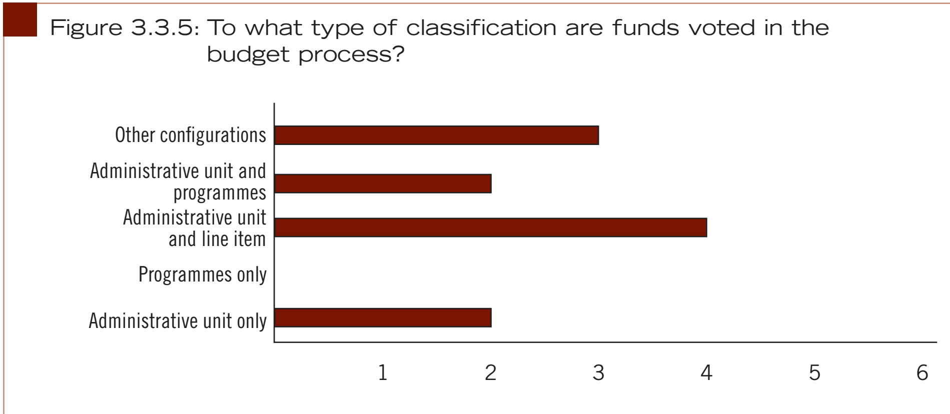


Figure 3.3.6: Do all receipts and payments of all units included in the general government sector appear in the government account?

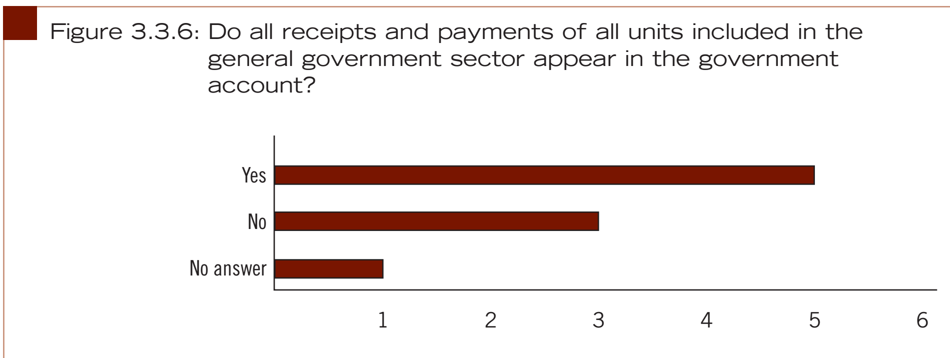
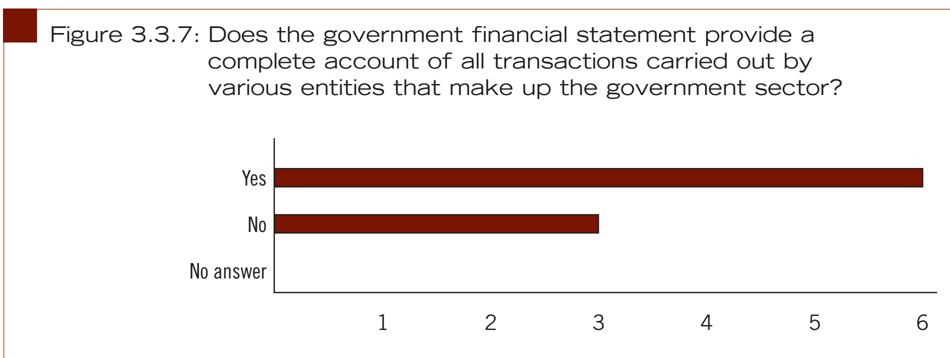


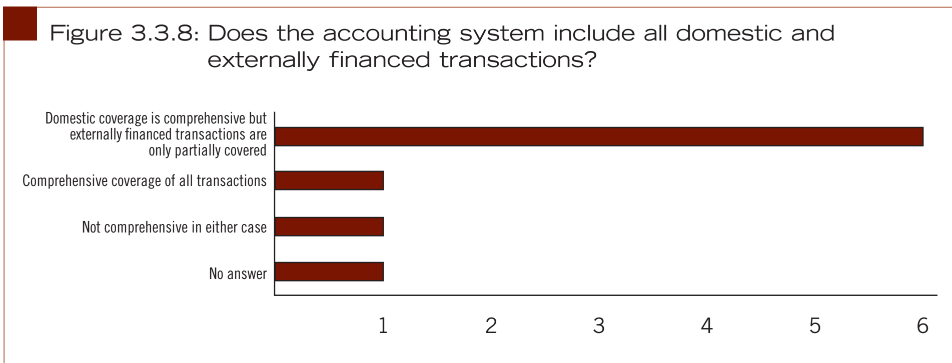
Figure 3.3.7: Does the government financial statement provide a complete account of all transactions carried out by various entities that make up the government sector?



In only one country does the accounting system provide a comprehensive coverage of all transactions; for the majority, the accounting system covers only domestic transactions (see Figure 3.3.8). In countries where externally financed expenditure is appropriated by Parliament, this creates problems. In Kenya, for example, the majority of externally financed projects are included in the development budget, whether they are managed through the government financial management systems or not. On the accounting side, however, projects that are managed through separate bank accounts and accounting systems are not captured in the government accounting system: the government of Kenya is then dependent on development partners for information to report back to Parliament on spending against the development budget. Delays in receiving and collating the information often result in under-reporting of development expenditure.

All countries have introduced reforms to their budget classifications system, and in all but one have reformed the chart of accounts over the past ten years. These reforms have been fully implemented in six of the countries.

Figure 3.3.8: Does the accounting system include all domestic and externally financed transactions?



3.3.3 Defining and recording capital expenditure

The distinction between capital and recurrent expenditure is helpful for analytical purposes, transparency and policy-making. This distinction is necessary to determine the operational costs of government. Capital spending generates a stream of future costs and benefits and, therefore, is analytically different from expenditures whose effects run out in a short period of time. It is important that capital spending is clearly defined and consistently applied across organisations.

Six countries reported using the international Government Finance Statistics (GFS) standard to identify capital expenditures. However, while all nine respondents reported that government's physical capital purchases would be classified as capital expenditure, only five reported that transfers to sub-national governments for capital

purposes would be so classified, and only three that research and development would be classified as capital expenditure. Thus, while countries differ in the specific criteria used to define capital expenditure, eight reported that they use well-defined rules to distinguish between recurrent and capital expenditure. However, there is great variation in how capital expenditures are financed (see Figure 3.3.9).

Only four of the nine respondents reported that they always reflected clearly on-budget how expenditures are financed. Four of the countries reported that they appropriate funding for capital projects incrementally each year until the project is completed, while one appropriated the entire cost up front, and three did not follow a general rule but reported that funding is determined on a case-by-case basis. One country did not provide an answer. However, a total of six countries reported that they do incorporate the recurrent cost implications of capital expenditure into the budget, and two of these did so over the medium term.

In most countries, a substantial proportion of public investment programmes is financed from donor resources. In half of the countries that responded to the question (eight in total), this accounts for more than 40 per cent of total spending in this area. (See Figure 3.3.10)

Figure 3.3.9: Are some capital expenditures financed differently from expenditures in general?

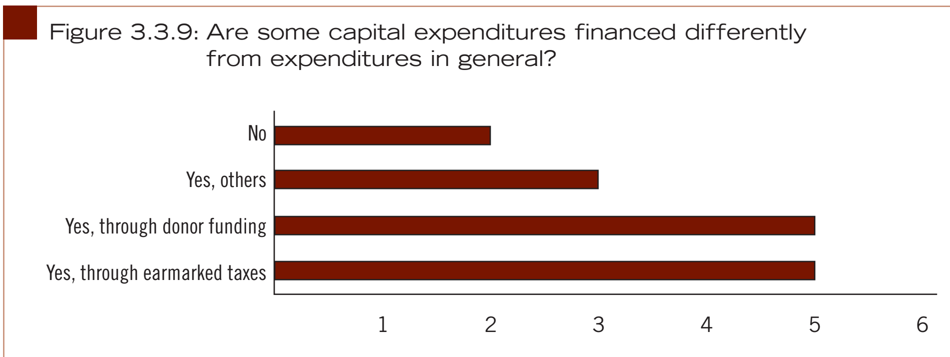
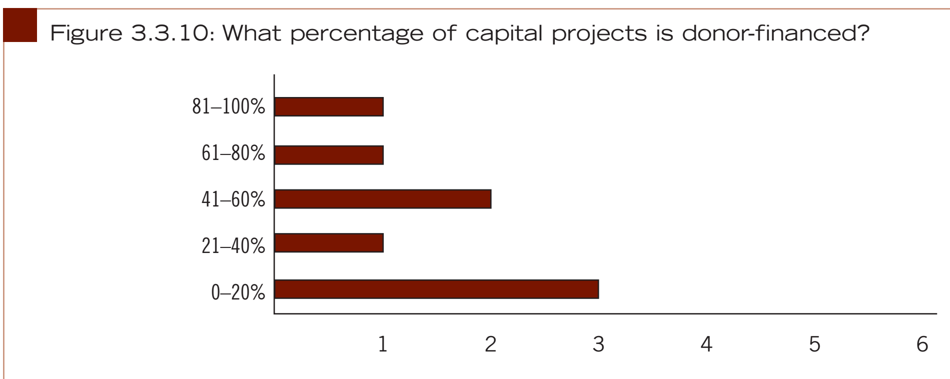


Figure 3.3.10: What percentage of capital projects is donor-financed?



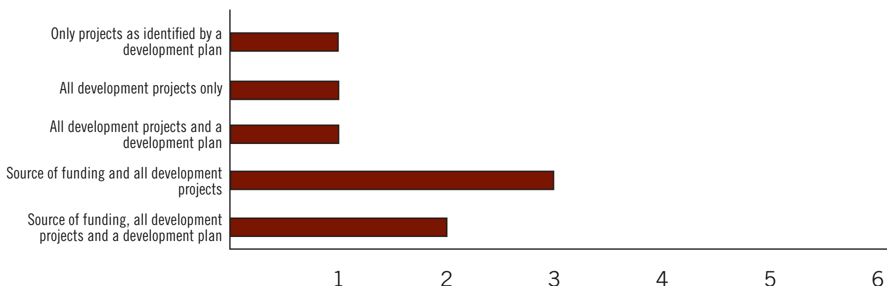
3.3.4 Dual budgeting

For analytical purposes, capital and recurrent expenditures should be distinguished from each other and their financing captured in the classification system, as probed in the paragraphs above. However, in a number of countries, the further step is taken to appropriate the capital/development budget separately from the recurrent budget. This is known as dual budgeting, which makes an integrated review of recurrent and capital spending difficult.

Seven of the nine responding countries reported that they appropriate separate capital and development budgets. The exceptions are South Africa and Mozambique. In five of the seven countries that have a dual budgeting system, both budgets are prepared by the same ministry. Three of the countries that operate a dual budgeting system use the same classification system for the development budget as for the recurrent budget. The classification system can be a useful tool in addressing the separation of the two budgets. When the recurrent and capital budgets use the same expenditure and budget classification system and coding scheme, it should be possible to integrate the data to get a unified information base.

However, different criteria are used to determine what spending should be in the capital budget and what spending should be appropriated under the recurrent budget. In most countries, the recurrent budget includes line items concerning capital expenditure, although these are usually not project-related but involve the purchase of physical capital. The questionnaire finally probed the bases on which expenditure would be appropriated under the capital rather than the recurrent budget (see Figure 3.3.11). Most countries use multiple criteria to identify projects as entailing development rather than recurrent budget spending.

Figure 3.3.11: Number of countries using different combinations of criteria to define when expenditure should be appropriated under the development (capital) rather than the operational (recurrent) budget



3.3.5 Additional trends in member country practices

In addition to the questions covered in detail above, the questionnaire probed member country practices regarding the structures and responsibility for co-ordination at the centre, how fiscal frameworks are determined and used in the budget process, and budget documentation. A brief summary of significant trends in these areas follows.

Co-ordination at the centre

- While most countries have a legal framework for budgeting, it is not always comprehensive or followed; and while most have a clear and comprehensive timetable for the budget, it is not necessarily adhered to.
- The central budget office is located in the ministry of finance in most countries, and has either a political appointee or a senior civil servant as its head. However, in most countries it is headed by a senior civil servant.

Central government fiscal frameworks

- Central government budget frameworks are commonly used to co-ordinate macroeconomic, fiscal and budget policies. Most countries have fiscal policy processes, and fiscal frameworks are generally determined in a top-down manner (i.e. targets for revenue and borrowing determine the overall expenditure envelope).
- All respondents bar one employ rolling budget frameworks with a forward time horizon, backed by multi-year macroeconomic and revenue forecasts.
- Most countries are subject to regional or international fiscal limitations, and in most countries the IMF and World Bank are involved in setting the fiscal framework.
- Most countries report managing uncertainty through conservatism in estimating GDP and revenue and by having reserve funds in place to cushion against uncertainty. However, few countries make explicit assessments of contingent liabilities.
- The information sources for these frameworks are diverse, and most countries have four or more agencies or institutions involved in decision-making, but in most countries, mechanisms exist to co-ordinate information into the budget framework.
- In only two countries does Cabinet approve the fiscal framework.
- Most countries use macroeconomic models to determine key economic variables for budgeting; however, more than half of the respondents reported that the method used to estimate current GDP is not always transparent

and that future revenue, given current tax policy, is not modelled. Only two countries allow independent review of key assumptions.

- Most countries stick to targets for revenue and borrowing, and adjust expenditures to absorb any shortfalls or overruns in revenue.

Budget documentation

- The trend of lack of comprehensiveness of budget information follows through to budget documentation: few countries publish comprehensive fiscal frameworks that include information on fund flows outside of main budget appropriations.
- 'Traditional' budget information (e.g. on macroeconomic and fiscal policies and outlooks and on tax policies) is still covered best in budget documentation. However, countries report publishing significant non-financial information, particularly regarding macroeconomic and fiscal policy.
- Most countries reflect their economic, administrative and functional classification of expenditure in budget documentation.
- Most countries report that budget documentation, and the timetable for its publication, forms an effective demand for information in the budget process.

4

Managing aid flows

4.1 Introduction

Many CABRI member countries have to manage significant inflows of external resources – albeit in the form of development loans or grants – for public service delivery. Historically, a substantial proportion of these resources was planned for and managed outside of the main budget process, fragmenting the funding of public services and making it more difficult to facilitate effective and efficient spending. However, during the 1990s, new modes of aid delivery emerged as a result of shifts in donor approaches to development aid.

Vivid debate on this topic arose mainly because the first wave of aid transfers did not fulfil the intended effect. As a result, the focus has started to shift from project-based and infrastructure-heavy assistance to the support of country-based, comprehensive poverty-reduction strategies through new types of aid instrument and architecture.

The argument was that the move towards programme-based approaches, emphasising partnership principles and channelling aid flows through government budgets, should make the management of aid flows less complex for recipient countries. Benefits should derive from reductions in the transaction costs of aid, increased predictability of funding and the strengthening of national planning and budgeting

systems, all of which should facilitate progress towards the overarching goal of poverty reduction.

However, there are also drawbacks to these practices, such as increased pressure on the recipient government in terms of administrative requirements and negotiation needs, particularly during the start-up phases. The shift towards the new modalities is still relatively new and it is too early to comment conclusively on their contribution to aid effectiveness.

The paper by Ann Bartholomew provides an overview of aid delivery and presents findings on preliminary evidence from evaluations of the new aid modalities. This suggests that some of the expected benefits are occurring and seem to be bringing corresponding benefits for recipient governments, enabling them to better manage their own budget processes and to strengthen aid co-ordination. However, the paper finds some aspects of concern, such as evidence that conditionality related to general budget support can result in unpredictability of budget funding, which, in turn, affects fiscal discipline. These problems are not necessarily related to the aid instrument itself but could be a consequence of donor behaviour that cuts across other aid modalities as well.

The Ethiopian case study provides insight into the complexity of establishing country-level institutions for effective harmonisation of donor funding. In the case of Ethiopia, the process followed from the development of a comprehensive, government-led aid policy and the painstaking putting into place of institutional building blocks. Important lessons to emerge are: the need for political commitment in the recipient country; accountability for and transparency in information, policies and procedures; and sufficient internal capacity with regard to upgraded systems that allow donor funds to be spent on the intended purposes. Fanos Habtewold and Worku Ayele emphasise the importance of country leadership in establishing a well-conceived institutional framework within which aid is received and administered. However, they also highlight a gap between international donor commitment to harmonisation and country-level concrete steps towards more aligned programmes and less costly aid modalities.

4.2 Making aid more effective: new modalities for development assistance

Ann Bartholomew[1]

4.2.1 Introduction

This paper examines the management of aid flows in the context of new approaches to aid delivery that emerged in the 1990s as a result of shifts in donor approaches to development aid. New aid instruments were introduced such as general budget support (GBS) and sector budget support (SBS), which were underpinned by Poverty Reduction Strategy Papers (PRSPs) and other frameworks such as Performance Assessment Frameworks (PAFs) and Medium Term Expenditure Frameworks (MTEFs).

These new aid instruments were a reaction to the perceived weaknesses of previous aid modalities, more specifically projects and structural adjustment programmes. They were new in that they consisted of a stronger focus on partnership, ownership by recipient governments and increased donor harmonisation and alignment.

This paper assesses these new trends in the context of the seminar theme 'Managing complexity: From fragmentation to co-ordination'; it examines the implications for recipient countries of managing aid flows in this new environment and considers the advantages and disadvantages of these new approaches. There is also a specific focus on the preliminary lessons learned from the Joint Evaluation of General Budget Support (IDD 2005), which is the first comprehensive evaluation of GBS.

4.2.2 Trends in aid management

There have been major shifts in the way that aid is managed and delivered, particularly since the mid-1990s when there was a significant evolution in aid relationships. This section of the paper begins by examining the experience of projects and structural adjustment lending, and assesses how the desire to overcome the weaknesses of these aid modalities resulted in changes in development paradigms, from which new types of aid instruments emerged. The evolution in development thinking and aid modalities is set out in Table 4.2.1.

The experience of projects

For most of the post-World War Two period, projects were the principal modality for delivering aid. This trend was underpinned by the belief that the main constraint to development was a lack of investment, which could be overcome by projects channelling capital investment to developing countries. Concerns regarding fiduciary risk could be overcome through parallel accounting and administrative systems, while the focus on building physical assets allowed governments to point to the specific outcomes from taxpayers' money to reassure domestic constituencies that it had not been wasted.

Increasingly, it became clear that the development process was more complex than had previously been considered, and the disadvantages of projects became more evident. These were primarily related to:

- high transaction costs of aid delivery, resulting from the heavy administrative burden imposed on recipient governments;
- tying of aid, particularly of procurement, leading to inefficient public spending;
- donor priorities being imposed on partner governments, leading to inconsistency in overall policy and inefficient public spending;
- bias towards capital investment rather than public spending, leading to imbalances between recurrent and capital spending and problems of sustainability due to inability to maintain capital investments; and

- reliance on parallel off-budget systems, thereby undermining the effectiveness of government systems and the democratic accountability of partner governments.

Table 4.2.1: Evolution in development thinking and aid modalities

	DEVELOPMENT PRIORITIES	AID MODALITY
1950s	Capital shortages (domestic and foreign exchanges) Knowledge and technology gaps	Projects (mainly infrastructure) and programme aid (typically, balance-of-payment support through commodity loans) aimed at financial transfer Technical assistance projects
1970s	Basic human needs (BHN)	Expansion of project aid to support social services and rural development
1980s–1990s	Macroeconomic stability Structural reforms External debt problems	Structural adjustment lending and sector adjustment lending in the form of programme aid, adding policy conditionality to balance-of-payment support Later, programme aid became linked to debt-relief initiatives (e.g. the Enhanced HIPC Initiative)
Mid-1990s	Building of core government systems Recurrent financing Policy and institutional coherence Addressing fungibility issues	New types of programme aid, including budget support (GBS and SBS), pooling funds under sector-wide approach (SWAp) arrangements, as well as pooled technical assistance (TA)

Source: GRIPS (2004)

Working outside government systems also led to government institutions being undermined and local capacity building being neglected. Similar criticisms applied to technical assistance (TA) projects, and it was realised that more attention should be paid to the fungibility of aid, in that as long as aid is fungible, overall policy priorities, budget allocation and management remain important.

There were additional problems for recipient governments in a project-dominated environment. Most Official Development Assistance (ODA) funding was off-budget and, therefore, it was difficult for finance ministries to have a clear overview of aid flows and activities being undertaken in sector ministries. This caused problems of fragmentation and made it difficult for governments to take the lead in aid co-ordination.

It also became increasingly evident that there was a need to address other issues, such as institutional, policy, social and human development aspects; and relationships between donors and recipient governments had to be improved. This thinking

was confirmed by studies like the World Bank's (1998) *Assessing aid: What works, what doesn't and why*, which found that aid effectiveness was dependent on the institutions and policies of recipient countries. This was supported by subsequent studies, which concluded that aid promoted growth in countries with good economic policy environments, but was not productive in countries with bad economic policies (Burnside & Dollar 2000; Collier & Dollar 2002).

The experience of structural adjustment operations

A similar experience occurred with structural adjustment operations in the 1980s and 1990s, leading to the conclusion that they were not bringing about the expected results. This was due to the approach underpinning the structural adjustment programmes undertaken by the International Monetary Fund (IMF) and the World Bank, which were designed to buy reforms and, because of this, were not effective (Collier et al. 1997). Budget support (defined as quick disbursing funds) was given on the understanding that governments would carry out a programme of structural reforms; this was normally accompanied by policy dialogue, which, in practice, was focused on conditions that governments committed to undertake. Disillusion emerged with this approach, as studies of the experience of policy conditionality indicated that aid disbursed on the basis of a promise by partner governments to undertake reforms was ineffective and undermined recipient government ownership (World Bank 1990, 1992; Killick 1998; White 1999; Dollar & Svensson 2000).

In general, it was also acknowledged that 'more conditionality cannot compensate for weak government commitment or implementation capacity' (World Bank 2005). These lessons convinced donors to pay greater attention to the policy environment and willingness of recipient governments to implement good policy. This led to donors shifting their focus onto countrywide strategies, poverty reduction, ownership by recipient governments and partnerships, rather than conditionality. A further implication for recipient governments was that there would be an overall move towards 'backing winners' by rewarding governments with good policies and a commitment to reform. This clearly provided recipient governments with a different incentive and motivation for reform; it also meant that those with 'bad' policies could expect reduced aid flows.

4.2.3 Current shifts in aid management practices

The lessons learned from the experiences with projects and structural adjustment lending led to a shift in aid management practices. This resulted in a move to programme-based approaches (PBAs) designed to encourage increased recipient government ownership and accountability and greater harmonisation and alignment.

Poverty reduction has become the primary objective of development assistance, with the Millennium Development Goals providing the principal framework. This has significant implications for the ways in which recipient governments manage their aid flows and budget processes, as there have been changes both in how aid is delivered and in the frameworks within which it is organised. These issues are considered more fully in the sections that follow, along with evidence from recent studies that assess the effectiveness of the innovations in aid management.

Programme-based approaches (PBAs)

PBAs are a prominent strand of new thinking in aid management and aid effectiveness. They have been designed to embody 'partnership' principles, and can be defined as:

> A way of engaging in development cooperation based on the principle of coordinated support for a locally owned programme of development, such as a national poverty reduction strategy, a sector programme or a programme of a specific organisation. (Lavergne 2003)

The characteristics of PBAs are that they incorporate:

- leadership by the host country or organisation;
- a single, comprehensive programme and budget framework;
- a formalised process for donor co-ordination and harmonisation of procedures for reporting, budgeting, financial management and procurement; and
- efforts to increase the use of local systems for programme design and implementation, financial management, monitoring and evaluation. (Lavergne 2003)

This means that increasingly aid flows are being put through recipient government budgets and are using government systems for disbursement, auditing and reporting. On the one hand, this can have the disadvantage of increasing pressure on recipient governments in terms of administrative requirements and the time involved in negotiating and engaging in dialogue with donors. On the other hand, the advantage is that it should reduce the overall transaction costs of the budget process and utilisation of aid, as compared to a project-dominated environment. The main PBAs – GBS, SBS and SWAps – are considered below.

General budget support (GBS)

A new rationale for GBS, closely linked to the development of Poverty Reduction Strategies (PRSs), emerged in the late 1990s. So-called 'new' or 'partnership' GBS (PGBS) focuses explicitly on poverty reduction, and it attempts to support nationally developed strategies rather than imposing external policy prescriptions. The move towards GBS was designed to overcome the weaknesses of structural adjustment programmes, particularly the problems experienced under the previous approaches to conditionality. GBS has been defined as:

> A form of programme aid in which Official Development Assistance (ODA) that is not linked to specific project activities is channelled directly to partner governments using their own allocation, procurement and accounting systems. General Budget Support (in contrast to Sector Budget Support) is not earmarked to a particular sector or set of activities within the government budget. The foreign exchange in GBS is usually accompanied by other inputs – a process of dialogue and conditions attached to the transfer, technical assistance (TA) and capacity building, and efforts at harmonisation and alignment by the GBS IPs. (IDD 2005)

In recent years, there has been a significant shift by bilateral donors towards GBS, by the World Bank through Poverty Reduction Support Credits (PRSCs) and by the IMF through Poverty Reduction Growth Facilities (PRGFs). The objectives for providing PGBS (and the range of anticipated effects from PGBS) are very wide and are expected to encompass the following main elements (see EC 2004; Lawson, Gerster & Hoole 2005):

- *to provide predictable increases in budget funding to partner governments*;
- *to promote ownership by partner governments* over their development policies and processes, by making available untied resource transfers to the national budget;
- *to accelerate national development and reform processes in partner governments*, which might facilitate progress towards the overarching goal of poverty reduction;
- *to improve the effectiveness of partner governments in achieving positive service delivery outcomes* by focusing attention on the results of policy and spending actions and increasing the level of scrutiny of results within governments, parliaments and wider civil society;
- *to strengthen national systems of planning, budgeting, control and oversight* by increasing reliance on national systems and by focusing dialogue, and

potentially technical assistance, on their continuous improvement; and

- *to reduce transaction costs associated with external finance*, both by aligning aid delivery systems to national policies and processes and by promoting harmonisation of procedures with donors.

In order to guide the provision of GBS and to try and ensure that these objectives are achieved, the OECD-DAC (2005) has produced guidelines on the provision of budgetary support, which identify four principles that are similar to those noted above:

- budget support should encourage partner countries' ownership;
- budget support should help to maintain the performance and accountability of partner countries' public financial management (PFM) systems;
- the transaction costs incurred by recipients of budget support should be minimised; and
- budget support should be delivered in a way that advances the predictability of resources and reduces their volatility.

These guidelines also emphasise the importance of sound fiscal strategies, which are critical to the effectiveness of GBS, as are poverty reduction strategies and government-owned policies and alignment with a comprehensive country-led expenditure programme.

Overall, it would seem that GBS has the potential to make aid co-ordination easier for recipient governments, and it should strengthen the position of ministries of finance, as funds flow through the national budget rather then being managed by sector ministries. GBS should also give governments more leverage over donors in terms of gaining greater access to information on donor activities and aid transfers, as ODA is flowing through the budget. This should overcome the problems experienced when projects predominated and most aid funds were off-budget.

Sector and targeted budget support

SBS is a financial transfer to the national budget of a partner government provided in support of a defined sector programme (EC 2004). This means that dialogue is focused on that particular sector, and a specific programme of reform and development is agreed upon between donors and the government with specified results. The objectives underpinning SBS are to widen government ownership over sector policy and resource allocation decisions within the sector, to increase overall coherence between policy, spending and results, and to reduce transaction costs. This process may be further formalised through a sector programme entailing a sectoral policy

document and overall strategic framework, MTEF and annual budget for the sector and a co-ordination process among donors led by the government.

There is normally an additionality[2] requirement in sector funding, and this is important in that the type of earmarking and reporting that is required has implications for how aid flows directed at sector budgets are managed. This has consequences for the funding choices that governments make and for the way negotiation and monitoring is undertaken.

Targeted and non-targeted budget support is often used where there is ineffective budget prioritisation due to spending constraints or an arrears or debt problem, which undermines budget programming and management, or to assist in strengthening PFM skills and systems in specific government institutions. Again, there are implications for partner governments, as the process requires identification of the budget lines to be targeted, verification of spending against these agreed lines through examination or audit, and procedures for disbursement of budget support.

Sector-wide approaches (SWAps)

SWAps emerged as a reaction to the observed weaknesses in project approaches and were designed to enhance synergies and cohesion between projects within the sector, as well as to strengthen dialogue and donor co-ordination and, as a result, to lower transaction costs for the government. They are not an aid modality in themselves, but rather a way of organising project approaches to increase donor alignment, and to work within a sector policy and government expenditure frameworks. This means that they can include a wide range of instruments, from a set of co-ordinated projects to the provision of SBS and sector pooling fund arrangements.

SWAps usually include three components (GRIPS 2004):

- an approved sectoral policy document and overall strategic framework, which define government priorities;
- an MTEF for the sector; and
- a co-ordinated process amongst donors, led by the government.

More recently, some donors have begun to move from SWAps to GBS. GBS is perceived to have the advantage of greater effectiveness and flexibility, as funds are channelled through government systems rather than through pooled or trust funds (Lawson et al. 2005). This means that SWAps are increasingly perceived as a way to move from projects to GBS through a process of gradual integration of all funding through the sector, bringing funds on-budget and developing a sector policy, common procedures and expenditure frameworks.

4.2.4 Current debates in aid management

Although recent innovations in aid management respond to the lessons learned from previous aid initiatives and to the wider debate on aid effectiveness, there is still disagreement on many issues that relate to these new aid management practices. More specifically, there are three main areas that are the focus of current debates on aid management:

- *Instruments*: the costs and benefits of moving away from projects to providing assistance through PBAs such as GBS and SWAps. This is related to the fact that many of these approaches are still relatively new and their benefits have not yet been proven in practice, although in theory they have the potential to be an improvement on previous aid modalities.
- *Ownership and accountability*: ownership and commitment of recipient governments and the relationship between these governments and their citizens. PRSPs have been one of the main mechanisms for focusing on these issues to try and ensure greater recipient government ownership. The use of conditionality is a related area where there is still disagreement on the nature and extent of conditions that should be used.
- *Donor practices*: this is the extent to which donor practices undermine the effectiveness of aid, and relates to the harmonisation and alignment agenda.

Part of the reason why discussion continues regarding these issues is that these aid modalities are relatively new and project approaches still predominate in many countries. This means that there is not yet a substantial body of evidence that can give a definitive judgement on the effectiveness of the new modalities and on whether they meet the expected objectives, which are a stronger influence on the policy environment, enhancement of recipient government ownership and better coherence of aid.

Similarly, despite there being a consensus on the problems associated with conditions relating to programme aid in the 1980s and 1990s, there is considerably less agreement on how explicit conditions should be and what form they should take. The same is true for the harmonisation and alignment agenda, in that although it is generally agreed to be a positive initiative, there is less agreement as to how to take it forward in practical terms, particularly in the light of bureaucratic constraints imposed by country headquarters and the need to be accountable to domestic constituencies. These issues are discussed in more detail below.

Harmonisation and alignment

Harmonisation relates to the process of unifying donor procedures and practices in

order to ensure a common approach. Alignment refers to the fit of donor policies, procedures and practices with national strategies, institutions and processes. The concern for greater harmonisation stems from the realisation that multiple donor requirements place a heavy burden on governments that often have limited capacity; as a result, the project approach imposes high transactions costs. In contrast, as GBS uses government systems, transaction costs should be lower as there is no need to develop parallel systems, which should free up time and resources.

Alignment can be undertaken in two ways – with government policies and with government systems. The PRSP approach has been fundamental in providing a policy framework for donors to align with, and it allows donors to align their individual programmes with the priorities established in the PRSP. This should then lead to donors co-ordinating their programmes and, through this process, harmonising procedures and documentation requirements. In principle, GBS should strengthen alignment because it automatically aligns donors with government systems, and alignment with government policies will occur if the performance assessment framework is based on policies that are owned by the government.

This point is emphasised by the OECD-DAC (2003) good practice guidelines on harmonisation, which focus on the need to ensure that aid management and co-ordination arrangements are tailored to a particular country's needs and circumstances. These principles were also outlined in the Rome Declaration on Harmonisation (High Level Forum 2003) and strengthened in the Paris Declaration on Aid Effectiveness (High Level Forum 2005). The Paris Declaration included commitments by donors to strengthen ownership, harmonisation and alignment with an agreement by donors to measure their success at making aid more effective by using a set of indicators and targets.

These concerns relating to the behaviour and practices of donors are important as they cut across the debate on aid modalities and have the potential to undermine any form of aid modality used. They can also weaken recipient government accountability, policy-making and effective implementation of plans. However, moves toward greater harmonisation and alignment have the potential to greatly reduce the costs of budget implementation for recipient governments by, for example, aligning commitment and disbursement with government planning and budget cycles and relying on government systems for cash management, procurement, monitoring, auditing and reporting.

Conditionality

As noted above, the shift with regard to conditionality was a reaction to the difficulties experienced in using traditional forms of conditionality, which were normally

defined by donors. There was a realisation that they had been less effective than had been expected and that domestic political factors are key in the economic and political reform process. As a result, there has been a move away from buying reform to agreement between recipient governments and donors on sets of milestones.

Embodied in this is the idea of 'partnership', which implies that common approaches should be agreed on by donors and governments. The concept is outlined by the Department for International Development (DFID) as follows:

> Within a framework of partnership, both donors and country governments need to agree on the purpose for which aid is given. This ensures that both parties have a shared understanding of how aid will contribute to poverty reduction, and can be held publicly accountable for delivering on their commitments. (DFID 2005)

In terms of conditionality, the DFID is a good example of this new approach; it is committed to promoting 'a more equal approach in which donors do not impose conditions but agree on benchmarks with partners' (DFID 2005).

Again, PRSPs have been an important part of this process by providing the basis for what should be a partner government-owned strategy. New style conditionality then focuses on institution building, strengthening democratic accountability and transparency and encouraging sound macroeconomic and public financial management. In practice, this means that policy-based lending has moved from short-term economic management to more sophisticated medium-term reforms with an agreed set of conditions supporting them.

This new approach to conditionality has led to GBS being designed with differing Performance Assessment Frameworks (PAFs) that are based on a mixture of the approaches taken by the EC, the IMF, the World Bank and bilateral development agencies when disbursing budget support and applying conditionality. There are three main types of PAF that are being used for GBS (Lawson, Gerster & Hoole 2005):

- A common performance assessment framework, which provides joint monitoring by all GBS donors and is used for management according to commonly defined principles. Disbursement is typically according to individual donor decision.
- The World Bank PRSC is used as the common assessment framework, which is often supported by a memorandum of understanding outlining common principles and the consultation process.

- The IMF PRGF is the basis for monitoring progress and disbursement decisions. This method is often supplemented by specific conditions for different donors.

This indicates that there are still differing approaches to conditionality and that there is not yet any agreement on a common or most effective framework, probably due to the fact that the implementation of these approaches is very recent and there has been no comprehensive assessment of them.[3] However, the way in which PAFs are designed and implemented can have important implications for recipient governments in terms of predictability of disbursements and level of transaction costs. For instance, if there is one set of conditions that all donors use for monitoring, then this may represent less of a burden on governments than if different donors specify different conditions. This then has transaction cost implications, and the number of conditions in the PAF is related to this. The predictability of disbursement is another issue, as failure to meet conditions can lead to delays in disbursements, which can have major impacts on the national budget.

4.2.5 Assessment of experiences with new aid modalities

In theory, the move towards programme aid and, in particular, the use of GBS should prove to have superior benefits for recipient governments and improve the management of budget processes in contrast to other forms of aid. However, very few evaluations have been undertaken of these new aid modalities, which means that it has not been possible to make a definitive judgement on their effectiveness. This section, therefore, surveys the evidence from studies undertaken thus far and assesses the preliminary evidence on the effectiveness of GBS from the Joint Evaluation of General Budget Support. This study is evaluating GBS in seven countries in Africa, Asia and Central America and is the largest evaluation that has been undertaken of GBS; consequently, it is expected to yield some useful contributions to the overall debate.

Early experiences of SWAps and GBS

A study of GBS in Tanzania was undertaken by the Overseas Development Institute (ODI) prior to the multi-country study. It found that the immediate effects from GBS were very positive and that its main role had been to facilitate a nationally driven reform programme. GBS could be linked to a large growth in discretionary spending and a major expansion of health and education services, but there were no signs yet of improved efficiency in public spending or long-term constraints to the quality of service being addressed (Lawson et al. 2005). Overall, the study concluded that

although not all of the expected gains had been made, those that had emerged as a result of GBS would not have been facilitated as effectively by other aid modalities.

United States Agency for International Development (USAID) undertook a study of five countries in 2003/2004 to evaluate programme assistance with a focus on GBS. It examined the perceived benefits of GBS and whether or not they had been achieved. The five countries were Mozambique, Malawi, Nicaragua, Tanzania and Timor-Leste. The study concluded that the host-country ownership of development programmes had been strengthened through policy dialogue and improved accountability. Donor co-ordination and harmonisation had improved in most cases, but not all. They also found that using performance targets rather than *ex ante* conditionality increases predictability of funding, as assessments impact on future rather than current disbursements. Transaction costs had not fallen but, in fact, had increased due to the time dedicated to designing, managing and evaluating activities (USAID 2005). However, the study did not examine the transaction costs related to the budget process and utilisation of aid, which would have been expected to fall, so it is not clear whether transaction costs as a whole have increased or decreased.

Similarly, other studies of GBS and SWAps have found that there is little evidence to suggest that GBS results in a lowering of transactions costs (Frantz 2004). This is due to the initial time spent establishing processes and mechanisms, which is confirmed by the World Bank and IMF (2004) who note that the process of establishing joint monitoring frameworks is very time consuming. A joint donor evaluation of programme aid in basic education found that for both SWAps and programme aid there was a large increase in administrative work for the Ministry of Education and Sports in Uganda, which resulted from a transfer of this work from donors to the government (Netherlands MOFA 2003). However, again transaction costs related to the budget process and utilising aid were not considered. On a different theme, Frantz (2004) and Foster (2000) found that aid had become less predictable under SWAps and GBS.

Joint Evaluation of General Budget Support

The Joint Evaluation of General Budget Support that is currently being undertaken is designed to answer similar questions to the studies discussed above and to assess the extent to which GBS meets its objectives (see section 4.2.3 of this paper). There is considerable interest in the outcomes of the study, particularly in the context of the ongoing debates regarding the effectiveness and mix of different aid modalities. The evaluation assessed the experience of budget support in seven countries during the period 1994–2004. These were Rwanda, Mozambique, Vietnam, Burkina Faso, Nicaragua, Malawi and Uganda. The purpose of the study was ‘to evaluate to what

extent, and under what circumstances (in what country contexts), GBS is relevant, efficient and effective for achieving sustainable impacts on poverty reduction and growth'.[4]

Although the time period spanned 1994–2004, the focus was on GBS since the end of the 1990s, which represented the beginning of partnership GBS. The starting point for the evaluation was to examine the inputs into the GBS process – finance, dialogue, conditions, TA and capacity building, and harmonisation and alignment initiatives. The evaluation then attempted to trace, through the flow-of-fund effects from GBS funding, institutional effects and policy effects, in order to identify intermediate impacts, outputs, outcomes and, finally, effects on poverty reduction. The main areas that the evaluation focused on were:

- the relevance of PGBS;
- the effects of PGBS on
  - harmonisation and alignment,
  - public expenditures,
  - planning and budgeting systems,
  - policies and policy processes,
  - macroeconomic performance,
  - delivery of public services, and
  - poverty reduction;
- the sustainability of PGBS; and
- the extent to which cross-cutting issues have been addressed through PGBS.

The study also examined the impacts of PGBS on transaction costs, predictability of funding, domestic accountability, allocative efficiency of public expenditures and effectiveness of state and public administration.

Preliminary cross-country findings[5]

The length of experience of PGBS differs considerably amongst the countries included in the study. Malawi and Nicaragua have limited experience, as PGBS in these two countries only began in 2004, whereas in the others the process has been longer established making it easier to draw more substantive conclusions. There are also wide variations in the design of PGBS. For instance, in Vietnam and Uganda, the process is led by multilaterals, whereas in other countries it is led by bilaterals. There is also a contrast in the complexity of PGBS between countries such as Uganda, where there are numerous parallel aid instruments, and Vietnam, where there is one instrument

(a World Bank-led PRSC). What is clear is that in all countries PGBS has evolved over time and is specific to the particular country context.

There are also noticeable differences in partner government attitudes to PGBS, with some countries (e.g. Uganda and Rwanda) encouraging donors to shift towards PGBS modalities and others expressing a preference for PGBS but being careful not to discourage other forms of aid. For Vietnam and Nicaragua, PGBS is too recent for the governments to have formed a specific preference.

The other preliminary findings relate to the expected benefits that it was assumed would emerge from a PGBS approach. These are as follows:

- *A new 'partnership' paradigm*. It is useful to consider whether there is evidence that PGBS does represent a shift to a new relationship based on partnership and country ownership. The study found that in Uganda, Mozambique, Burkina Faso and Vietnam there is evidence of a different relationship than under structural adjustment. Indeed, in the first three countries there have been pivotal changes in aid management relationships that have affected non-PGBS relationships. However, the use of political conditionality in some countries (Uganda and Rwanda) has caused delays in disbursement or suspension of funds, which have been a source of tension between donors and partner governments.

- *Predictability of funds*. Evidence on the predictability of donor funding is mixed, with predictability being a problem in some countries but less so in others. Often non-fulfilment of conditionality delays tranches, or donor disbursements are delayed for bureaucratic reasons. There is clearly more that donors could do to ensure greater predictability of funding, although compared to projects, the disbursement record of PGBS has been favourable.

- *Transaction costs*. There is ambiguous evidence on transaction costs. Clearly, by its nature, PGBS should lead to a reduction in the transaction costs of the budget process and utilising aid, as funds are channelled through the national budget. The start-up costs of establishing and engaging in dialogue can be quite high for both governments and donors, although it is assumed that these may well fall as the process becomes more established. Also, in some countries the proliferation of PGBS instruments constrains the extent to which transaction costs can be lowered.

- *Harmonisation and alignment*. PGBS is resulting in alignment with government systems and often has had indirect effects on other aid modalities. Policy alignment was only possible when there were credible national and sectoral strategies. In many cases, PGBS and associated dialogue and review systems complemented and enhanced existing sector mechanisms, providing forums for addressing cross-sector issues.

- *Public expenditures*. In most of the study countries there are significant flow-of-fund effects from PGBS, which have led to either increased public expenditure or reductions in the budget deficit. These were found in all countries apart from Malawi and Nicaragua, where the process was too recent to discern an impact.

- *Strengthening of policy and processes*. There is evidence of PGBS policy dialogue influencing policies and processes, particularly in Uganda and Mozambique, whereas in Vietnam the impact is less on processes and more on policy. This may well be because all three of these countries have strong government ownership of the reform process.

- *Macroeconomic performance*. There is little evidence of PGBS contributing to macroeconomic performance, apart from in Uganda and to a certain extent Mozambique. This is unsurprising given that satisfactory macroeconomic performance is often a prerequisite for PGBS. In some countries, PGBS itself had a negative effect on fiscal discipline as a result of the suspension of PGBS funds.

- *Service delivery*. All countries found some impact of PGBS on service delivery, although the strength of this effect varied. Only in Malawi and Nicaragua was no effect found.

- *Poverty impacts*. The study had difficulty in tracking distinct and separately identifiable effects on poverty.

Overall, the study has found that, except for Malawi and Nicaragua where the PGBS effects are too recent to evaluate, there are positive assessments of PGBS impacts, suggesting that PGBS is an efficient and effective form of aid delivery. This is significant as it indicates that some of the expected benefits of GBS are likely to be achieved, which should bring corresponding benefits for recipient governments. On the other

hand, there are some aspects of concern, such as evidence that GBS conditionality can result in unpredictability of budget funding, which, in turn, affects fiscal discipline. However, it should be noted that this is not necessarily a problem of the PGBS instrument itself but could be one of donor behaviour that cuts across other aid modalities as well.

Poverty impacts could not be identified, mainly due to the inability to distinguish PGBS effects from impacts of other variables at this level or the fact that PGBS was too recent to have had an influence. However, it should be noted that PGBS as an instrument is unique in terms of the fact that it directly supports national PRSs.

4.2.6 Conclusion

In theory, managing aid flows for recipient governments should have become easier since the introduction of GBS and SBS. As aid flows move on-budget, and donor activities are aligned with government policies, this should improve the proportion of external funds subject to the national budget and the government's ability to match public expenditures to national development priorities. Transaction costs of aid management should be reduced and predictability of funding improved.

In practice, the case has not been definitively proven, because GBS is a relatively new aid modality. What does emerge is that the evidence from the Joint Evaluation of General Budget Support points to the efficiency and effectiveness of GBS as an aid modality. However, it is unlikely to be effective in all cases, due to the need for partner government commitment, credible policies that are owned and sufficient capacity to implement policy and deliver services. There are also other issues that need to be considered, such as the degree of fiduciary risk involved and the possibilities for increased corruption, as well as the limits of PBAs due to capacity constraints and problems with absorption of aid if there is a scaling up of ODA flows through this mechanism.

Overall, it should be noted that budget support approaches are a relatively new innovation, and currently represent a mutual learning experience for both donors and recipient governments. In order for the potential benefits to be reaped, it is likely that there will need to be further adaptation and change in donor and partner government practices to ensure that key objectives are met.

Endnotes

1 Ann Bartholomew was team leader for the Vietnam country case study for the 2005/06 cross-country general budget support study and participated in the drafting of the synthesis report. She is a principal consultant of Mokoro Limited.

2 Additionality means that SBS should generate additional funding in the sector, and is a response to the fungibility problem. The objective is to ensure that SBS does not replace partner government resources that would have been allocated to the sector.

3 A recent assessment of PAFs in GBS was undertaken by Lawson et al. (2005).

4 The study was commissioned by a steering group of donors, which includes Australia, Belgium, Canada (CIDA), Denmark, the European Commission, France, Germany (BMZ), Inter-American Development Bank (IADB), the IMF, Ireland, Japan (JBIC, MoFA), the Netherlands, New Zealand, Norway, OECD-DAC, Spain, Sweden (Sida), Switzerland (SECO), United Kingdom (DFID), USA (USAID) and the World Bank. The study was carried out by University of Birmingham, International Development Department, with partners (Mokoro, Ecorys, DRN, NCG and local consultants).

5 The findings are preliminary at this stage as the evaluation findings have not yet been formalised, nor has the final synthesis report been submitted.

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4.3 Ethiopia: a case study

Fanos Habtewold & Worku Ayele

4.3.1 Introduction

Ethiopia is a federal state with a population, in 2004, of 73 million people. In 1992/1993, the government initiated market-based structural reforms, signalled by an ambitious adjustment and reform programme focused on achieving the sustainable economic growth and medium-term financial viability that are perceived to be essential for poverty reduction. In its development agenda, which concentrates on the improvement of social welfare, the government recognises that poverty reduction is not possible without sustained economic growth.

Against this background, multilateral and bilateral agencies have continued to support Ethiopia's development through Official Development Assistance (ODA). International financial institutions have been responsible for the largest share of aid to the country, followed by bilateral donors, the European Union and the United Nations agencies. Ethiopia receives much less aid per capita (US$13) than other developing countries.

The government maintains that the development of a well-conceived institutional framework within which ODA is received and administered would significantly

improve the impact of external assistance. The adverse effects of the proliferation of donor projects have often resulted in overwhelming functional stress on the government bureaucracy. It is maintained that the uncoordinated and un-harmonised donor-by-donor and project-by-project approach that for a long time has characterised the mode of external assistance in the country has created a burden on the government's capacity to meaningfully receive and manage aid. At the same time, the government has recognised the need for capacity strengthening in a number of areas to ensure that external assistance is better solicited, accommodated, managed, reported and monitored, and that its effect/impact is maximised in the interest of poverty reduction and without incurring undue transaction costs. Donor harmonisation, therefore, serves as a guide for the acquisition and utilisation of external funds.

4.3.2 Developing an explicit aid policy

The fundamentals of aid management in Ethiopia include:

- country ownership;
- the enhancement of partnership through dialogue, co-ordination, harmonisation, alignment and information sharing;
- the focus of external assistance on poverty reduction;
- capacity building as an integral part of external assistance;
- direct budget support (DBS) as the preferred mode of external assistance;
- partnership with non-state actors; and
- predictability of donor flows and multi-year financial commitments.

Guided by these principles, Ethiopia has formulated a set of aid policies to guide the country's relations with donor countries and multilateral agencies. The policies are centred on key issues in donor management – aid acquisition, planning, budgeting and financial management, reporting and monitoring, financial oversight and accountability, technical assistance and dialogue and co-ordination. Each is discussed briefly below.

Aid acquisition

The fight against poverty will be at the centre of development co-operation in Ethiopia. All intervention in this area will be guided by a comprehensive framework for pro-poor growth and poverty reduction. Ethiopia has committed itself to putting in place structures and systems that will prepare the ground for the enhancement of external resource inflows by raising, in the medium term, the country's per capita ODA level to the sub-Saharan Africa average. A shift in the profile of external assistance towards

greater grant support is targeted. For the remainder of the portfolio, the country will seek to minimise costs by strengthening and maintaining a coherent, prudent and sustainable borrowing policy to ensure a favourable country rating. It is the government's position that, for the sake of efficiency, reduction in implementation transaction costs and the enhancement of local ownership of development programmes, donors ought to move towards DBS. However, in the interaction with its co-operating partners, the government will remain open to different modes of assistance, including projects, programmes and budget support.

Planning, budgeting and financial management

All external sources will be integrated into the government budget and, in this respect, the government will strive to align the timing of donor pledges to the budget and planning cycles and ensure that all aid that is negotiated is included in the country's financing framework. Donors are expected to provide relevant and timely information on commitments and disbursements in order to ensure the predictability of aid flows. Aid management should happen within the context of fiscal decentralisation, which devolves financial autonomy from the federal to the lower levels of government, a policy to which the government is committed.

Reporting and monitoring

The process of reporting and monitoring aid will be owned and led by the government of Ethiopia. This implies that donors will assume less leadership responsibility regarding the procedures, processes, timing and content of what is reported and monitored. The Sustainable Development and Poverty Reduction Strategy Paper (SDPRSP) will remain the primary reference point for guiding the reporting and monitoring process in the country. All state-funded agencies and donors will capture all forms and sources of funding and provide sufficiently disaggregated data.

Financial oversight and accountability

The government will support an effective auditing function to ensure that public resources, including those originating from donors, are accounted for in a sound and transparent manner. As far as possible, donors' procurement procedures for their supported projects and programmes in Ethiopia will be aligned to the principles and procedures outlined in the Government Procurement Directive

Technical assistance

Ethiopia will continue to use technical assistants, who will work with national counterparts to allow for easier transfer of knowledge and skills. Technical assistance will

be integrated into the national framework of management, and the experts will be accountable to local institutions and will fall under the country's planning, budgeting and human resource development systems.

Dialogue and co-ordination

The government of Ethiopia has committed itself to facilitating an effective multi-level dialogue architecture in which it takes the leadership role.

4.3.3 Donor harmonisation

Donor harmonisation, the streamlining of engagement with donors, is an important objective of Ethiopia's aid management policies. The overarching objectives of aid harmonisation are to reduce transaction costs and make disbursement of external assistance more flexible and smooth, towards enhanced efficiency and effectiveness. This means that harmonisation is not an end in itself. The following priority areas for harmonisation have been identified:

- procurement;
- monitoring and evaluation; and
- financial reporting and disbursement.

Among the countries that have endeavoured to undertake harmonisation initiatives, Ethiopia has been leading in many ways. It is a pilot country of the Strategic Partnership for Africa. Also, it is a pilot for IMF donor budget support, with the poverty reduction strategy paper process and a country environmental analysis. In addition, the World Bank, African Development Bank, European Union, Sweden and Canada have expressed their willingness to provide DBS. Norway, Ireland and the Netherlands are considering offering budget support. Many bilateral donors will use the IMF's Poverty Reduction Support Credit (PRSC) process to harmonise their assistance.

The agenda for harmonisation has been supported by progress on a number of prerequisite institutional factors for donors to align their support with government plans and programmes of development. These include the SDPRSP, which is analytically sound, strategically prepared, result-oriented and operationally focused. It has won donor community credibility and acceptance of the need to enhance the volume of per-capita aid. The harmonisation programme has covered crucial areas in the SDPRSP. A policy matrix now strengthens the SDPRSP, and efforts are harmonised towards increasing DBS and sector-wide approaches. However, the harmonisation agenda also covers project-level operations and all modes of assistance, including capacity building, analytical work and training.

Harmonisation is fully anchored within the new development architecture, including a high-level government-donor forum and in an aid development process prepared by the joint Government-DAC Task Force on Harmonisation.

The government has also undertaken an upgrade its procedures, practices and systems to world standards to ensure that donor funds are safe and spent on purposes for which they are given. The financial calendar is comprehensive, so that donors can extend their support with a high degree of predictability and consistency. The calendar for budget support is now aligned with the national budget year and the annual review process for the SDPRSP. DBS partners would be expected to provide the government with early, specific and firm commitments of DBS to enable it to plan its budgetary obligations on the basis of more predictable resource flows.

The monitoring and evaluation systems for the SDPRSP, including indicators, have been initiated after thorough discussion with the donor community and other stakeholders. An overarching joint conditionality and monitoring framework has been established, with agreed conditions and indicators, and this has facilitated harmonised DBS.

Finally, the political commitment for harmonisation has been sustained, allowing for full realisation of the potential benefits of harmonisation and the establishment of government leadership and ownership. However, donor commitment and support for capacity building is vitally important for the smooth transition from donor-driven practices, procedures and policies to country-driven policies and practices.

Some of the recent milestones in the harmonisation agenda are considered in more detail below.

The Procurement Assessment Report (March 2003)

This report provides strong support for the government's harmonisation agenda. It analyses the country's public sector procurement institutions, including the legislative framework and organisational practices, and indicates areas where improvement is required to comply with world standards. Historically, substantial delays have occurred in procurement due to cumbersome procedures and practices of the donor community. The recommendations of the report were co-ordinated with donors such as the EU, UK and Sweden, who are also engaged in procurement reform initiatives with the government.

The Financial Accountability Assessment Report (June 2003)

Fiduciary responsibility is a central concern of donors in disbursing development aid. Therefore, the discussion and completion of the financial accountability assessment, which is primarily concerned with fiduciary matters, will facilitate progress

in harmonisation efforts. The basic objective of this assessment was to highlight the capability of the country's financial management structures in both the public and private sectors. The report defines the strengths and weaknesses of accountability arrangements in the use of government and donor funds.

Intergovernmental Governance Review and Fiduciary Assessment

Critical to the provision of harmonised budget support on an annual basis is the ability of DBS partners to verify systematic improvement in the general government (i.e. including sub-national governments) fiduciary framework. Several diagnostic tools, for example the Country Financial Accountability Assessment and the Public Expenditure Review (PER), have been prepared. However, the government and donors have emphasised the need to find some mechanism under the Intergovernmental Governance Review and Integrated Fiduciary Assessment for a regular 'light review' or 'stocktaking' of the quality of the public sector fiduciary framework.

The Joint Budget and Aid Review

The Joint Budget and Aid Review (JBAR) is a key element linking the government's own fiscal processes to dialogue with partners providing DBS. This instrument replaces the PER. Given the JBAR and the establishment of a medium-term fiscal framework, the government has exchanged ideas about the transition from project/programme support to DBS with donors who are either providing or intending to provide DBS. Since the government's vision for DBS has been shared by the donor community, it has encouraged those who cannot provide significant DBS to support sectors via sector programmatic support, or earmarked budget support instruments, in preference to providing project aid.

National Capacity Building Programme

In order to absorb increasing amounts of foreign assistance and transition processes – and to steer the development process – a strong country capacity for planning, management, monitoring and evaluation is required. This topic has been the subject of lengthy discussions among donors and between donors and the government of Ethiopia. If donors are to use the government's systems, procedures and practices, the country's capacity for absorption has to be developed and upgraded first. Ethiopia's Civil Service Reform Programme has been launched for this purpose. Donors, including the Canadian International Development Agency, the United Kingdom Department for International Development, the European Commission, France, Germany (GTZ), Ireland, Italy, Netherlands, Sweden and the United Nations

Development Programme, have committed themselves to finding a single-design solution that reinforces the Ethiopian National Capacity Building Programme as integral to harmonisation. Capacity development in public procurement, financial management and in the health and education sectors will be supported by collaborative efforts of donors.

Poverty Reduction Support Credit

Increasingly, donors have signalled willingness to harmonise their policies and practices around the IMF's PRSC-II. It has been agreed that the government's SDPRSP policy matrix is the framework for PRSC assistance. However, given the size of this matrix, it has been generally agreed that donors could identify specific actions and indicators of particular interest to their respective agencies, and, on this basis, a smaller matrix could be created for DBS dialogue.

The Annual Progress Report of the SDPRSP

The Annual Progress Report (APR) has been an important milestone on the road to harmonisation and DBS. The objective of the APR is to provide domestic and international stakeholders with a summary report on implementation of the SDPRSP, including key results and challenges. The release of budget support is contingent on this annual report, and it has become a key element in the revised fiscal calendar.

Instruments for donor harmonisation, given fiscal decentralisation

Ethiopia is deeply committed to fiscal decentralisation and has created instruments that allow for effective aid disbursement, given the intergovernmental set-up. While foreign assistance and loans are negotiated by the federal government – the Ministry of Finance and Economic Development (MoFED) is responsible for negotiations, signing of agreements and debt repayments – in its intergovernmental system, block grants, which include internal revenue and foreign assistance and loans, are allocated to autonomous regional states. Regional states, in turn, allocate block grants to local governments. Regional states are obliged to submit reports on the use of funds to the central government. An offset system is applied for additional donor funds to regional states; however, for specific-purpose grants by donors to regional states, the offset system is not applicable.

The four disbursement channels that donors can use to channel funds are:

- Channel 1 – government formula-based budget disbursement including own revenue, grants and loans. Management is the responsibility of each level of government, executed through MoFED, Bureaux of Finance and

Economic Development (BoFED) and Woredas (districts).

- Channel 1.5 – hybrid channel used for the Food Security Programme. It bypasses BoFED to support programmes at lower levels.
- Channel 2 – funding direct to sector public bodies to use and account for donor funds.
- Channel 3 – donors finance projects directly (sometimes, but not necessarily, recorded in the government's development budget).

Sector-wide approaches (SWAps)

Within this popular modality of aid delivery, health, education and transport partners have been discussing arrangements such as pooling resources for technical assistance in the health sector and comprehensive harmonisation in the transport sector, where significant progress has already been made. Belgium, Ireland, Sweden, the United Kingdom and the Netherlands have decided to harmonise support of the teacher development component of the education programme with the pooling of funds relying on Ethiopian government laws, regulations and procedures.

It will be some time before evidence of the impact of harmonisation and alignment on the national economy can be measured conclusively. If effective, all other things being equal, harmonisation should have a positive impact on economic growth, employment, inflation, income distribution and the level of national savings. Through the harmonised and aligned policy framework, total available resources (including foreign assistance as a supplement to domestic resources) will be spent on the key national priorities of sustained economic growth, productive employment, agriculture-led industrialisation and food security, access to basic social services, good governance and a strong democratic system, gender equality and HIV/AIDS. Indicators in each of these areas can also be used to analyse and assess the impact of harmonisation and alignment.

4.3.4 Lessons learnt

Four areas, each vitally important to initiating, planning and implementing donor harmonisation and development, can be singled out for the lessons they provide.

Political will and commitment

The political will and commitment of the government is the backbone of the harmonisation exercise. Harmonisation and alignment experience recognises that planning and implementation at the country level is difficult and, therefore, requires high-level attention and support. In the process of harmonisation and alignment, partnership

and co-operation regarding aid relationships have changed substantially from a donor-dominated environment of policy and operation to a government-dominated environment. The necessity of building strong political support with proper vision is a primary lesson of the Ethiopian experience.

Institution building

Harmonisation needs to be set up with the right institutions for constructive dialogue, comprehensive planning and a robust implementation strategy. Aid will only be converted into growth and poverty reduction when countries have a home-grown framework for pro-poor growth. This should be supported by adequate local institutions of planning, implementation, oversight and evaluation. When this home-grown framework is absent, neither offering nor withholding aid will be effective in supporting a country on a development path.

However, development partners are part and parcel of the harmonisation and alignment exercise. Institution building needs to occur at the right time, with the right purpose and in partnership with donors. The Ethiopian experience points towards the establishment of a strong institutional architecture for harmonisation (e.g. a high-level government-donor forum) as a necessary step towards aid effectiveness. Such a forum would need to be set up in a manner that fosters closer dialogue, trust, transparency, honesty, foresight, flexibility, patience, mutual respect and understanding. If strategic thinking around the objectives and goals of development – around an instrument such as the SDPRSP – is backed by such a forum, the fostered consensus becomes a springboard for equitable development and the focus for donor support.

Wider participation and consultation

Two types of participation are important. Firstly, wider participation and consultation are imperative for successful planning and implementation in an exercise like harmonisation and alignment. The Ethiopian government has used all opportunities that were available to gain experience and to convey its case to the donor community and the rest of the world. The government has participated in all national and international forums to widen its understanding and vision of harmonisation. Secondly, it has also given unpredicted priority to obtaining inputs from within Ethiopia. This has been done through a wider participatory approach, including consultation with civil society and the private sector.

Data management

It is not realistic to embark upon a harmonisation and alignment exercise without the

support and backing of a well-managed data and information system. More than 40 bilateral and multilateral donors are supporting in excess of 600 projects throughout the country. While the government wanted to mobilise external resources, it faced problems with respect to gathering, storing, processing, collating, analysing and disseminating reliable information on the use of such resources, due to the absence of a well-organised database and data-management system, where the support of different donors and the status of donor-funded projects could be captured. This information is essential for policy-making, planning and programme development.

4.3.5 Conclusion

Since mid-2002, the Ethiopian government has invested considerable effort in creating a supportive environment for harmonisation, in order to lower the transaction costs of aid and to improve its effectiveness. Within a short period of time, the government has accumulated in-depth knowledge about the benefits of harmonisation and alignment, has learnt lessons and ways of planning for it and has prepared an agenda focusing on priority reform areas (e.g. aligning donor cycles with government budgeting, reporting and monitoring and annual reviews).

In seeking to improve the quality and flexibility of aid, several donors now deliver aid as DBS rather than project or sector investment finance. The government of Ethiopia has indicated that reliance on government systems can enhance aid effectiveness. However, older practices persist and several challenges remain, including persisting conditionality and additional requirements, externally driven assessment of aid, staff awareness and capacity constraints and declining donor assistance.

Despite the willingness of donors to move towards a fully harmonised system, a wait-and-see approach is also prevalent. So far, donors have not come up with a concrete and time-bound action plan to expand their share of the collective and co-ordinated efforts. Instead, they emphasise the need for further dialogue sessions and additional or new requirements. It is arguable that the global commitment to harmonisation and alignment does not easily translate into country-level action. To sustain the Ethiopian government's enthusiasm, constructive steps need to be taken, together with a firmly committed action plan from donors, to accelerate and scale up implementation of the donor good-practice papers that are continuously produced.

5

Decentralising public functions to public entities

5.1 Introduction

Public agencies can be an efficient route to deliver key public services. If designed well and managed under government institutional strength, they can bring about better focus, enhance accountability and engender greater transparency in the funding and delivery of discrete public services. Several reasons can drive the formation of agencies. In contrast to classical government departments, agencies can have a sharper focus on implementation within a smaller area of activity; they can specialise. Greater ease in implementing private sector models for human resources and functional management can improve effectiveness and even efficiency. It may also be necessary for certain functions, such as electoral oversight or regulatory functions, to be administered at arm's length from political control, necessitating the establishment of an agency.

However, experience has shown that agencies are also created for reasons that do not concern the effectiveness and efficiency with which they are likely to perform their functions. Agencies may be formed to access additional, earmarked revenues, albeit through fees and charges or through the creation of extra-budgetary funds. They may also be formed for the purpose of taking functions outside of the routine scrutiny that applies to ordinary government spending ministries.

Even where agencies are formed with better service delivery in mind, they often add to the complexity of managing public finances. A quite common finding is that increasing numbers of agencies mean decreasing transparency in public finances, and lack of clarity on and overlap of roles and responsibilities. Large numbers of agencies, particularly those funded outside of the central fiscus, make it more difficult to achieve the comprehensive view of government revenue and spending necessary to maintain fiscal discipline and engender contestability in the use of public resources. Even where agencies are funded fully by the fiscus, transfers are not subjected to the scrutiny applicable to ordinary ministries, and rules for using funds against budget and the rolling over of funds may not apply or be applied as stringently. Ministries of finance often find themselves providing emergency bail-out funds in the course of the spending year to poorly managed public agencies.

These problems arise especially when agencies are established within fragile legal frameworks and under conditions of institutional weakness. Assigning expenditure responsibilities to public agencies can then result in unchecked, irrelevant and inefficient expenditure; or worse, they can be instruments of political patronage and corruption. Once created, agencies are difficult to reverse.

Discussion at the seminar explored the minimum institutional arrangements in central government that are necessary to manage public agencies within the budget process. Principles of budget comprehensiveness, transparency, accountability, a strong legal framework, clear funding rules, a strong, sequenced and disciplined budget process and the building of sufficient oversight capacity in line ministries responsible for agencies came to the fore. The need for mechanisms of recourse when agencies are not performing was also raised.

This chapter comprises the two inputs from the seminar: a paper by Olaf Merk, from the Organisation for Economic Co-operation and Development (OECD) Directorate for Public Governance and Territorial Development, and a brief case study of the Kenyan experience. The Merk paper sets out a framework for understanding critical principles in the creation and management of public agencies, and highlights the pitfalls as evidenced in the OECD experience. Kubai Khasiani and Phyllis Makau from the Kenyan Ministry of Finance share the history of creating public agencies in Kenya and the problems they pose for effective public management, particularly by fragmenting public finances, undermining competition for scarce resources and complicating oversight. Both inputs emphasise the necessity for enforceable systems of regulation, control and open reporting.

5.2 The OECD experience: benefits, pitfalls and management

Olaf Merk

5.2.1 Introduction

The purpose here is to establish under what conditions the decentralisation of functions to agencies can prove to be a helpful tool. How can it work in increasing efficiency in public expenditure? In order to answer this question, three other questions need to be answered. What are we talking about? Why could it help? What are the international experiences? Thus, the following structure is adopted below: definitions and arguments in theory, evidence in practice and conditions under which it can work.

5.2.2 Definitions

At least four different terms can be distinguished: decentralisation, spatial de-concentration, functional de-concentration and market-type mechanisms.

Decentralisation is usually meant to indicate the delegation of public functions to another level of government, such as regions, provinces or municipalities. Over

recent decades, several public functions, some of them very substantial ones, such as education and health, have been delegated to decentralised levels of government.

Spatial de-concentration is the delegation of ministerial functions to the regional branches of a ministry. This has to be distinguished from *functional de-concentration*, in which public functions are delegated to other publicly controlled bodies, such as agencies.

A connected set of policy tools is summarised under the term *market-type mechanisms*. Commonly used market-type mechanisms are outsourcing, public-private partnerships and vouchers. *Outsourcing* implies delegating the responsibility for implementing a public service to a private party. *Public-private partnerships* are arrangements in which (part of) the financing, design, building, maintenance and operation of public infrastructure is done by a private party; in this way, public risks are shared with private parties. *Vouchers* provide a means of public financing that introduces competition (and thereby markets) in public services.

Although different in nature, these policy instruments have many things in common. The principal similarity is that they share a common objective, namely to improve public service provision by trying to enhance the quality or efficiency of the public services provided. The various policy instruments are also interconnected in a way. They can be introduced or can occur simultaneously. So, for example, the United Kingdom has de-concentrated public service provision, as well as a considerable proportion of outsourcing and public-private partnerships, whereas many Scandinavian countries combine de-concentration with decentralisation and outsourcing.

The focus below is on the experience of functional de-concentration and outsourcing in OECD countries, the aim being to find out under which conditions these policy tools can be implemented.

5.2.3 De-concentration

Defining de-concentration

There are several forms of de-concentrated government, in contrast to the classical, concentrated, ministerial departments. One form is that of departmental agencies, which remain quite close to the ministry, fall under the responsibility of a minister, are run by civil servants and rely on tax funding. In a more far-reaching form, de-concentration can be represented by public-law administrations, which are partially or fully legally separate from the state, have a mixture of public and private customers, have a staff that usually does not have exactly the same status as civil servants and are funded only partially by taxes, the other sources of funds being fees and

sales. The most radical form of de-concentration is represented by the so-called private-law bodies, which are legally separate entities, have mostly private customers and private-law employment relations, and are funded mainly by sales revenues (OECD 2002).

Arguments for de-concentration

Several arguments are advanced for using de-concentration as a policy instrument. The most important argument has to do with efficiency. The idea is that an agency, in contrast to a ministry, has a sharper focus on a certain domain or type of activity, so that it can specialise. It usually has a smaller span of control and is able to separate policy making, implementation and supervision. This ensures that enough time and consideration are given to implementation and supervision, in contrast to a ministry where the priority lies in policy making. De-concentration can also stimulate efficiency because it might be easier to apply private sector management models than it would be in a ministry.

Another argument for de-concentration is that some tasks need independence from politics; this is especially true in matters of supervision and possible conflict of interests. Other arguments that are used for de-concentration include the potential it offers for building up a centre of expertise, and the advantages of a distinct identity for the organisation and greater interaction with society.

The intellectual context of most of these arguments was formed by a school of thought that increasingly came to see government bureaucracy as a bad thing. New Institutional Economics' literature asserted a preference for organisations with simple and clear functions, in order to make it easier to align the incentives of officials with public purposes and to reduce the scope for opportunistic behaviour (OECD 2005).

Occurrence of de-concentration

How many agencies there are in the OECD countries is not entirely clear. There are no overall statistics on the number of agencies in OECD countries. It is evident, however, that over the years there has been a huge increase in the number of agencies. This is as true for the OECD as it is for several other regions, such as Central and Eastern Europe. The United Kingdom, for instance, has created 131 new agencies since 1988; and South Korea, 23 new agencies since 1999 (OECD 2005). As can be seen from Figure 5.2.1, the increase in number of independent regulatory agencies has been significant, especially since the beginning of the 1990s. With so many agencies in place, meaningful conclusions and lessons can be drawn from the experience.

The main motivation for the initial use of agencies was their assumed efficiency, but the evidence on this point does not seem overwhelming. Few studies have been

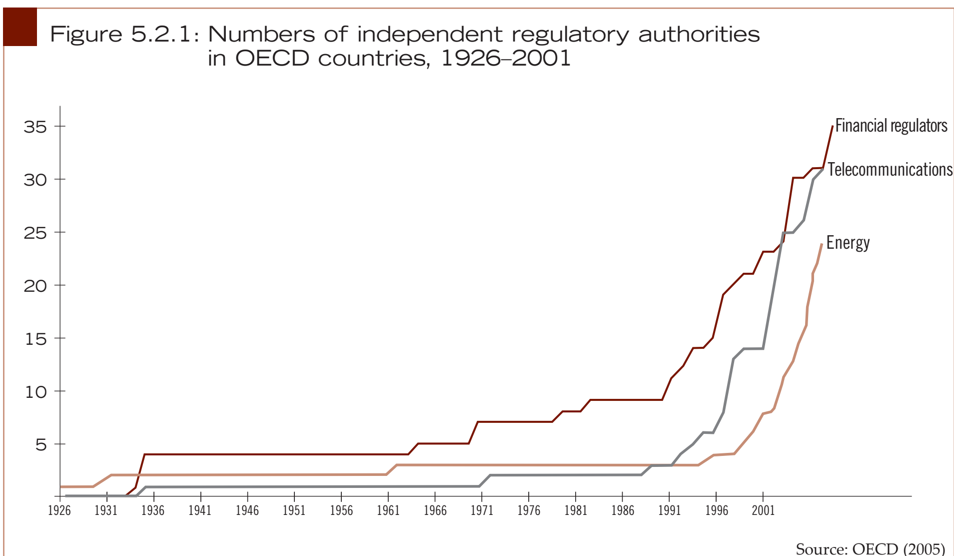
conducted and only one, from the United Kingdom (HM Treasury 2002), establishes that de-concentration encourages efficiency.

A quite common finding is that the increase of agencies has led to a decrease in transparency. There might be too many agencies around, the division of tasks between agencies, or between agencies and ministries, might be unclear and nobody really knows who is responsible for what or who is doing what, so that in the end the system gets blurred. Not surprisingly, this lack of transparency can lead to a lack of accountability. When it is not clear who is doing what, it is equally unclear who is to blame for what.

Since agencies operate at some distance from the ministries, they can less easily be corrected when they do not perform as wished for. A government or ministry does not always have the tools to ensure improvement of public service delivery in the case of non-performance. It might even be difficult for a ministry to determine whether there has been non-performance or not. Because agencies can try to control the information that a ministry receives, undiagnosed non-performance can occur. This happens when an agency does not function well enough, but the ministry is unaware of the fact, due to lack of good information. This might be a more severe problem than obvious non-performance; since the problem is not recognised, there is no chance that there will be a solution.

While it might be acceptable to set up agencies for their ability to attract good and talented staff, the downside could be that the agencies end up with employees who are far better paid than civil servants. This can cause public outcry and, if

Figure 5.2.1: Numbers of independent regulatory authorities in OECD countries, 1926–2001



Source: OECD (2005)

unrestrained, inefficiency. A more radical consequence would be corruption. Since procedures are not set and checked by the central government, corruption could go unnoticed and unpunished for a longer period than would have been the case had it taken place within a ministry.

Other setbacks have been observed. Once an agency has been formed, it is very difficult to dismantle it later. Almost all agencies develop a built-in resistance to change: they will not agree to abolish themselves. So, besides the official goal for which they are established, there will always be the side-goal to continue to exist as an institution.

Some observers have stressed that the creation and design of an agency should be consistent with the national context: there might be a temptation to copy Western examples that do not fit. Furthermore, the institutional constellation of an agency might be less robust than that of a ministry; the interests of an agency could be more easily ignored in times of economic downturn than would those of a ministry (Beblavy 2002).

Conditions for de-concentration

The evidence from the variety of cases that have presented themselves over the last few decades seems to suggest that some focus is needed when creating an agency. Evidence indicates that the establishment of agencies should be focused on areas where political independence is needed. These can be conflict-of-interest areas, such as the oversight of elections; areas where independent judgement is important, such as the decision to open national markets to certain medicines, or economic forecasts; and regulatory oversight of areas where the government is an actor, such as postal services and the telecommunications sector (Netherlands Ministry of Finance 2003).

In general, there are conditions that should apply to the institutional framework and to the agency itself. The institutional framework is the collection of institutions that together provide the correct checks and balances in order for an agency to be effective. The primary institutional condition is the existence of a sound legal system. The establishment of an agency creates a formal structure, in which rights and obligations become more explicit and legalistic. In the final instance, when an agency is not functioning at all, a ministry should have the authority to approach the courts to achieve its objectives.

Another condition is that there should be sufficient administrative capacity within the ministry. Creating an agency requires civil servants who are able to monitor what the agency is doing (or avoiding doing). Although the creation of an agency involves the transfer of responsibilities, it also leaves the ministry with a new kind of steering responsibility, and its civil servants should have the capacity to manage these relationships (Schick 2002).

Connected to this is the presence of sufficient control mechanisms. If they are lacking, the central government has no guarantee that the required results will be achieved; in such a situation, it would be better not to transfer responsibilities.

Considering these necessary conditions, it might be preferable not to engage in a drastic movement to de-concentration. Instead, a period of phasing in, during which agencies could be created gradually, would be advisable.

An additional factor is what can be described as 'national culture'. This is to stress that the national context might provide varying degrees of institutional trust, which could be essential for an agency model to work. The high importance that is given to honesty and moral decency in Scandinavian countries (at least as far as the tables of Transparency International can be used as an indicator), and, as a consequence, the higher probability that things will be done as agreed, might explain why agencies provide efficient organisational models in these countries, but not necessarily in countries where these values have less practical significance.

There are further conditions that seem necessary for the organisations concerned to abide by. Agencies should have clear objectives, without functions that overlap with other government bodies. They should provide measurable services, so that the outputs or outcomes of an agency can be seen. For this to be transparent, there needs to be a cost-price model and a system of evaluation.

5.2.4 Outsourcing

Defining outsourcing

As mentioned above, outsourcing means the delegation of the implementation of public services to private parties, who usually compete with each other to get the assignment, either by tender or by another procedure. So far, outsourcing has been done in three different of domains. The first is that of blue-collar support services, the domain of canteens and cleaning services, functions that usually do not belong to the main activities of a ministry, that are not too complex, that are relatively easy to measure and that, consequently, can be outsourced without too many problems.

The second domain is that of high-technology support services, which can be within the field of information technology or human resources management, for example. These functions are more complex and less measurable, but still not a main activity of a ministry and, thus, quite commonly outsourced.

In some countries, outsourcing has extended to a third domain, that of core government activities, such as the running of prisons. This kind of outsourcing is more controversial, as the responsibility for a core government task is delegated away from the ministry.

Arguments for outsourcing

The arguments in favour of outsourcing are comparable to those for agencies. The main argument seems to be the desired reduction of costs that could be achieved by competition among suppliers as part of the outsourcing process. Another argument is the access to expertise that could be tapped by outsourcing. A third, and similar, argument assumes that outsourcing and public service provision by private providers could be a substitute for poor government service.

Evidence on outsourcing

Although no comparable statistics exist on outsourcing, an indication can be derived from the amount of goods and services being purchased, as opposed to those provided by the ministry itself. Although this might overstate the extent of outsourcing, it still can serve as a rough estimate of national practices. Such an overview is given in Figure 5.2.2.

What is remarkable is the huge variety between different OECD countries: the proportion of outsourcing ranges from 20 per cent to 80 per cent. The countries that seem to outsource most are the Anglo-Saxon countries (such as the United Kingdom, United States and New Zealand), as well as Scandinavian countries (Norway and Sweden). The OECD countries that seem more wary of outsourcing are the continental and southern European countries.

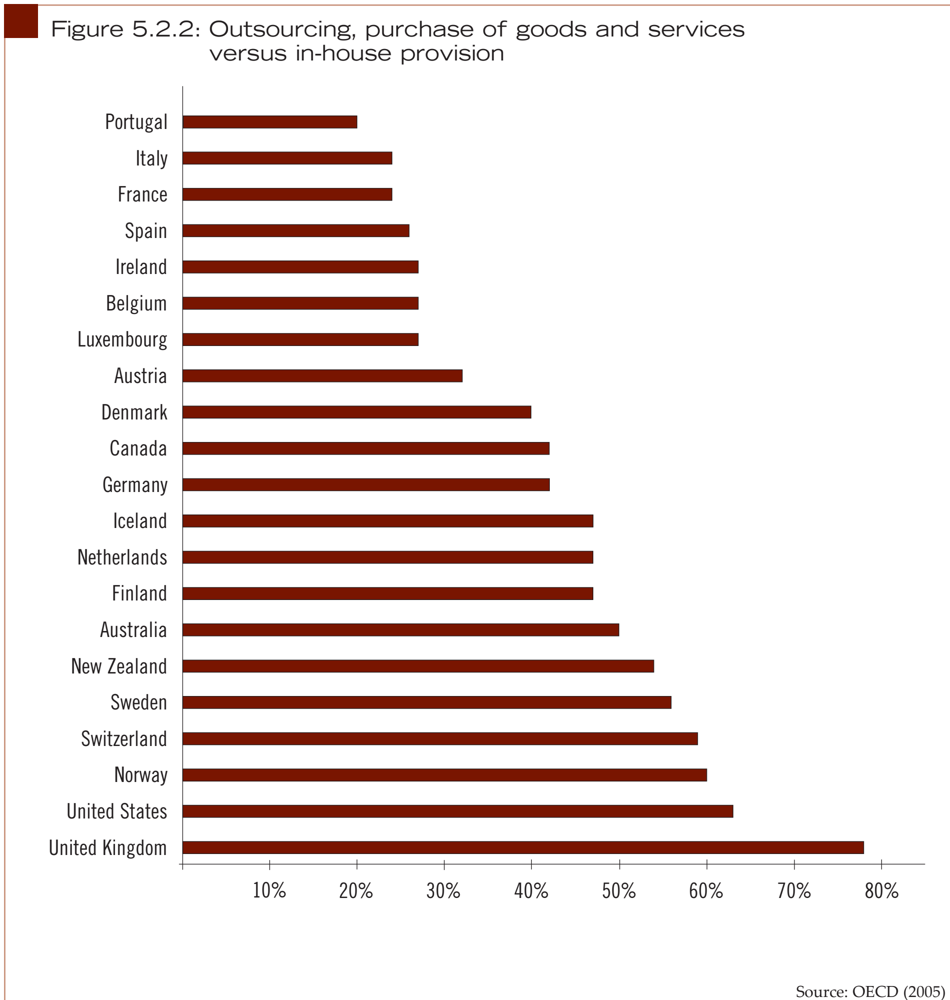
There are several studies that confirm the realisation of cost savings as a result of outsourcing. The highest cost reductions have been recorded in the US (33 per cent), but substantial cost savings have been found in other countries: 25 per cent in the UK, 20–25 per cent in Iceland, 5–30 per cent in Denmark and 15–20 per cent in Australia. There are fewer studies on the improvement of services after outsourcing, but the existing study on the US shows a substantial service improvement of 25 per cent (OECD 2005).

As with de-concentration, there are several concerns connected to using outsourcing as a policy tool. First of all, outsourcing can raise the issue of who is responsible and accountable for the provided service.

A second concern could be the costs resulting from changes in public preferences. The civil service might be more flexible in realigning its internal priorities than a contracted private provider would be; there is some evidence that changes in public preferences tend to result in the renegotiation of contracts and higher public costs.

A third concern could be dependency on the contractor; especially when the contract has a long time frame, the expertise and knowledge at a ministry might decline, as might the alternative of providing the service in-house. This increasing dependence could encourage the contractor to raise the price of the service. Connected to this concern is the loss of public information that might result from outsourcing.

Figure 5.2.2: Outsourcing, purchase of goods and services versus in-house provision



Source: OECD (2005)

Since some of the outsourced functions involve large databases, outsourcing might mean that the updating of data is no longer done by the ministry, resulting in a loss of information available to it.

A further concern is the transaction costs that are involved in negotiating and concluding outsourcing contracts, which can be very complex. The resources and energy invested in getting a good deal could have been devoted to the task itself had it not been outsourced. Not surprisingly, there are many principal-agency problems connected to outsourcing. The ministry does not have the market information that the private provider has, and this lack of information might put it at a disadvantage in negotiations with the provider.

Conditions for outsourcing

Some of the same conditions necessary for de-concentration are required for outsourcing. One of the important institutional factors is the existence of a sound legal system. Since outsourcing, even more so than de-concentration, is based on a contract between a ministry and another party, it is essential that the obligations under the contract can be enforced by the judicial system.

Another essential institutional element is effective competition in the market for the goods and services that the private party provides. If there is no competition, a ministry does not have a real alternative solution and would thus pay a price higher than it would have in a competitive market. In such a case, it would be better for the good or service to be provided by the ministry itself.

There are also some necessary conditions linked to organisational capacity within a ministry. First of all, outsourcing requires the existence or enhancement of commercial skills within the ministry, since negotiating contracts is not necessarily a core task of a civil servant. In order to obtain the benefits of outsourcing, it is very important that staff are sufficiently competent to secure them contractually. This has implications for the human resources management of a ministry; it is probable that more people with commercial skills will have to be recruited and that additional training will have to be given.

Outsourcing needs a clear description of outputs and outcomes. Furthermore, it has to be apparent that people will be treated equally by the private provider. This might pose difficulties because it could impinge on the autonomy of the private provider to use whatever instrument it chooses to reach the desired outputs. There should be no weakening of the power that clients have accumulated over the years to complain and obtain justice in the case of poor service, through redress mechanisms, ombudsmen, and so on.

5.2.5 Conclusions

The experiences in OECD countries with de-concentration and outsourcing are mixed. When looking at the research that has been published on the subject, there seems to be more evidence for the effectiveness of outsourcing than for de-concentration. Furthermore, each appears to be desirable only under strict conditions, for both the institutional framework and the internal organisation within a ministry itself. The crucial question is whether countries meet these conditions. The alternative is to rely on a professional civil service for providing goods and services. At the same time, however, a well-capacitated civil service is necessary for de-concentration and outsourcing to be effective – these strategies rarely offer a viable alternative if the core systems do not work well.

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5.3 Kenya: a case study

Kubai Khasiani & Phyllis Makau

Decentralisation of public functions to public agencies in Kenya can be traced back to both before and after independence. Prior to independence, substantial activities of the colonial government were delivered through public entities and bodies. This was expanded following independence in 1963. The expansion was due mainly to the fact that the objectives for which the colonial government established these entities had not changed, and as the government grew in response to the need after independence to take services to all the people of Kenya, so did the use of public agencies expand.

There are various explanations for the increasing role of the state in providing services through public agencies during the early years of independence. First, there were very few indigenous Kenyans who had the capital to undertake big projects. Second, the private sector was not sufficiently developed to take over some of the functions best suited to it. Third, the government wanted to use these agencies to promote regional development and deliver goods and services to areas that private markets would otherwise fail to reach. Fourth, there was a deliberate attempt, through the Kenyanisation policy, to use these agencies to empower Kenyans economically, especially by using agencies as an avenue to create jobs for the growing population. Fifth,

the socio-economic ideology of African socialism at the time gave the government a high level of command over economic and commercial activities.

It can also be argued that one of the forces behind the establishment of agencies was the concerted drive to maintain a high degree of public control over national resources. According to Sessional Paper Number 10 of 1965 on African Socialism and its Application, the agencies were also seen as vehicles of development, especially those created for serving regional areas. By the late 1980s, there were more than 200 public agencies and over 100 bodies engaged in the provision of public services and goods. Many of these agencies and bodies were drawing funds either directly from the exchequer or indirectly in the form of transfers or subsidies from the government, such as tax exemptions and guarantees of access to both international and domestic credit markets.

5.3.1 Types of public agencies and bodies in Kenya

There are mainly three types of public agencies in Kenya:

- There are autonomous bodies that are completely de-linked from the central government and which produce goods and services. These agencies are established through an Act of Parliament. However, they either receive direct subsidies from the government through the exchequer or are exempt from certain taxes. Such bodies have complete authority to decide on prices for their services or goods, without recourse to the Treasury. These agencies provide power, printing services and education materials, for example.

- There are semi-autonomous bodies that are established either through an Act of Parliament or through a government decision and which are created to provide specific services. Such bodies mostly depend on the exchequer, they do not have full authority from the government to levy fees or to increase their operations and always have to obtain authorisation from the Ministry of Finance.

- Then there are funds established through an Act of Parliament or through government administrative rules, which are not fully autonomous but can charge for their services and use the proceeds for their operations. Examples are the Health Fund and the Veterinary Fund. There are others in this category that may not charge any fees but fund their activities through earmarked revenues; for example, the Constituency Fund, the Fuel Levy Fund, the Petroleum Levy Fund and the Electrification Fund. Generally,

these bodies are not forced to compete for resources through the annual budgetary process. Therefore, they have some independence in operational status, with fewer restrictions and less oversight than ordinary government institutions subject to the budget process.

All these entities are commonly overseen by a management board to which they are accountable. This board is normally appointed by the government and includes representatives of relevant ministries. The chairperson of the board usually serves in a non-executive capacity.

5.3.2 Justification/objectives for setting up public agencies and bodies

Independent agencies are still being created in Kenya, despite recent calls for rationalisation of such bodies. While operational effectiveness and efficiency are often the driving force behind the creation of these bodies, the following reasons also prevail:

- To provide better service to all the citizenry. The Kenyan government has remained centralised since independence, with ministries providing services to the citizenry. Decentralisation is seen as a framework for enhanced service delivery through localised provision and accountability.

- To offer incentives to raise more resources. The setting up of public agencies in Kenya was also in an effort to increase the resource base. The establishment of the Veterinary Fund and the Health Fund was part of the introduction of cost sharing in the agriculture and health sectors; thus, these agencies are able to charge for their services, collect fees and, consequently, improve their operations.

- To attract and retain professional and skilled personnel. As the central government continued to expand, the remuneration or the terms and conditions of service of its personnel were eroded. Some of the specialised areas started losing their professionals to the private sector; as a result, in some cases, certain agencies had to be created so that they could attract and retain these professionals, outside of the central civil service, often with far better remuneration structures.

- To secure funding. Some of these agencies are funded through earmarked revenues, and often the percentages are set in the Acts of Parliament that establish them. Where they provide a service, they are allowed to collect

and retain their revenues. Frequently, these agencies have been justified as a means of securing certain public services against undue political interference, and of shielding them from the ordinary ups and downs in the fortunes of government resources. Thus, their funding is predictable and not restricted by the central government. In a few cases, these entities become vehicles for donor funding, when donors consider the central government too bureaucratic and poor in governance.

5.3.3 Complexities of public entities, agencies and bodies

The creation of independent agencies has added to the complexity of managing public services. The fact remains that these bodies are providing services that are part and parcel of central government operations. The complexities in the management of these agencies have included:

- Burdening the exchequer. Substantial resources, including earmarked revenues and subsidies, are transferred directly to these agencies to fund their operations. In some cases, there is exemption from taxes; for example, agencies engaged in the printing of educational materials are exempt from corporate taxation. There are also those that, due to mismanagement, have not been able to pay their statutory deductions, including the servicing of their debts. The total burden on the exchequer is estimated to be more than 2 per cent of GDP and more than 20 per cent of the total budget. In all circumstances where they incur liabilities and fail to meet them, the exchequer is expected to take on the liability. This is often unpredictable, as the operations of the agencies are not always part of the central budget process, and oversight is often inadequate.

- Duplication of activities. Some of these organisations had specific mandates when they were established but, as the government expanded and new policies were adopted, their functions were often not adjusted. For example, the regional bodies set up in Kenya to take development to the rural population duplicate the role of the Ministry of Agriculture, which has similar programmes in rural areas. The creation of agencies also does not necessarily mean leaner central government ministries; therefore, instead of generating greater efficiency, they frequently contribute to the bloating of government operations.

- Limited accountability. Some of these agencies operate outside the budget

process with revenues that do not pass through the exchequer, as most of them collect and retain their own resources or have earmarked revenue disbursed directly from collection. Therefore, these funds are not part of the government's overall planning and prioritisation process. Thus, they are not subject to the standard controls and procedures applicable to other public resources: the scrutiny to which a one-line transfer is subjected is not the same as that given to a detailed budget.

- Limited financial skills capacity. These agencies are managed through boards often appointed by government and which may not be fully conversant with the complexities of public financial management. Also, due to the limited financial skills in these organisations, the Ministry of Finance has to allocate its own personnel to the functions of reviewing the detailed financial operations of these agencies.

- Inflexibility within the central government to shift resources, in particular the earmarked resources. Some of the agencies get a percentage of revenues, which reduces the ability of the government to implement a framework of prioritisation and trade-off in the allocation available resources. On the other hand, the criteria for the earmarking of these revenues for agencies may be due to political patronage.

- There is often no exit plan when the funds or bodies established are no longer relevant, in which case it may take time before operations are eventually discontinued. In the meantime, funding their operations, albeit through transfers or earmarked revenues, is allocative inefficiency.

- Since the entities are outside the central government, they easily fall victim to political patronage and control, with their employment policies not being honoured as the politicians use them to reward their cronies. Decentralisation without an appropriate fiscal framework only results in a strain on scarce national resources, and may not necessarily spur economic development; more often, it is an additional cost on non-discretionary expenditures.

Having realised the costs and complexities of these agencies, the government of Kenya embarked on a reform programme aimed at reducing the burden on the exchequer by winding down some of these agencies and privatising their functions. Despite the negative experience with a number of agencies, granting public institu-

tions more financial independence has improved their financial health; for example, universities are now meeting 30 per cent of their requirements through their own income-generating activities.

A key inadequacy in the management of these agencies is the lack of a comprehensive policy and regulatory framework to govern the circumstances under which particular types of agencies can be created, what the processes are for creating them and under what sets of rules different types of agencies should operate. Together with a focused programme of capacity building for their management from central government, and a clear set of rules for their management and oversight in the annual budget process, such a framework is critical to ensure that the continuation of agencies is efficient and contributes optimally to the effectiveness of the government in addressing key development goals.

6

Policy, budgeting and oversight: the role of the legislature

6.1 Introduction

Several CABRI member countries are experiencing pressure for greater involvement of the legislature in the *ex-ante* budget process. The Ugandan Parliament passed legislation in 2001 that redefined and strengthened its role by, *inter alia*, demanding more information at an earlier stage. In South Africa, the Constitution gives Parliament the right to amend budgets, but requires Parliament to pass legislation setting out a procedure for such amendments. Pressure for this legislation to be enacted is rising; in the meantime, dedicated sector committees are using improved in-year flows of information on actual spending to challenge the executive on performance. In Zambia, the legislature has used a more programmatic classification structure to challenge the executive's allocation decisions, causing funds to be reallocated to priority spending areas. In Tanzania, the legislature plays an active part in reviewing past performance for future budget decisions through its participation in the expenditure review process. In Ghana, the legislature was instrumental in channelling public discontent about new consumption-tax proposals. These are but a few examples from member countries.

Parliamentary activism would impose additional burdens on an already congested budget process. In addition, many associate it with significant fiscal risk and wastage

through demands for spending on sometimes unaffordable and often less-effective and less-efficient, but politically expedient, programmes. The two essays in this chapter illustrate that this does not necessarily have to be the case. As with executive budget processes, the incentives in public budgeting allow individual actors to overestimate the benefit of their proposed spending against the perceived cost. This is addressed if the parliamentary budget process is designed to co-ordinate claims on spending in such a way that individual claimants are forced to take the real budget constraint into account.

Indeed, greater risk is associated with not allowing a meaningful role for Parliament in the budget process. The legislature's role as a check on the excesses of the executive emerged out of its gaining power over the purse. In all democratic constitutions, the legislature is still a critical pillar in the division of power between the branches of the state, but its role in budgetary matters has waned over the centuries. The recent trend towards a greater role for the legislatures of CABRI member countries is not isolated: more than a quarter of the countries in the world have revised their constitutions over the last 15 years to give Parliament more say. This has been driven partly by the recognition that Parliament is a necessary link in the accountability chain and plays a significant role in demanding policy accountability and performance from executive office holders and managers.

This chapter's theme essay by Alta Fölscher sets out options for designing a role for Parliament that allows it sufficient oversight, while managing the risk of ill-disciplined parliamentary action leading to excess spending, or Parliament becoming a conduit for narrow, ineffective spending demands. In the Uganda case study, Ishmael M Magona of the Uganda Ministry of Finance and Planning illustrates that there are real public finance benefits to be derived from a co-operative relationship with an empowered Parliament.

6.2 A balancing act: fiscal responsibility, accountability and the power of the purse

Alta Fölscher

6.2.1 Introduction

Vertical, or public, accountability (i.e. being answerable to stakeholders outside of the executive) is a necessary component of any public financial system. While various formal rules supporting good budgetary outcomes may be in place internally, such as the use of ceilings, commitment controls, accounting rules and audit requirements, public accountability is necessary to ensure that budgetary actors in the system comply with these rules (Schick 1998). Without a functioning system of public accountability, horizontal, or internal, accountability is weakened and budgetary outcomes are compromised in terms of fiscal discipline and effective and efficient spending.

Vertical accountability is a function of the institutional arrangements within the executive. Functional levels of transparency require that accurate, accessible,

comprehensive, regular and timely information is provided throughout the budget process. The processes supplying and demanding such information should be institutionalised if the executive is to be held to account systematically. At the same time, institutionalised mechanisms (points of interface) are required through which information to, and feedback from, external stakeholders can be effectively channelled, such as tabling the budget in the legislature or a process for receiving and acting on Parliament's recommendations following audit reports.

This is the supply side of vertical accountability. In order for accountability to ensue, there should be an operative demand side as well – stakeholders outside of the executive who have an active interest in the information provided and who take meaningful steps to make the executive answerable. The legislature is the institution of state through which such accountability is put into operation.

Thus, an effective legislature is a necessary building block in a properly functioning public finance management system. The institutional arrangements within the executive should supply information and provide meaningful access, and the institutional arrangements of the legislature (e.g. legal frameworks, organisational structures and capacity) need to generate the necessary will to demand an effective voice in budget making and implementation.

In practice, many systems have evolved that treat the legislature, at best, as a necessary but largely meaningless step to turn the budget into a legal instrument of control (and, at worst, as a threat to budget discipline and integrity) and a compliance 'checkpoint' in the required audit process. In many CABRI member countries, however, the legislature is flexing its constitutional muscles. This essay argues the case for why such displays of interest should be welcomed and attempts to provide an overview of the institutional building blocks required to facilitate a constructive role for the legislature and to ease the co-ordination burden that comes with a more meaningful legislative budget phase.

The concern here is largely with the potential role and institutional arrangements for the legislature's oversight of the executive's policy direction *ex ante* (in other words, before the spending year begins). Clearly, the legislature's role *ex post* is of equal (some would argue, greater) importance; this role is more readily accepted by the executive and causes less concern in terms of co-ordination. Moreover, the linkages between having an effective role *ex post* and sound systems for an effective role *ex ante* are not always well constructed. That is the terrain this essay explores.

6.2.2 Legislatures, democracy and the power of the purse

Viewing the role of the legislature in terms of its contribution to the internal efficiency of the public finance system is a narrow perspective, although it is one of particular

relevance to senior budget and planning officials. It is useful also to consider the broader context in which a functioning public finance system is a necessary component of good governance, and an effective legislature is an essential part of the checks and balances on state power.

Governance can be defined as the exercise of political, economic and administrative authority in the management of a country's affairs at all levels. Good governance may be thought of as a system in which the exercise of such authority is set up so that power is divided constructively across the institutions of society (including the organs of state, civil society and the private sector) and is prevented from being usurped by any singular institution, thereby minimising the risk of it being abused. Participation, transparency, accountability, the rule of law and equity are instrumental to good governance. A public finance system – the system whereby a society decides what level of resources should be made available to fund what public goods and ensures that the funds are used as indicated – contributes to good governance across all dimensions if it is participatory, transparent, accountable and equitable and adheres to the rule of law. This means that Parliament should be included, not marginalised.

Parliament is a vital organ of state, balancing the power of the executive and the judiciary in the exercise of authority. Denuding it of meaningful power over the purse (however troublesome this may be for an already congested budget process) will detract from its ability to fulfil this role, and may undermine the establishment of developmental democracies.

How the executive and the legislature coexist in the division of checks and balances and the sharing of power is determined by the structure of the state and the political system, the state of politics and the formal and informal institutional arrangements that have evolved historically in a country.

Both the structure of the state and the formal political system are founded on a country's constitution. Broadly, two types of system for sharing power between the executive and the legislature can be discerned – presidential systems and parliamentary systems. In a presidential system, power is formally divided, with the executive being elected separately from the legislative branch of government. In a parliamentary system, power is formally shared and the executive is formed out of members of the legislature. Usually, legislatures in presidential systems are more influential in determining the level and distribution of public taxes and spending. In parliamentary systems, the constitutional principle that disagreement between the legislature and the executive on the budget would equal a vote of no confidence and bring down the government means that the incentives for members of the legislature and the executive are aligned to avoid such disagreements. It is in such systems that

notions of parliamentary checks and balances on the state's power to raise taxes, and oversight of the executive's spending of those taxes, can turn out to be little more than paper ideals.

Notwithstanding the underlying system and its organisational structure, democratic legislatures fulfil a set of core interrelated functions, all of which are relevant in considering their role in the budget process (OECD 2001). Firstly, legislatures *represent* the interests of the electorate and, as such, are an important check between elections on whether a government's policies, as expressed in the budget, are in line with the needs and priorities of its acknowledged principles. Secondly, legislatures *make laws* that set the formal rules for a society, in accordance with the nation's policy priorities. Clearly, there are conflicting interests in any nation, resulting in conflicting policy priorities. In principle, through its functions of representation and law-making, the legislature is where the public reconciliation of conflicting interests and different agendas takes place. Insofar as the budget is the ultimate expression of a reconciliation of different interests within available resources, the legislature's approval of the budget is a critical annual process in the legislature's mandate to make laws. Thirdly, the legislature has the function of *oversight*, on behalf of the electorate, of the executive's actions in policy making and implementation. Once again, the budget process is the primary vehicle through which the legislature exercises this function.

In fact, the development of the legislature as an institution providing a check on the powers of the executive is interwoven with the development of parliamentary control over what taxes may be raised and how those taxes may be spent (Schick 2002; Stapenhurst 2004). The evolution of this *power of the purse* dates back to medieval times when the English monarch, King John, agreed with the barons in the Magna Carta that no taxes would be raised without their consent. While the king originally still had full say over where taxes would be spent, over the centuries Parliament negotiated further concessions in exchange for voting additional taxes during times of royal need and providing parliamentary support for political and religious battles; for example, the concession that money may only be spent for authorised purposes and that the king's own money should be kept separate from tax income (Schick 2002).

From controlling the crown to pork-barrelling

In England, the power of the purse, including its transfer from the crown to an elected executive, evolved over time. In France, a similar battle for control over public resources raged, but it required a revolution to finally break the power of the crown and to establish the principle of control by representatives of the people.

Yet parliamentary systems today are characterised by legislatures that are weak in

terms of their role in the budget process. Schick (2002) and Wehner (2003, drawing on the work of Krafchik) identify several reasons for this decline in power.

Firstly, the parliamentary traditions that evolved were in the interest of the legislature at the time of their invention, but have lost their appropriateness as circumstances changed. However, these practices are so entrenched that their relevance to modern-day public finance management is rarely questioned and, if questioned, difficult to change. For example, in Westminster-styled parliamentary systems, the budget is often approved several months after the start of the budget year, in effect meaning that parliamentarians approve spending that has already commenced. Even if rules are in place to prevent new spending proposals (over the previous year) from being implemented, when Parliament annually votes the bulk of funding, spending will go ahead without parliamentary approval. This parliamentary tradition (in terms of which Parliament only approves spending proposals that come from the executive and does not formulate its own) derives from mechanisms deployed over centuries to force the crown to spend more of its own money (more economically) rather than tax the population.

A second set of reasons concerns the marginalisation of Parliament in fundamental decision-making processes. The budget is probably the most important policy vehicle for government – it is the instrument through which government makes choices about what its real priorities are and how they are ranked. For a long time, the budget was thought of as merely the technical expression, in financial terms, of policy made elsewhere and as a tool to deliver financial objectives and produce the public accounts. It was only over the past few decades that the role of the budget process in making policy became fully appreciated. By then, however, the role of Parliament as an institution had been sidelined: while it still approved the budget, the process of doing so had become a hollow ritual, focused on appropriation for purposes of control and restriction rather than in terms of policy, accountability and government performance.

One contributing factor towards this was the rise of organised political parties, which set the legislative agenda and force legislators to vote according to the party line. In coalition governments, for example, trade-offs are negotiated between political parties behind the scenes at the start of the parliamentary session, diminishing Parliament's role in making laws and in exercising oversight. Also, the rise of interest and pressure groups means that agreements about resource allocation are reached outside of Parliament, making it difficult for parliamentarians to introduce changes that represent their constituents' needs. Schick (2002) draws a distinction between pluralist and corporatist democratic societies. In the former, the large number of narrowly defined interest groups means that decisions are made on the margin; the

demands of individual interest groups can be satisfied by a little less tax or a little more spending, detracting from the formation of a comprehensive view of public finances. In the latter, larger pressure groups are formed around collective interests (e.g. labour or the private sector), and institutions outside of Parliament negotiate agreements that are then simply ratified in the parliamentary processes.

A third set of reasons concerns the growth in the size of the state and the complexity of its structures, financing mechanisms and expenditure agendas, which make it increasingly difficult for parliamentarians to get a comprehensive picture while assessing the marginal social cost and benefit of individual spending and taxing proposals. As governments have grown, their bureaucratic institutions have become more complex. Budgets are determined and implemented through professionalised and frequently huge government bureaucracies and bureaucratic processes that are difficult to penetrate. The proliferation of arms-length agencies, boards and commissions in recent decades has added another layer of complexity to the practice of parliamentary oversight of budgetary decisions and their execution. Of course, the tradition of executive secrecy in budgeting has not helped.

The expansion of government services has meant not only that bureaucracies have grown impenetrable, but also that voters (rather than the crown) are increasingly benefiting from public services. While Parliament's early task was relatively simple and focused on restricting the burden placed by executive spending on the pockets of the people, its task is now far more complex; it needs to weigh the distributional burden against the distributional benefits of spending. It is sound budgetary practice to pool spending proposals in a comprehensive, periodic budget for a consistently fixed time period against an assessment of the available revenue for the same period. This supports fiscal discipline, policy contestability, redistribution and efficiency. However, it does make it more difficult to assess the marginal cost and benefit of individual proposals. Schick (2002) points out that earlier parliaments made appropriations long before governments budgeted. While such piecemeal approvals had a cost in terms of overall budgetary outcomes, it was much clearer what was being proposed and who would pay for it.

Schick (2002) argues that voters may not always want parliaments to restrict spending in order to limit taxation, since those who benefit from spending, often the majority, may not carry the burden of paying for it. Similar to legislatures, voters also face the difficulty of calculating the trade-offs between what they pay in tax (given the complexities of tax structures and intergovernmental systems) and what they receive from spending programmes. While the principle of no taxation without representation led to the rise of parliaments, the effect of representation without taxation may be detrimental to parliamentary power; the incentive then would be

to not take a comprehensive view and turn down spending proposals because they are inefficient or even ineffective, but rather to approve them. In addition, the main growth in spending over the last 50–100 years has not been through tightly authorised spending on limited activities, but rather spending on entitlement programmes, often established under laws that operate outside of the main budget process.

A fourth set of reasons concerns the public finance impact of representational political systems. The work of Von Hagen has been influential in this regard. Von Hagen (2005) is concerned with the nature of public spending as a narrative in which some people spend other people's money, often even on a third group of people. This disconnection between the cost and benefit of public spending means that voters can reward politicians for targeted policies that benefit them, but for which they do not have to bear the full cost. Thus, politicians can use the public purse strategically to reconfirm their election to office. Schick (2002) points out the tension between this incentive on parliamentarians as individuals to promote their own careers or the interests of their constituents, on the one hand, and their role as members of a collective institution with the interest of the making sound, coherent laws, on the other.

This common-pool property of public finance, where each individual would seek to maximise his or her personal benefit from the common resource pool without fully perceiving the long-term cost of their combined actions, has operated to give legislatures the bad reputation of being a high risk for pork-barrelling budgets and breaking fiscal discipline, either in pursuit of electoral interests or in pursuit of parliamentarians' private gain. There are many examples of parliamentarians acting as agents for particular interests (especially in pluralist societies where there are many small interest groups) or only being interested in the short-term gains of their constituencies, leading to a multiplication of claims on the budget, collusion between individuals within parliamentary processes to approve those claims and a gradual, incremental increase in spending, taxes and borrowing. To put it simply, there are histories of parliaments that are less concerned about using the power of the purse to oversee the executive's proposals for spending in the long-term interest of the nation than they are in adding to those proposals the financial impact of their own short-term interests. The recent example of the Kenyan Parliament refusing to pass the supplementary budget unless concessions were made to increase the personal allowances of parliamentarians is a case in point (the negotiated compromise, after a significant public outcry, was that ministerial allowances would not be financed by the parliamentary budget, which was the second demand).

Of course, none of these reasons on its own or in combination is sufficient to argue that the legislature should not play a role in budgeting. Traditions can and often should be changed in the pursuit of better budgetary outcomes, even if it means

reorganising the full budget calendar. Institutional arrangements should be such that Parliament's role in negotiating trade-offs between interest groups adds to the likelihood of better outcomes. Fiscal and budget transparency, the parliamentary budget process and the institutional arrangements around accountability chains should be such that Parliament has both a comprehensive view to assess the marginal cost and benefit of spending proposals and the technical expertise to do so.

It is easy to forget that in a democracy, whether a presidential or parliamentary one, marginal decisions in the executive are also driven by politicians, subjected to the same political incentives as parliamentarians. There are far more examples of spectacular public finance collapses being driven by poor, short-term executive decision-making than by parliamentary decision-making (partly, of course, because few parliaments have the power in practice to have such impact). It is not difficult to see that if Parliament, backed by sufficient technical expertise, retains its role as an effective check and balance against executive short-term largesse, the division of power within the state would operate better to enrich the debate, point out dangers and restrain deficits.

A new millennium

The pendulum is swinging back. An Organisation for Economic Co-operation and Development (OECD) survey of parliaments conducted in the late 1990s highlighted that an increasing number of countries are assigning more active roles to the legislature in budget processes. While the changes may not directly increase the power of the legislature, they may improve the quality of discussion, impacting on the wider political context. Trends include the following: some legislatures now vote budget totals before considering the distribution of spending, allowing a greater voice in fiscal and economic policy-making; many legislatures have created specialist budget committees with the expertise to engage with budgets (these committees are backed by legislative support staff, often with dedicated offices for budget committees); much more and much better information is forthcoming from the executive on spending proposals and implementation; and legislatures are more active not only in approving budgets, but also on the monitoring and audit side.

Recent changes in African practices concerning budgets and parliaments reflect similar trends: improved budget documentation, containing more information in terms of comprehensiveness and frequency, and better classification systems have improved discussions in parliaments; parliaments have become more vocal in their oversight roles, demanding changed systems or holding members of the executive publicly to account through strengthened committees; and parliaments have become more effective in channelling voter discontent with fiscal decisions.

The reports on the OECD survey (1998 and 2001, the second containing results of a wider survey including non-OECD countries) and several other authors, such as Schick (2002), Stapenhurst (2004), Wehner (2003) and Kunas (2002), talk about a continuum of legislative activism. On the one hand, modern legislatures are very active, often in presidential systems (e.g. in the United States where the Congress has constitutional powers and the technical resources to make its own budget proposals). On the other hand, they can be very inactive, usually in parliamentary systems. In either system, the prevailing political context is an important variable. When there is a single-party majority government in a parliamentary system or when both the legislature and the executive are controlled by the same party in a presidential system, there is less legislative activism, given constitutional powers. However, when there is a coalition government in place or where different parties control different branches of the state, legislatures are more active.

6.2.3 Building better public finance institutions

Countries face a critical choice regarding which road to take for legislatures to express the greater demand for legislative action. The wave of public finance management reforms affecting the full cycle of policy, budget, implementation, audit and evaluation creates opportunities to address the role of the legislature in this cycle in the interest of better development outcomes. There can be little doubt that given the primacy of budgets in determining the nature of governments, a changed role for the legislature in the budget process will eventually alter the underlying relationship between the legislature and the executive.

There are several dimensions to the choice, some of which have already emerged from the discussion above. Primarily, legislatures need to choose between a system that is fundamentally in conflict with the executive or one that acknowledges the tension, but which embraces co-operation towards the shared objective of improving the outcomes of spending. Linked to this is the choice as to whether the legislature wants to be an institution that remains a powerless instrument of financial control, or an institution that is engaged in the budget process. If it is the latter, the choice is between making budget policy (i.e. proposing new spending options), either in conflict or in a participatory manner with the executive, and playing an active role in policy accountability and performance. The choice is whether the legislature will attempt to duplicate or take over the executive's role of drafting and implementing the budget or whether its role will be primarily one of oversight of executive action (see Box 1).

Of course, there are trade-offs between these roles. Parliament's role in the budget process is best conceptualised against the budget cycle, from policy planning and

Box 1

Parliamentary action in action

In Kenya, the government has introduced a constituency development fund through standing legislation, the aggregate level of which is set to a percentage of GDP. The fund is allocated to constituencies outside of the budget process, and within constituencies by constituency development committees chaired by the sitting member. The implementation of the fund is managed separately from the budget.

While there are good arguments for locally based development funding, the way in which this fund is managed creates several classical budgeting problems. Firstly, the allocation of funds to constituencies is not viewed in terms of all the claims on national resources. In voting for the system, parliamentarians did not have a comprehensive view of the impact on public finances and the opportunity cost involved, which allowed for a focus only on the social benefits that would ensue, without measuring the social cost (and social opportunity cost). In early 2006, there were already demands by parliamentarians that the allocation should be doubled; however, such a move would effectively absorb all the domestic resources that are currently available for investment in development.

Secondly, projects undertaken at community level with the funds are not integrated with the budget, and economies of scale are not accessed. Two neighbouring constituencies may both build secondary schools, which will not only have an unacceptably high unit cost when finished, but may not even have teachers and text books because either the linkage was not made or the aggregate impact of many constituencies building schools constitutes an unsustainable recurrent budget.

If the fund had been set up in an established institution with sound legislative public finance practices, these potential negative effects could have been prevented.

preparation (currently, predominantly the domain of the executive, particularly in parliamentary systems), through legislative approval, to budget execution and finally evaluation and audit. There are trade-offs involved in participation during these phases: a legislature that actively contributes towards budget making during budget preparation is compromised when it comes to oversight of the resulting proposals in the legislative phase; similarly, a legislature that makes budget policy through the introduction of spending proposals, or amends proposals significantly during the legislative phase, is compromised when it comes to holding government accountable for the results achieved with spending. It would be far too easy for government to argue that it was unable to achieve the objectives set because Parliament significantly altered its financial plan.

The executive's choices regarding the supply of information and points of entry for legislative action, and the legislature's choices of institutional arrangements for its budget process, will determine whether, given a particular constitutional structure, the effect of Parliament's role is one of stabilising and enhancing the pursuit of the development goals of public finances, or one of disrupting fiscal balances, growing deficits, ineffective and inefficient spending and unsustainable levels of government debt.

There are sound reasons for senior budget officials and ministers of finance to be wary of active legislatures. Executives have superior access to information and arrive at the budget proposals after months of analysis and negotiation. An active Parliament, especially one that is not supported by dedicated capacity, or where the committee system does not encourage the development of members' capacity, introduces risk into the system. This risk takes several forms.

Firstly, parliaments, parliamentarians and parliamentary committees may be vulnerable to lobbying, whether by external interest groups or by spending ministries; for example, line ministries that have been turned away by the executive for good policy and public finance reasons may use their dedicated committees to get proposals funded.

Secondly, an annual budget cycle is already a very short period in which to plan and implement public programmes. In principle (and in practice), ministries wait for final approval before starting this cycle. Medium-term expenditure frameworks have been introduced to promote funding and policy predictability and a medium-term outlook for public planning and spending. If parliaments are going to make last-minute fundamental changes, the loss of policy and planning predictability could have an adverse impact on implementation.

Thirdly, there is the risk that parliaments may set out a legislative budget process that is at odds with the public finance management vision; for example, executive-driven reforms may have the aim of giving managers greater discretion in exchange for their accountability for results, whereas a legislature, in constructing a new role for itself, may be more interested in directing and controlling the details of the inputs chosen.

Finally, the ubiquitous risk is that Parliament's impact on the budget (in the interest of specific sectoral development objectives, for example) may be at odds with the executive's macroeconomic and fiscal policy stance.

Despite these risks, it is desirable that Parliament has an effective role in the budget process. One way of limiting the risks is to design a role for Parliament that is primarily about oversight of implementation, with very limited powers to make or amend budgets *ex ante*. On the face of it, this would fit well with a role focused

on strengthening accountability and the incentives for performance by managers. However, experience has shown that in the absence of powers to affect the funding that line ministries receive, Parliament's oversight of implementation is compromised. Parliament's contribution to *ex-post* accountability will be limited to the public shaming and blaming effect of calling officials to account for things gone wrong, unless it is accompanied by the threat of interference in future years. When officials know that a call to account for spending transgressions is a first warning that may lead to changes in a department's funding, parliamentary committees gain some effective bite. This is particularly true of parliamentary systems with large single-party majorities; the parliamentary check on executive exercise of power generally remains weak without an effective right to engage and amend the budget.

What then are the institutional arrangements that need to be in place to balance Parliament's right to affect and oversee the budget against the risk of its engagement affecting budgetary outcomes adversely?

Ex-ante substantive rules

One set of instruments involves setting *ex-ante* rules that limit the effect Parliament can have on the budget. Unfettered amendment powers would allow Parliament to increase and reduce expenditure and revenue, and to change the fiscal deficit. This would mean that Parliament would have final control over fiscal policy. Many parliaments across the world have chosen to limit their powers substantively; for example, by not allowing amendments that would change the deficit.

In principle, parliamentary decisions can have four types of effect: firstly, they can merely adjust the distribution of expenditure (or adjust budget allocations); secondly, they can also adjust the distribution of the tax burden (or adjust tax policy, but not affect the balance between expenditure and tax); thirdly, they can affect fiscal policy narrowly (altering the balance between revenue and expenditure); and, finally, they can affect fiscal policy broadly (increasing or decreasing borrowing requirements and the debt burden). Parliament needs to decide where it should set the limit as to the public finance policy areas that its amendments affect. A brief review follows of a few options deployed elsewhere.

Adjusting expenditure only. Rules that allow adjustments to expenditure only either permit no adjustment to the fiscal balance or leave it to the executive to balance the budget. In other words, if Parliament adjusts expenditure downwards, the executive would have the choice of either reducing borrowing or reducing the tax burden. Three versions are commonly used, in terms of which Parliament:

- May adjust expenditure upwards or downwards.

- May not adjust expenditure upwards, but can adjust it downwards. This would mean that Parliament can use its amendment powers only to reduce spending department budgets.
- May only adjust on a 'pay as you go' basis (similar to the balanced budget rule considered below, except that increasing the revenue side of the budget is off limits). Parliament can adjust expenditure upwards or downwards, but can do so upwards only if it cuts expenditure elsewhere. If it reduces expenditure, it is up to the executive to reduce the deficit or reduce revenue.

Adjusting both expenditure and revenue. Parliaments are allowed to adjust both revenue and expenditure, and this capacity may or may not be subject to further limitation. Common models of this option are:

- A balanced budget. When a balanced budget option is exercised, Parliament can reduce and increase both expenditure and revenue, as long as the deficit remains the same. This means that Parliament can increase expenditure, provided it is willing to reduce expenditure in another area or to increase revenue. This option allows Parliament some room to adjust fiscal policy, but means that the executive sets the limit on borrowing and determines debt policy.
- A reduction in revenue and expenditure (affecting fiscal policy). Under this rule, Parliament may choose to reduce expenditure, but then also has the option of choosing where to make the countervailing reduction in revenue.

Other substantive limits. Some countries deploy limits, not by restricting what Parliament may do in terms of adjustments, but by setting criteria that the adjustments must fulfil. Such criteria include:

- Fiscal rules. This option involves not setting limits on the kind of amendments that can be brought, but adhering to rules for the fiscal outcome of decisions. An example of this is the European Union Maastricht rules, to which parliaments are subject. The option need not necessarily be exercised through the enactment of separate fiscal rule legislation; it may be expressed in the legal instrument regulating Parliament's role, or in other legal instruments requiring Parliament to pay due consideration to macroeconomic policy objectives or to prudent macroeconomic management (such as New-Zealand's fiscal code). The requirement may also simply be that Parliament's

amendments must comply with the 'golden rule' that net borrowing may not exceed net capital investment in any budget cycle.

- Rules limiting the expenditure effects of amendments. Another substantive limit, which is in line with several of the principles discussed above, is that Parliament can make any amendment, but should not introduce new spending proposals, other than on the basis of existing legislation. This would prevent parliamentarians from bringing narrow-interest proposals, and would significantly reduce lobbying pressure on Parliament, without limiting the kind of amendments that can be made. Parliaments may limit themselves to considering the affordability, efficiency and effectiveness of proposed spending, focusing on past underperformance and spending proposals that are not in accordance with stated policy priorities.

Many parliaments use various forms of these *ex-ante* rules, which restrict what type of amendment power the legislature has. Table 6.2.1 provides a sample.

Ex-ante rules, however, often do not succeed over the long term in limiting the potentially adverse effects of parliamentary action (Von Hagen 2005; Stapenhurst 2004). This is true particularly if they are not backed by an effective parliamentary process that forces parliamentarians to take a comprehensive view of the budget, noting the full social cost of individual spending and tax proposals. Stapenhurst (2004) cites the example of Brazil. The Brazilian congress may adjust expenditure

Table 6.2.1: Amendment powers, by country

COUNTRY	AMENDMENT POWERS
Australia	Members may reduce revenue and expenditure
Germany	All amendments are allowed, but the deficit may not exceed total capital expenditure (subject to EU deficit requirements)
India	Members may vary revenue and reduce expenditure
Mali	Balanced budget requirement (no increase of deficit)
Philippines	Amendments may not result in increase of total expenditure; increases must be financed by corresponding cuts elsewhere
Poland	Balanced budget requirement (no increase of deficit)
Sweden	Unrestricted (subject to EU deficit requirements)
UK	Members may reduce revenue and expenditure
USA	No constitutional limit on amendment powers (scope of amendments determined by Congress)

Source: Hickey & Wehner (2000)

only, and then according to the pay-as-you-go rule. However, a loophole allows it to adjust revenue if it finds that the executive has made errors or omissions. To mitigate potentially negative consequences, the committee charged with budgeting matters has now set absolute limits by restricting the number of amendments that members can make and putting a money limit on the amount of each amendment.

Process rules

Countries may choose to make parliamentary amendment powers subject to process rules, which have the effect of disciplining the number, value and type of amendments that can be made. Many parliaments have substantively unfettered powers already, but remain passive on account of the process requirements for making amendments. Process rules include the following.

Executive veto. An executive veto means that the legislature may propose amendments, but that the final decision to accept or reject them is left to the executive. If the executive rejects an amendment, the process may revert to Parliament for reconsideration, where the amendment may be passed again, but only with a greater majority, or the veto will stand, but it may be required that the executive issue a statement explaining its disagreement.

Time limitations. Rules could limit the time that Parliament has to consider the budget. Krafchik and Wehner (2000) highlight the very limited time available for the legislative budget process as a key variable in determining how meaningfully parliaments engage in the budget. Limiting parliamentary time may also result in low-quality adjustments, particularly when the political context encourages parliamentary action but there is insufficient time to consider the consequences properly.

Ceiling limitations. Another option is to design a parliamentary budget process that mimics the incentives operative in a medium-term expenditure process, where ceilings are used at various levels to enforce prioritisation in line with policies. Alternatively, the rules may limit the proportion of the budget for which amendments can be proposed (e.g. amendments should be within a 20 per cent margin of the proposed vote ceiling). This could be subject to a substantive limit rule (e.g. only changes to expenditure may be proposed within the existing ceiling) or in an environment of unfettered powers. If it is the latter, a proportion-of-budget limit on amendments can facilitate greater discipline in the parliamentary process, without limiting the public finance policy areas that Parliament can address.

Information-sharing requirements. Good information can support rational decision-making. If the parliamentary process requires that all stakeholders be heard before amendments are introduced, parliamentarians are under greater pressure to make more objective decisions.

Voting rules. Lastly, voting rules can make it more arduous for parliaments to adopt amendments that have greater fiscal impacts.

A disciplined budget process

As is the case with the executive, the policy effect of parliamentary decisions on the budget is a function of the quality of the process that determines those decisions. As explored above, the core of the common-pool problem of public budgeting is that money from a general tax pool is used to finance distributive policies that benefit particular groups in society. Individual parliamentarians (or committees) may assume that an increase in public spending on targeted policies will allow their constituencies (or majority interest groups) additional benefits at only a fraction of the total cost. As a result, the incentive is to ask for more public services than would have been the case had the true budget constraint been fully realised (Von Hagen 2005). A significant purpose of a parliamentary budget process, therefore, would be to reduce excess spending by ensuring that decision-makers realise the true budget constraint.

Krafchik and Wehner (2000) and Kunas (2002) approach the question of what the objectives of a good budget process should be from a slightly different angle; namely, by asking what institutional arrangements should be in place to ensure that parliaments play an effective role in the budget process (by being able to make amendments that have meaningful social consequences).

From both of these perspectives, it is clear that the institutional and process design for Parliament's engagement with the budget is a serious consideration for the overall public finance management system. There is broad international experience about the key institutional arrangements that need to be secured to ensure that public spending is affordable, effective and efficient (assuming that Parliament would have similar objectives). The principles of a disciplined process that sequences individual decisions, of deciding on ceilings before making individual expenditure choices, of balancing discretion in decision-making with accountability for decisions, of the role of good information and of the need for comprehensiveness, contestability, flexibility and predictability are all widely accepted elements of a good budget process. The design of a parliamentary budget process should pay attention to these principles. A few key variables are discussed below.

Location of amendment powers

Krafchik and Wehner (2000) found that where dedicated committees consider amendments, the likelihood of the amendments being meaningful is higher. Where amendment powers are located on the floor of the house, the debate takes on a politi-

cal, rather than technical flavour, and the opportunity of proper oversight of executive budget proposals is lost.

The OECD surveys (1998, 2001) recorded a rise in the number of dedicated budget committees. In principle, this has merit because it de-fragments and centralises the parliamentary budget process, allowing greater opportunities for the true budget constraint to be realised. On the other hand, dedicated sector committees, dealing with sector issues all year round, may have a better grasp of amendments within sectoral (or departmental) ceilings. A parliamentary budget process, therefore, needs to sequence decision-making and the flow of information so as to co-ordinate the amendment decisions of committees and to induce them to take a comprehensive view.

Sequencing of decision-making

The issue of sequencing arises even earlier. Many parliaments have adopted a system whereby the fiscal framework is voted before individual spending and tax amendments are considered. This means that parliaments impose limits on themselves in terms of which trade-offs need to be negotiated. An option is for portfolio committees to be given the mandate to consider amendments within the sector ceilings, but for amendments that require an increase in spending to be referred to the central dedicated budget committee for consideration.

Information flows and participation

The quality of information before the legislature when making decisions is critical. This includes ensuring, on the one hand, that the executive is required to make submissions on proposed amendments and, on the other hand, that Parliament has the power to demand from the executive information that is relevant to budgetary issues.

Parliament may also be required to hold public hearings before proposing and deciding on amendments. This may improve the breadth and/or quality of information that is before it. For example, public hearings could provide information on the likely effectiveness of new spending proposals, or on progress with the implementation of a programme. The OECD surveys highlighted an increase in parliaments consulting with civil society (in the broad sense) during parliamentary budget procedures.

An equally critical aspect is that information deriving from the workings of audit committees, and parliamentary oversight of in-year implementation (e.g. annual reports, public expenditure reviews and actual spending reports), should be taken into account when amendments are proposed or when Parliament is faced with

spending ministry pleas for additional money. This will have the effect of improving the quality of both *ex-ante* decision-making and *ex-post* accountability. In the German Parliament, for example, the audit committee is a sub-committee of the budget committee, allowing for a strong link between parliamentary action in the budget phase and in the audit phase of the budget cycle.

Parliamentary committees tasked with budget scrutiny should also participate in the consideration of other laws with fiscal impact. Many public finance management systems now require all bills to include a memorandum on the fiscal impact of the proposed legislation. While the budget committee cannot be involved in the scrutiny of all bills, it can have powers regarding bills that propose the raising of monies, whether through levies, taxes or charges. This will ensure that such proposals are considered in the context of overall affordability, spending effectiveness and tax efficiency.

Parliaments should be empowered to undertake their own investigations of spending ministry effectiveness and efficiency; this would allow for greater insight and expertise during the consideration of spending proposals. Some countries, for example Tanzania, already include the legislature in public expenditure review processes.

Parliamentary capacity

Budgets are highly technical financial and policy tools. The executive is usually staffed with the level of expertise necessary to make budgetary decisions and manage their implementation. Parliaments, on the other hand, especially those that are weak and ineffective in the budget process, have very little capacity for meaningful budgetary scrutiny. Should Parliament's role in the budget process be geared towards improving budgetary outcomes, it must have access to the requisite capacity. Several parliaments have opened budget offices with permanent, dedicated research staff (see the Uganda case study below). Others have set up systems, often in combination with budget offices, that facilitate the specialisation of members in specific areas. In some parliaments, certain members of the budget committee become 'rapporteurs' on sectors, developing a deep understanding of sector issues over the years. The internal organisation of the budget committee, its relationship to other committees and the processes that it undertakes are of critical importance in setting the context within which capacity can grow. In this regard, it is also important that committee membership remains relatively stable.

6.2.4 Opportunities for legislative action

In conclusion, the modernisation of public finance management systems requires the modernisation of the role of the legislature. Important current budget reform foci

create opportunities to enhance the role of legislatures in the interest of spending affordability, effectiveness and efficiency; and these should be taken up in the paradigm within which legislatures approach their role.

Firstly, legislatures have an important contribution to make in shifting the focus of oversight from inputs (although that remains important) to the outputs and achievements of spending. Through relating the use of amendment powers to policy effectiveness and efficiency, making connections between *ex-ante* and *ex-post* oversight, and setting or approving frameworks for performance, legislatures can play a critical role in budget outcomes by demanding performance first.

Secondly, and related to the first point, reforms to classification systems (see Chapter 3) and the rise of monitoring and evaluation frameworks and instruments now present information in ways that make it easier for legislatures to hold the executive to account for policy achievement and performance.

Thirdly, the introduction of medium-term expenditure frameworks has opened up new possibilities for legislatures to take a medium- to long-term view of policy effectiveness and sound financial planning against policy priorities. There is plenty of opportunity to influence the quality of budgetary decision-making (and to demand proper forward planning and meaningful projections from the executive) long before amendment powers would need to be used.

Overall, the legislative budget process should be designed with the same care that is taken with the executive budget processes. It should be disciplined and transparent, operating under clear rules with optimal information flows and accountability for decisions made. While the legislative budget process may cause conflict with the executive, it is in the interest of the ministry of finance to maintain a co-operative relationship with Parliament; as the role of the central budget office shifts from control and constraint to that of demanding policy accountability and performance, its key ally can be the legislature, which usually has a constitutional mandate of oversight. Many countries, including Uganda, Kenya, Tanzania and South Africa, have already shifted from traditions of secrecy and exclusion during the drafting process to an open approach, where legislatures are exposed during drafting to key policy questions and decisions. Parliament has a crucial function in guiding the strategic direction of policy and in holding government to account. Embracing an active legislature, while ensuring that the institutional arrangements are in place to optimise its role, paves the way to better budgetary outcomes.

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6.3 Uganda: a case study

Ishmael M Magona

Uganda has made significant progress in enhancing the credibility of its policy-making and budgeting processes. This has been achieved through increased involvement of key stakeholders including the private sector, civil society and the legislature. Bringing on board the legislators has not been an easy task and there are still several difficulties that must be overcome for the country to fully enjoy the benefits of their participation.

6.3.1 The Ugandan legislature

The Ugandan Parliament derives its mandate and functions from the 1995 Constitution of the Republic of Uganda, which provides the overarching framework, rules and procedures for policy making, budgeting and the oversight function of the legislature. The legislature in Uganda primarily plays an oversight role, through:

- passing laws for the good governance of Uganda;
- officially debating and enacting the budget;
- scrutinising and monitoring implementation of government policy and programmes;

- ensuring increased transparency and accountability; and
- representing the interests of individual constituencies.

Over the years, the legislature has evolved in structure and composition to suit the political, social and economic environment prevailing in the country. The present-day Parliament has just over 300 members: 214 constituency representatives, 56 district women representatives, 10 army representatives, 10 ex-officio members (the vice-president and ministers) and 5 representatives of each of the disadvantaged groups, namely the youth, persons with disabilities and workers.

Due to the 'movement' type of governance (in which parties do not exist officially) that has characterised Uganda's politics for nearly two decades, official figures on the party balance of parliamentary seats are not available. However, anecdotal evidence suggests low representation of the opposition in Parliament. This situation is likely to change greatly with the multi-party system, come the elections slated for early 2006.

In the movement system of governance, Members of Parliament (MPs) are elected on the basis of their 'individual merit' rather than through a party structure. This implies that when they engage in the policy and budget-making processes, they represent their own views and those of their constituencies, since the movement government has no comprehensive party-line positions across a large number of issues.

6.3.2 Involvement of the legislature in policy-making processes

The active involvement of the legislature in policy-making processes dates from the mid-1990s when government technocrats, led by the Ministry of Finance, Planning and Economic Development (MFPED), sought the participation of MPs in the formulation of the Poverty Eradication Action Plan (PEAP), which is also Uganda's Poverty Reduction Strategy Paper (PRSP).

The active and early involvement of parliamentarians in the planning process was vital for three key reasons: firstly, there was the need to ensure that the varying interests of the constituencies in the country were properly reflected in national plans; secondly, it was necessary that parliamentarians became aware of the main policy issues underpinning the budget that they enact; and, thirdly, it was important to make parliamentarians part of the group seeking solutions to key policy implementation bottlenecks.

In the initial years, only a few MPs participated in the planning processes; the others either were disinterested in activities that they considered to be outside their core business or had extremely busy schedules. There was a general lack of know-how within the government on how to involve the MPs effectively. Innovative

approaches that gradually led to the increased involvement of MPs in the planning processes included focused half-day consultative workshops exclusively for them, increased dissemination of summarised policy and budget documents to Parliament and the targeting of specific sessional committees.

However, at the beginning of 2000, we noted that it was not sufficient to involve MPs only in the planning processes; they needed to be part of the budget process as well if they were to be able to make informed choices in determining budgetary allocations to different national priorities. This realisation coincided with Parliament's increased assertiveness and demand to be more involved in the budget process adequately in advance of the budget being tabled for consideration and enactment.

6.3.3 Involvement of the legislature in the budget process

Prior to 2000, the budget was drawn up largely by government ministries led by the MFPED, with limited participation of other stakeholders. This made the budget less credible, as some of the priority concerns of specific sections of the population were not well reflected in the budgetary allocations. The situation has improved since then, with the enactment of the Budget Act in 2001, which provides for and regulates the budgetary procedures for a systematic and efficient budgetary process.

The budget process

Since the enactment of the Budget Act, the budget-making process has become more open, transparent and consultative, involving a cross-section of stakeholders, including Parliament, Cabinet, line ministries, local governments, the private sector, non-governmental organisations and development partners. These stakeholders have an opportunity of early and continuous involvement in the setting of priorities and the monitoring of public expenditure for social and economic development.

On the basis of the Budget Act, the budgeting process follows consultative procedures that are implemented every year. These are outlined below.

A *National Consultative Meeting* is held in October or early November at which all stakeholders including the MPs are given a chance to deliberate on the Medium Term Expenditure Framework (MTEF) and the Macroeconomic Framework and to raise issues that impact on resource allocation over the medium term.

Local Government Consultations start in November, providing local governments with an opportunity to raise pertinent issues that have implications for policy as well as for the overall resource envelope.

Sector-level Consultations provide Sector Working Groups with input to enrich their sectoral plans and budgets and to rationalise resource allocation targeting key poverty-reducing activities. Each sector submits its Budget Framework Paper

(BFP) to the MFPED by 31 December, and these are merged into a National Budget Framework Paper (NBFP).

Ministerial Consultations are held for the sector ministers to meet with the Minister of Finance to agree on critical policy and resource allocation issues. The NBFP is refined on the basis of these meetings and then submitted to Cabinet in March for agreement on the sector expenditure allocations.

Parliamentary Consultations then take place. The Budget Act requires the President to prepare and lay before Parliament the Macroeconomic Plan and Indicative Framework not later than 1 April in each financial year. Parliament is given one and half months to deliberate on the NBFP.

Within Parliament, the Speaker commits the indicative allocations to the Parliamentary Budget Committee and to each relevant Sessional Committee. The rationale for this is to enable Parliament to undertake a detailed review of the indicative allocations and make recommendations where necessary. The recommendations are submitted to the President on 15 May for consideration. The input of Parliament is used to finalise the budget and the budget speech, which is read on or before 15 June of every year.

Following the reading of the budget speech, Parliament approves the Vote-on-Account covering expenditures for the first four months of the financial year as it debates the draft estimates. It can then make variations or amendments to the appropriation of funds that may not have been directly addressed in the final budget presented by the Minister of Finance.

In case of dissatisfaction with any aspect of the budget, Parliament (through its committees) exercises its power and authority by calling on public officials (including ministers) to clarify matters and provide the necessary information and documentation. On several occasions, ministers and officials from the MFPED have been summoned to explain the rationale behind the inter- and intra-sectoral allocations, and it is on the basis of the explanations given that Parliament decides what the optimal allocations should be to various national priorities. This has made the MFPED more alert and professional in scrutinising the budget allocations and ensuring that the right priorities are addressed before the budget is submitted to Parliament for consideration.

6.3.4 Capacity enhancement

The Budget Act contains several provisions that require both the MFPED and the legislature to do things differently in order to improve budget efficiency and effectiveness. This has put pressure on these institutions to step up their capacity in all aspects that relate to the policy-making and budget processes.

The Ministry of Finance, Planning and Economic Development

Within the MFPED, the introduction of the Integrated Financial Management System (IFMS), results-oriented management and output-based budgeting, as required under the Budget Act, has necessitated that all officers in the ministry are trained in all these aspects in order to enable them do a better job. In addition, computerised packages have been introduced to enhance and speed up the interaction between central and local government. The ministry has found it necessary to prepare a long-term expenditure framework to enhance its forecast of revenues and expenditures in relation to the expected outcomes within a long-term horizon.

To enhance communication between the MFPED and the legislature, the ministry prepares various budgeting documents and provides Parliament with them well in advance to keep the legislature informed of the key emerging policy issues in the country. The enhanced capacity within the MFPED has led to an improvement in the whole budgeting process and the budget content, in terms of being more focused on the desired outputs and outcomes as they relate to the PEAP.

Parliament

During the past four or five years, Parliament has put considerable effort into strengthening its own institutional capacity in support of law making and budget preparation and monitoring, in order to comply with the new requirements under the Budget Act and to become more effective. The capacity enhancement measures include the following.

The Parliamentary Budget Committee and Budget Office

In line with the Budget Act, Parliament now has a Budget Committee as a standing committee, with all chairpersons of the other committees as ex-officio members. The Committee specifically scrutinises the preliminary estimates and the macroeconomic plan, reviews the national budget and compiles amendments, which are referred to the appropriate committees.

In executing its duties, the Budget Committee is supported by a Budget Office. The Budget Office consists of budget and economic experts whose specific roles are to:

- provide budget-related information to all committees;
- submit reports on the economic forecast, budget projections and options for reducing the budget deficit;
- identify and recommend bills that provide an increase or decrease in revenue and the budget;

- prepare analytical studies of specific subjects; and
- give general advice on the budget and national economy.

The work of the Budget Committee and Budget Office has increased the analytical capacity of MPs as well as increasing their access to key information needed in the budget process. This has led to improvements in the quality of debate in the house and speed with which matters are expedited. Officers of the Budget Committee and Budget Office have a close working relationship with the MFPED, interacting almost on a daily basis to discuss key policy issues and to access key budget documents and information as well as recent research findings.

Legislative support services

In the law-making area, there are trained members of staff who collectively are used by MPs to assist in writing and tracking legislation. The staff provide a legislative research and information service. Since coming into operation, these services have been heavily utilised by many MPs to do research on a number of topics and to support legislative initiatives.

The committee system

There have been important developments in the committee system, particularly in the area of budgeting. An effective system of dividing legislative labour to encourage specialisation, to assist in majority consensus building and to address the more specialised needs of constituents has been promoted, thus improving the efficiency and effectiveness of the legislature. Parliament is using its sessional committees, whose mandate is to oversee the budget, to monitor spending and performance of government programmes.

Increased interaction with civil society

Parliament has established an open working relationship with civil society organisations (CSOs), in order to support the legislature in the planning and budgeting processes through the provision of up-to-date information on service delivery and the impact of government programmes. CSOs are Parliament's allies in holding the government accountable, making the budget more effective and contributing to the capacity and knowledge of the legislature. For CSOs, the legislature is a primary channel for influencing budgetary decision making. Some CSOs have provided budget training to the legislature and have produced accessible guides to the budget process.

Parliament's effectiveness

The increased involvement of Parliament in the policy-making and budgeting processes has led to positive outcomes in terms of improving fiscal discipline and budget efficiency and effectiveness, albeit with some challenges. Armed with adequate information on the performance of the budget and the impact of government programmes, several steps are being taken to improve budget efficiency and effectiveness:

- mechanisms are being put in place to increase transparency and accountability within the public sector to enhance the reach and value for money of public services;
- rules and procedures that curb excessive borrowing have been introduced;
- a commitment control system is being promoted across government to ensure that expenditures are within the available resource envelope; and
- Parliament has introduced stringent measures to effectively manage the release of funds within the agreed ceilings – the funds are released by the MFPED in accordance with the limits set out by the Appropriation Act, and where a supplementary budget is needed, it has to be approved by Parliament.

In the area of accountability and audit, accounting officers are required to produce accounts, which are consolidated for audit purposes. The accounts are prepared in accordance with the Public Finance and Accountability Act of 2003 and the Local Government Finance and Accounting Regulations of 1998. The Auditor General audits the accounts and submits a report to Parliament. The Public Accounts Committee of Parliament then ensures that all queries raised in the report are addressed by the spending units concerned.

Parliament's increased effectiveness is also reflected in the way it is striving to improve the links between planning, budgeting and service delivery. The legislature continuously advocates for reallocations to reduce spending in areas that do not contribute directly to improved service delivery and poverty reduction. The MPs are also advocating for the following changes:

- eliminating wasteful spending and low-priority activities from the budget, thereby maximising value for money and efficiency in spending (e.g. reduced dependency on donor inflows and rigorous prioritisation of government expenditure on public administration, which takes a relatively large share of the budget, is needed);
- ensuring that the NBFP is increasingly outcome-oriented;

- increasing the effectiveness of the commitment control system to reduce the stock of domestic arrears;
- rationalising expenditure and improving accountability within the defence sector;
- limiting supplementary expenditures that are a major source of budget disruption; and
- improving linkages between the PEAP priorities and the budgetary allocations.

6.3.5 Conclusion

In spite of the increased involvement of the legislature in the budget process, there are still some challenges. It is not uncommon that, due to social and political pressures, funds are sometimes shifted to purposes other than those for which they were approved.

The oversight demands on the legislature are challenging because budget cycles overlap. Simultaneously, the legislature might be approving one budget, monitoring the implementation of a previously approved budget and considering audit reports of the already implemented budget. These pressures sometimes make Parliament less efficient in scrutinising the budgetary allocations, let alone having sufficient time to participate effectively in the budget process.

Based on Uganda's experience, these challenges can only be overcome gradually as we strengthen the capacity of the legislature and its interaction with the budgeting process by: increasing Parliament's research capacity in budget issues; increasing Parliament's access to comprehensive, accurate and timely information on different policy and budget issues and audits; strengthening the system of specialised committees; and allowing sufficient time for legislative scrutiny of draft budgets.

7

Angola: a contribution to the debate

7.1 Introduction

Public finance management reforms never occur in a vacuum. They are a reaction to public institutions that developed within a specific political and economic context and which subsequently have become dysfunctional in the pursuit of a state's new development objectives. At the same time, they are often coupled with broader economic reforms and occur within a particular political economy and within sets of bilateral and international financial, economic, trade and political relationships, which may influence their design and implementation. The essay on Angola addresses the political, social and broader economic context of public finance reforms in the country. It draws upon historical perspectives on economic development in Africa and on the country's own experience. It illustrates how economic structures and governance systems have been directly linked to the platform of natural resources and social relationships in Angola and in Africa generally.

The Angolan paper was a voluntary contribution to the 2005 seminar. It was not part of the formal programme and was presented during a lively evening seminar session convened for the purpose. It stimulated much debate and introduced themes that were brought into the subsequent formal and informal discussions during the seminar. CABRI welcomes this initiative by a member country to use the network as

a platform for debate amongst peers and, therefore, is pleased to include the essay in this 2005 seminar resource materials volume.

7.2 Economic reforms in Angola in the general context of Africa

Dr Adriano Neto & Dr Ilda Jamba

This paper will firstly discuss reforms that have been undertaken in Angola, given its historical background, and then it will discuss the effects of these reforms and point out future challenges that the country is facing. The study will conclude with a broader analysis of the political and economic situation in Africa.

7.2.1 Economic reforms in Angola

The current political environment

After end of the 27-year civil war, the process of consolidating democratic institutions has shown good results, especially with the ruling party revealing its agenda for the next elections in 2006. The Angolan government has outlined several goals that will aid economic and social reconstruction, amongst which are the eradication of hunger and poverty. Other goals include capacity building for state institutions as well as ensuring sound state administration and the administration of justice across the whole country.

Box 1

A brief historical background of Angola

In 1482, Angola was discovered by Portuguese explorers and became a link in trade with India and Southeast Asia. Later, it was a major source of slaves for Portugal's colony of Brazil.

In 1975, following a 14-year war of independence, Portugal finally granted independence to Angola. No period of peace followed, however, as the National Union for the Total Independence of Angola (Unita) disputed the ascendancy into power of the Popular Movement for the Liberation of Angola (MPLA). As a result, civil war broke out almost immediately.

With the fading of the cold war and the withdrawal of Cuban troops in 1989, the MPLA began to make the transition to a multiparty democracy. Free elections took place in 1992, with the serving president José Eduardo dos Santos and the MPLA beating Jonas Savimbi and Unita at the polls.

There were four years of relative peace between 1994 and 1998. In 1997, it was agreed that a coalition government with Unita would be implemented, but Savimbi violated the accord repeatedly by refusing to give up his strongholds, failing to demobilise his army, and retaking territory. As a result, the government suspended the coalition rule, and civil war spread across the country again.

In 2002, government troops killed Jonas Savimbi and, on 4 April that year, rebel leaders signed a cease-fire deal with the government. This was the end of the civil war.

Although peace finally seemed secure, more than a 500 000 Angolans were facing starvation. Thousands of refugees returned to their country in 2003, but their prospects remained doubtful. Today, Angola is the second-largest oil producer in sub-Saharan Africa, yet its people are among the continent's poorest.

The government has also been intensively engaged in diplomatic initiatives to expand the country's international relationships and to diversify its economic partnerships. Contacts have been strengthened with South Africa, China, Brazil and Israel. China is Angola's second-largest petroleum export destination and one of the key financiers of the government's plan for infrastructure development.

The global increase in petroleum prices and the ease of obtaining bilateral finance credit (mainly guaranteed by the petroleum revenue) eliminated pressures for an agreement between Angola and the International Monetary Fund (IMF). While the IMF is positive about Angola's future and has paid tribute to the progress in its economy, the relationship between the IMF and the Angolan authorities has cooled. At present, there are no prospects of a traditional financial support programme.

However, developments have taken place that indicate the return of a supportive relationship between Angola and the IMF.

Currently, the Angolan authorities are more inclined to resort to a new IMF aid instrument, involving presenting to the IMF a plan with policies that focus on achieving economic stability. The country will not seek financial support from the institution, but rather economic advice and IMF assistance in monitoring the plan's execution. In this way, the risk of interference, which, according to the Angolan authorities, is always associated with a traditional financial support programme, is diminished.

Economic reforms and developments

The models adopted by Angola after independence were in line with those followed in the international arena. In 1975, Angola was identified as believing in a strong state that would solve all the social and economic difficulties faced by the society. By 1990, however, following international trends brought about by globalisation, the country adopted the fundamental ideas of a multiparty political system and a market-oriented economy, together with the processes of political and economic liberalisation that remained in line with the phenomenon of globalisation.

Since 1990, with the support of bilateral and multilateral donors, Angola has implemented a series of initiatives aimed at reforming its public administration. In 1996, with assistance from the United Nations Development Programme, the country launched a Programme for Institutional Reform and Administrative Upgrading, which focused on decentralising and modernising public administration, and reducing its level of bureaucracy. The more effective programmes turned out to be those that focused on improving public services. In 2002, the Programme for Institutional Strengthening of the Public Administration was implemented. Subsequently, in the administrative scope of the Ministry of Finance, budgetary procedures were established and put forward as 'golden rules'. These were in accordance with the universally accepted principles for good management of public finance, particularly emphasising the principles of transparency, accountability, discipline and financial equilibrium. Given scarce resources, justification of public expenditure also became a central feature of the budget process.

The year 2003 is generally considered as marking the beginning of a new era, closing the cycle of 27 years of war, and presenting some achievements through the economic reforms, especially with regard to monetary and exchange policies. Considerable stability in the currency markets and a revalorisation of the national currency were achieved. The following were key positive indicators:

- a slowing down of inflation rates (annual accumulated inflation dropped from 116 per cent in 2001 to 106 per cent in 2002 and 76 per cent in 2003, and since 2003, it dropped further to 31 per cent in 2004 and 20.5 per cent in 2005);
- greater stability in exchange markets; and
- increasing confidence in the national currency.

Stabilisation and development of the financial system

The Angolan financial sector (consisting mainly of credit bank institutions) has also shown signs of growth and improvement in terms of upgrading its systems and synchronising its regulations with those on the international scene. The implementation of the ATM machine sub-system also marked an improvement in the payment scheme, which now covers payment operations processed through electronic cards that are valid or accepted throughout a network of ATM machines and debit-card facility terminals. In addition, the economy has witnessed a healthy increase in competition due to: the opening of a greater number of credit institutions; the expansion of the compulsory reserves for long-term deposits; and the liberalisation of currency sales for exporters (through a mechanism of resources linked to import operations) and for individual residents (who do not have to submit proof of shipment).

Capital markets were established with the negotiation of treasury bills, constituting a landmark development in the financial system, and the Central Bank strengthened its role in foreign exchange markets. Co-ordination between fiscal and monetary policy resulted in simultaneous enforcement of fiscal discipline and restrictions on money supply. This contributed greatly to the easing of inflation. The fiscal deficit decreased by two percentage points in 2003 (from 9 per cent in 2002). The goal for 2004 was 4 per cent. Public expenditure for that year had a primary surplus of 1.1 per cent of GDP, and estimates for 2005 leaned towards an even higher surplus of 3 per cent.

A key instrument in achieving fiscal discipline was the introduction of cash budgeting. Whereas previously spending departments and agencies were funded through monthly guaranteed releases of cash against budget, they now had to justify their planned expenditures quarterly and were given cash releases in line with actual government revenues. A peculiar feature of Angolan budget execution, however, remains taking on expenditures on commitment and delaying payment internally.

A considerable change has been seen in public investment behaviour; between 2002 and 2003, it more than doubled (an increase of 115.6 per cent), which testifies to the government's real engagement with the urgent rehabilitation of physical infrastructure that is vital in order to foster economic growth. Given the easing of the

fiscal situation, there is some argument that the current level of investment can be increased even further (in the interest of long-term growth and poverty eradication) without causing short-term macroeconomic deterioration.

The highlights of future developments of the Angolan economy include a structuring of the national economy and integration of the different sectors in systems that anticipate better distribution of realised earnings, and placing greater emphasis on job creation for the Angolan people. A more detailed report on future reforms is outlined in the next section.

The prospects for future reforms and changes

For the period 2005–2007, it is anticipated that annual economic growth in Angola will reach an average of 18 per cent. Simultaneously, inflation should continue to slow down, reaching 5 per cent in 2007. The basis for this impressive scenario, which will place Angola amongst the higher growth-rate economies, lies in the expansion of the petroleum production sector. As for the non-petroleum related sectors, expectations are more modest, in spite of the presence of diamond deposits and resources potentially related to agriculture. It should be noted that forward projections of economic growth in Angola are subject to limitations in the current statistical base. Therefore, they should be seen as indications of a trend. However, there are several projects and programmes that the government has undertaken (or is planning to embark upon) that will support outcomes in line with the projections.

Firstly, the successes of the public finance upgrade programme, which includes modernisation of customs services towards greater fairness and predictability and fiscal reforms, underpin continued good results. Soon a new law, the Accounts and Auditors Act, will come into force, stipulating compulsory auditing of companies' accounts systems, which will contribute to improved tax administration.

The further modernisation of budgetary and financial management methods is perhaps the greatest challenge the Angolan government has taken upon itself. Amongst other initiatives, a modern budget structure has been introduced to reflect the consolidated budget of the public sector (combining the budget of the central state administration, autonomous institutions, funds and public enterprises). A treasury single account is in operation and transactions involving treasury bonds have been rationalised and made transparent. These operations are underpinned by efforts to improve the relationship between the National Treasury and the Central Bank in order to ensure that undesired monetary effects do not reflect on the financial performance of the state budget. A decree is also in force regulating the procurement of goods and services by the state, which is receiving bilateral support from the government of Norway and technical assistance from the IMF and the World Bank.

Secondly, there are programmes aimed at diversifying growth and enhancing it in other economic areas. Structuring sectors for a new domestic economy – energy, the processing industry, agriculture and construction – will gradually increase their share of participation in the GDP: 28.7 per cent in 2005, 31.7 per cent in 2006 and 34.9 per cent in 2007. The combined effect of growth in the petroleum and gas industry and other sectors is that GDP per capita is expected to expand from US$1 400 to US$1 900 per annum between 2005 and 2007 in nominal terms.

However, there are still limitations in the economic and social developments of the country. For example, there have been no substantial changes in the composition of public expenditure investment towards the health and education sectors, or towards implementing a medium-term macroeconomic plan or the relinquishing of foreign finance through the access to petroleum-secured loans.

In summary, the optimism that might arise with regard to the Angolan economy results essentially from the impact caused by the rise in petroleum prices, which caused greater acceleration of the GDP, higher fiscal earnings, the possibility of reducing foreign debt and the controlling of inflation. Prospects for the development of sectors other than petroleum, improvement in inflation rates or growth of monetary reserves showed very little change.

7.2.2 Economic reforms in the general African context

Economic reforms and developments in Angola should be seen in the general African context. As is the case with many other African economies, Angolan economic development and its relationships with other states are dominated by its rich natural resources.

Centralising regimes: origin and economic reasoning

Despite the struggles for independence having had different effects on different countries, the states of Africa share many characteristics that have deeply marked the post-independence period. The most outstanding of these is economic dependence on natural resources, which makes the countries extremely vulnerable to world market fluctuations and to climate changes. This dependence occurred mainly for historical reasons.

Firstly, the economic structures inherited from colonialism were essentially directed towards the production and extraction of basic raw materials. Secondly, after the disappearance of the colonial systems, the economies did not have an autochthonous class of entrepreneurs that could respond to world market changes and lead the necessary economic diversification. There were few Africans who were owners of capital companies, with access to the markets and with the technological capacity

for competing internationally; and the infrastructure itself created obstacles to the development of markets. The lack of an African class of entrepreneurs led to the creation of alliances with foreign companies that remained in these countries after independence, in order to preserve economic growth during the transition period. Thus, after independence, the pillars of these economies were mainly foreign mining and agricultural companies.

In this context, four main strategies for wealth accumulation dominated the economic structures in the region:

- state capitalism;
- a monopolistic production regime;
- public regulation of grassroots agriculture, and
- large agricultural plantations.

With the state at the centre of economic development, state capitalism based on revenue became the key form of capital accumulation in the mining, agricultural and energy sectors. With state control expanding over these sectors of natural resources, governments ensured a permanent influx of revenue to finance their development priorities.

As states became aware of the need for economic reform programmes, reserves of natural resources played a role in what programmes were adopted and how these programmes were implemented.

Natural resources, economic reforms and African reality

As far as the political economy point of view is concerned, the relationship between economic reforms and natural resources can be summarised in two basic questions:

- In what way do economic reforms alter the position of the economic agents in terms of the control of resources?
- Through which political and economic processes or relations are the transfers of the control of resources made?

All the economic reform programmes that have been implemented in African economies contain basic elements of the so-called Washington Consensus or neo-liberal economic paradigm. The latter constitutes the reasoning of the global economic policy driving globalisation. The Washington Consensus has the following presuppositions:

- the market is the only means for allocating resources – if there are structural distortions in the economy, such distortions are caused by public interventions;
- the private initiative is the only one capable of rationally using the resources, because the economic agents try to maximise their use and act in compliance with the rational expectations; and
- there is freedom of circulation of the resources within and outside the country.

Based on these presuppositions, the neo-liberalism movement believes in:

- reducing the state's role as an economic agent and stimulating private economic agents to become the driving force of the national economies;
- dismantling domestic barriers to the international flow of goods and capital so that export-oriented growth can lead to national and global economic expansion; and
- national institutions, including the legal codes, the regulatory systems and the regimes of ownership, need change in order to support economic reforms.

These recommendations and the subsequent reforms enhanced open-economy operations in states rich in natural resources. Yet despite positive expectations, the results had contrary effects. Social imbalances increased at national, regional and global levels, constituting a direct challenge to the approach and the international financial institutions (IFIs) associated with it.

Notwithstanding, it is only fair to acknowledge that economic reform programmes enabled such countries to launch a process for the transfer of control over natural resources from the state to private economic agents. The first step in such transfers was towards foreign companies, which offered considerable investment capacity and afforded wide access to international markets. Concessions were also granted to national economic agents for the exploration of natural resources, but on a smaller scale than with foreign companies.

These changes were driven mainly by conditions attached to support programmes agreed to with the IFIs. The privatisation of natural resource sectors became a key goal for reform programmes, supported by the provision of guarantees for the private sector. Thus, the IFIs were instrumental in the conceptualisation of a new institutional framework for economic policy.

However, problems relating to the redistribution of wealth soon arose in the affected

countries. This made the IFIs integrate a political dimension into their approach, from a rejection of political influence over structural reforms, to an acceptance of the political complexities of economic reform, leading to the current and more normative approach, which leans towards the fostering of good governance.

According to Michel Camdessus, former IMF Director-General, to achieve good governance one should 'maximise government's financial operations transparency and create systems that minimise the possibility of making ad-hoc decisions that privilege the treatment of persons and organisations'. These are the principles that now underpin governments' relationships with the IFIs and serve as criteria to grant or refuse developing countries' access to financial resources from the international community. In effect, countries are forced to adopt market-oriented economic structures, leading to:

- The end of monopolies in key economic sectors. Policies are designed to put an end to monopolies, at both state and private level, in order to free key economic sectors and distribution mechanisms.
- Curtailing state capitalism and encouraging market-oriented wealth accumulation. This can be achieved through the privatisation of public enterprises, dismantling of business centralisation, opening of markets to private investors and eradication of other various situations involving revenues and government agencies.
- Increasing the relevance of rural areas compared to urban areas. This objective may be achieved by a series of fiscal reforms aimed at reducing subsidies for urban workers, by the lifting of explicit and implicit taxes on agricultural products and by improving the services rendered to rural populations.

The objective of these changes suggested by the international community is to increase competition amongst the various agents and economic groups, and to lead governments to adopt more transparent mechanisms to settle conflicts of interest. As the critical competing economic groups emerge, centralised systems for economic decision-making become more and more inadequate to manage the new economic dynamics.

The basic idea behind the concept of good governance is to establish institutions and regulatory systems that are capable of running effective markets. Transparency and stability in economic interaction are key aspects of good governance. It is still not very clear how markets would be compelled to execute priorities and strategies defined by society.

Initially, the IFIs believed that reform implementation consisted mainly of apply-

ing a set of neutral economic instruments aimed at creating more efficient economies, increasing productivity and encouraging competition. The instruments that were to be used to achieve this were designed to increase general social well-being. Any costs associated with the reforms were regarded as provisional and soon to be outweighed by the gains. The concept of neutrality soon collided with the phenomenon of the political complexity and social impact associated with the implementation of reforms in sub-Saharan Africa, South America and Asia at the end of the 1980s and beginning of the 1990s.

At that time, the big wave of democratisation in Africa made the IFIs think that these new regimes offered a better opportunity for implementing economic reforms, because they were chosen by a popular vote and had a clear political mandate. However, due to the instability of most of these democratic regimes and the pressures from different interest groups, they became unpredictable partners in the implementation of the economic reforms. Issues not directly related to the implementation of macroeconomic policies, but to social justice (with the dynamics of the rural sector and with the role played by the different ethnic, social and cultural groups) rapidly affected reforms. There was no way to deny the political realities in the economic reform process.

World Bank Vice-President Ernie Stern summarised this when he stated the following:

> We emphasize enough that economic reforms represent a vast redistribution of the economic power and, subsequently, in many countries, the political power. These are not neutral changes. They do not happen easily or just on their own. The political predicament implicit with economic reforms took considerably longer to be implemented in some countries. I believe that, if the World Bank does not understand the process, it cannot provide further assistance.

One can say that during certain periods the African economy lost track of reality and remained in a virtual universe of economic formalism and romanticism, increasingly moving away from the reality of procedures peculiar to production, distribution, consumption, accumulation and sharing. This has had consequences at the political level, as much as politics have impacted on economic reforms. Thus, from an economic perspective, one must refer to many different 'Africas' in terms of development and political stability.

Firstly, the Africa of tumults; condemned to a vicious circle of civil war, this is the area of violent economy with its own rationality and search for wealth, with the warlords in control of drug trafficking and diamond and petroleum smuggling.

Frequently, this entails vast vacant areas around mining sites and oil wells that are controlled by armed groups financed by such activities.

Secondly, the relatively stable Africa; although not yet achieving a high rate of development, but with a favourable political and institutional environment, these states are able to impose juridical rules on companies in order to ensure a stable macro-economic system within the prescribed fiscal policy and balance in public finance, together with a restrained rate of inflation and an exchange rate that is attractive to local producers. In such countries, public authority is capable of carrying out reforms in the areas of health and education, of implementing programmes to promote urban employment and of improving transport, while adopting policy guidelines that aim to increase real productivity to support established companies.

Thirdly, the emerging Africa; this covers the countries showing rapid growth rates and experiencing significant transformation processes. These are the countries in West Africa, in the triangle demarcated by Ivory Coast-Mali-Burkina Faso and, on the other side, Ghana and Benin. In the north of Africa we have Tunisia as an example. In Southern and East Africa we may point to South Africa, Botswana and Uganda, which have been showing positive and increasing growth rates since 1997.

Over and above these groupings, there are some trans-cultural economic networks, which escape the control of African states, while living in parallel economies and crossing borders with their own logistical means and possessing their own systems of monetary circulation.

7.2.3 Conclusion

There are very specific political-economy issues concerning countries with economies that rely on natural resources, which need to be addressed in order to consolidate the political processes of such countries and ensure development, notwithstanding their differences, at democratic, cultural and traditional levels of public administration. In spite of disparities between economies, a key set of government initiatives can contribute to creating a political economy that is anchored in transparency, accountability and good governance:

- A clear and articulated structure of targets and reliable legislation, which helps the government and its partners to attain the results that the citizens are fighting for and which balances the need for government oversight and facilitation with economic freedoms.
- Leadership exercised by politicians and officials in order to achieve such result-oriented governance. This requires the reform of government decision-making processes and changes in the bureaucratic culture to support the

development of horizontal policy. The impetus for such change must come first from the government policy-makers and the central agencies.

- However, leadership alone will not suffice to transform the governing processes. It becomes important to transform the governing processes and to create structural incentives so that the independent departments can co-operate thoughtfully.
- Another important aspect is the circulation of results. This permits the governing departments and their partners to review their performance and refine their initiatives as time passes. In addition, the circulation of results can create an incentive for these agencies to remain focused on the goals of the society, as citizens remain engaged in policy and governing processes. Over time, this can only serve to increase the government's legitimacy.

While the central government has the right and duty to define the state's orientation and its goals, the executive agencies' frontline needs to operate locally, with knowledge, capacity and the practical networks necessary to attain successful reforms. The processes should work in both ways. The centre needs to learn from the localities about implementation, and the local institutions need to learn from the centre about commitment to the goals of reform. The protectionist system of budget categories is the most severe limitation to extending the benefits of interaction and collaboration amongst government agencies. It is what helped in creating the fragmentation that now motivates collaborative efforts and it is what blocks these successful efforts in the implementation of programmes.