Macroeconomic and Financial Management Institute of Eastern and Southern Africa

public expenditure and financial management handbook

MACROECONOMIC AND FINANCIAL MANAGEMENT INSTITUTE OF EASTERN AND SOUTHERN AFRICA

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Public Expenditure and Financial Management Handbook

December 2008

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FOREWORD

The preparation of the Public Expenditure and Financial Management Handbook was motivated by the compelling desire by MEFMI to address in a tangible manner some of the critical capacity gaps impacting on macroeconomic management in the region. Based on several interventions in capacity building over the years, the institute identified serious weaknesses in management of public expenditure notwithstanding the existence of some handy guidelines notably from the World Bank. This handbook has benefited immensely from the very sound foundations laid by earlier documentation from the World Bank in particular. The point of departure and major orientation of this handbook, however, is a special focus on the situation of Sub-Sahara African countries with deliberate efforts to put the whole public expenditure management process within the regional context.

As is well documented, many countries in the region have over the years engaged in various structural adjustment reforms. The reform programmes invariably included comprehensive reviews of public expenditure. In recent times the Poverty Reduction Strategy Programmes (PRSPs) have been very much in vogue. Effective implementation of these calls for sound public expenditure management.

The handbook thus seeks to provide Public Expenditure and Financial Management (PEFM) practitioners in governments, civil society and donors in the MEFMI region with a practical tool as well as a handy reference guide for strengthening and implementing reforms in all aspects of their public expenditure and financial management systems. The scope of the handbook includes a conceptual framework for PEFM; experiences of PEFM reforms in the MEFMI region, and the rest of the world; practical guidance on introducing and implementing all aspects of PEFM; and practical tools (the PEFM Assessment Tool) for assessing systems and capacities for PEFM.

The handbook as earlier intimated seeks to compliment the comprehensive guidelines contained in the handbook prepared by the World Bank, customised to include the needs and systems specific to the MEFMI member country context. This was partly achieved by working with member states throughout its preparation including involving a team of experts responsible for PEFM from member states to participate in the final review.

It is our sincere hope as MEFMI that the handbook will prove to be a valuable tool for various levels of public officers involved in the design and execution of public expenditure programmes. Needless to say the handbook should be seen as a live tool that will always benefit from continuous feedback from stakeholders. The Institute will therefore welcome inputs and comments to assist further refining of this document to take account of new developments in macroeconomic management in the region and beyond.

Ellias E. Ngalande (PhD)
EXECUTIVE DIRECTOR

ACKNOWLEDGEMENTS

The Handbook was prepared by Ms. Elizabeth Muggeridge and Mr. Tony Mends of Consulting Africa assisted by country teams under the guidance of the Macroeconomic Management Programme of MEFMI. In this respect, MEFMI acknowledges the outstanding quality work and the high level of professionalism showed by the consultants while preparing this Handbook even under tight deadlines at various stages of preparation.

The Handbook also benefited immensely from a wide range of inputs from a team of experts in Public Expenditure Management drawn from the MEFMI region who participated at various stages of the preparation. Here we single out the initial contributions by team members from member states who provided feedback through completed questionnaires on the proposed outline and content of the Handbook, namely; Malawi, Swaziland and Zambia. A special recognition is extended to the group of country teams from Botswana, Kenya, Malawi, Lesotho, Mozambique, Namibia, Swaziland, Tanzania, Uganda and Zimbabwe who participated in a review workshop held in September 2008 in Livingstone, Zambia. Their enthusiasm and commitment provided inspiration and numerous useful inputs which were key in customising the handbook to be more relevant to the region. MEFMI also acknowledges the outstanding final editorial work done by Mr. Anthony Higgins.

The Programme also acknowledges the initial contribution by Mr. Dumisani Masilela, the Principal Secretary of the Ministry of Finance, Kingdom of Swaziland who during the early stages was a programme officer in MEFMI at the time when the project was first conceptualised.

The project was carried out under the overall guidance of Dr. Ephraim Kaunga, Programme Director, Macroeconomic Management Programme and Mr. Amos Cheptoo, Programme Officer.

Executive Summary

Objectives and Scope of the Handbook

MEFMI currently runs Public Expenditure and Financial Management (PEFM) courses for its member countries which provide an overview of the issues and techniques in effective PEFM systems, whilst also providing an opportunity for member institutions to share their experiences in this area.

Most MEFMI member institutions are implementing a number of Public Expenditure and Financial Management reforms and the Handbook seeks to provide useful information on the experiences and approaches to the implementation of PEFM reforms.

The MEFMI PEFM Handbook is a reference document for officials responsible for all aspects of PEFM including practical suggestions for strengthening PEFM systems and implementing reforms within MEFMI member institutions.

There have been a number of documents produced on Public Expenditure and Financial Management, including the Public Expenditure Management Handbook produced by the World Bank and most recently Managing Public Expenditures produced by the Organisation of Economic Cooperation and Development (OECD). These documents and others provide very useful background to PEFM principles and issues, and references are provided throughout this Handbook to these documents.

However, there has been limited documentation of the MEFMI member institutions PEFM reforms apart from the documents produced as part of the PFM Performance Measurement Framework (PEFA) and in seminars such as those organised by the Collaborative Budget Initiative (CABRI).

The representatives of MEFMI member institutions attending a workshop in September 2008 at which the draft Handbook was reviewed agreed there is a need to undertake case studies of MEFMI member institution reforms and develop best practice in the implementation of these reforms.

Overview of Public Expenditure and Financial Management

In the past, public sector financial management focused on ensuring that government expenditure and revenue were controlled in line with the overall approved budget levels and also that ministries abide by the financial legislation and regulations.

This approach to managing public finance has not delivered the key requirements of improving the quality and impact of public resources. In recent years governments and donors have focused on wider issues through Public Expenditure and Financial Management reforms which include:

- Ensuring that limited resources are allocated to priority areas over the medium term
- Ensuring that all resources are planned and managed together, i.e. Recurrent and Development (Capital), government and donor so that they are all targeted at the same priority areas
- Increasing transparency in the use of public funds
- Introducing a performance focus in planning and budget management so that the results of public expenditure are more clearly identified at the planning stage and can be reported on during implementation
- Ensuring that the planning, management and reporting of public funds meet international standards.

Addressing these issues involves widening the scope of financial management to include consideration of:

- Ensuring that stakeholders' roles support these principles
- Introducing and implementing appropriate sanctions and incentives to encourage improved service delivery
- Providing increased freedoms for managing public funds, while also holding managers accountable for delivery of improved performance

Institutional and Legal Framework

PEFM Institutional Framework

The institutional framework for Public Expenditure and Financial Management consists of the key stakeholders who have an interest in the PEFM system, both within and outside government, the roles of the stakeholders, the information provided to them and how they interact with each other.

Ensuring that there is a clear and functioning institutional framework is now seen as a key component of an effective PEFM system. It is possible that sound processes, regulations and controls may be in place but the impact of these can be undermined if the institutional issues are not addressed at the same time.

Key institutional issues and challenges in the MEFMI region include ensuring that there are clearly defined roles and responsibilities for PEFM, that these are followed in practice and that effective champions are identified to lead PEFM reforms. One of the most common issues faced by MEFMI member governments is the merging and separation of Ministries of Finance and Planning. While there is no correct institutional structure for these two functions, it is important that roles and responsibilities are also more closely coordinated in line with more integrated planning and management of resources.

Capacity building is a key issue to be addressed in reforming and strengthening PEFM systems, and the reform process itself needs to include capacity building programmes.

Legal Frameworks for PEFM Systems

All countries have a legal framework within which the PEFM system operates. In many countries the Constitution will include requirements for effective PEFM, with the more detailed requirements being covered in financial laws, regulations and operational procedures.

Although all governments will have these regulations in place, often these are not complied with, which undermines the effective and transparent implementation of PEFM systems. Many governments are in the process of reviewing and updating their financial legislation framework and it is important that these reforms are based on a clear and widely agreed set of objectives and principles for the operation of the PEFM system.

Reforming PEFM

In developing countries, reforms to Public Expenditure and Financial Management systems have focused on improvements in the following areas:

- Fiscal discipline which was a significant driver of reforms in some countries such as Uganda starting in the 1980s
- Improved allocation of resources in line with priorities between and within sectors
- Improved efficiency and effectiveness of expenditures

Additional objectives include improving transparency, accountability, and predictability in availability of funds, wider participation of stakeholders and legitimacy of the PEFM system.

Specific reforms to PEFM systems include:

- The **Medium Term Expenditure Framework (MTEF)** which seeks to improve the links between planning and budgeting, to ensure that limited resources are allocated within a three year hard budget constraint, and to improve the services delivered with public funds and their impact on the population
- **Integrated Financial Management Information System (IFMIS):** the introduction of computerised financial management systems with an emphasis on improving the accuracy, timeliness, control and management of public funds.
- Strengthening management processes such as **procurement reforms, payroll and personnel management reforms**
- Bringing systems into line with **international standards** such as accounting standards, internal and external audit standards
- Reforms to the **legal framework** through the introduction of new legislation and strengthening the roles of the oversight organisations

In some countries reforms have been implemented as a single reform. In others they have been introduced as part of a comprehensive PEFM reform programme, with a number of reforms being implemented at the same time in an integrated programme. While there is no single correct way of implementing PEFM reforms it is important that they are government led, and take account of stakeholder roles and interests.

Planning Approaches

Governments will prepare and implement a number of planning documents and processes including:

- National plan documents: long term and medium term plans, Poverty Reduction Strategies, Medium Term Expenditure Framework and Growth Strategies
- Ministry level plans including strategic plans
- Local government and community level plans
- Project plans and Public Investment Programmes
- Sector wide approaches

Previous approaches to development planning tended to be separate from the budget process resulting in:

- A shopping list approach as the activities in the plan documents were often not constrained by the level of funds available in the budget
- The plans not being implemented through the budget

In addition development plans usually focused on the development budget, i.e. on individual development projects with insufficient emphasis on planning and assessment of the policies and services implemented through the recurrent budget

Recent reforms to planning processes include the increased focus on poverty reduction through the Poverty Reduction Strategy Paper (PRSP) process and more recently on economic growth as the means to reducing poverty through the preparation and implementation of Growth Strategies.

Increased emphasis is also now placed on:

- Linking the planning and budget process through the Medium Term Expenditure Framework (MTEF) process so that ministry plans are developed within the framework of the funds that will be available in the budget
- Focusing the planning of individual projects within a wider framework of a ministry's programmes and policies
- Integrating the preparation of the recurrent and development budgets

The Medium Term Expenditure Framework

The Medium Term Expenditure Framework (MTEF) process was introduced to enable the achievement of the three objectives of:

- Improved fiscal discipline
- Improved allocation of resources in line with priorities
- Improved efficiency and effectiveness of expenditure

Achieving these objectives involves a top down and bottom up approach of matching limited resources with unlimited needs. More specifically:

- Defining the availability of resources (both government and donor) over the medium term (usually three years) through the development of a macroeconomic and fiscal framework
- Dividing these resources between the spending programmes of line ministries on the basis of government priorities, which involves line ministries providing an indication of their funding requirements as an input into the setting of ceilings
- Ministries preparing a three year performance based, integrated (recurrent and development) budget, focusing scarce resources on priority activities

Most MEFMI member governments have introduced some form of the MTEF approach to planning and budgeting, with varying degrees of success. Some governments started with a focus on defining the fiscal framework and line ministry ceilings (i.e. the top down element), while others focused more on the three year performance based budget process (i.e. the bottom up process).

As the process has been in place for over ten years in some governments, both elements of the process are now being addressed by most governments in the MEFMI region.

Budget Preparation Principles and Processes

Until recently budget preparation processes have tended to focus on a detailed line-item approach to the recurrent budget and a separate development or capital budget. This meant that budget preparation focused mainly on inputs rather than outputs or the goods and services to be produced with approved funds.

Many MEFMI member governments have introduced a range of reforms to the budget preparation process through the introduction of the Medium Term Expenditure Framework (MTEF) process.

These reforms have included:

- A three year time frame for the budget estimates: the first year being approved by Parliament and the second and third years presenting indicative estimates
- Introducing a stage in the budget preparation process which enables line ministries to provide an input to the setting of ministry ceilings
- Introducing a performance focus in the budget by linking budget estimates to the levels of performance to be delivered
- Introducing a level of political involvement to the setting of ceilings and to the allocation of resources to priority programmes.

While these new approaches to budget preparation have been implemented for a number of years, ensuring that these reforms provide the full benefits requires:

- Ongoing assessment of the reforms to identify strengths and weaknesses
- Ministries to continuously assess their programmes, outputs and activities rather than the new processes becoming incremental
- Linking improvements to budget preparation to budget implementation, performance monitoring and evaluation

Budget Coverage, Presentation and Approval

Budget information and documents in many developing countries tend to focus on detailed estimates of revenues and expenditures, focusing on the inputs required to implement the budget. This is because the main emphasis of budget preparation and management traditionally has been on the control of inputs.

Reforms to budget classification and preparation processes enable improved budget presentation, analysis, scrutiny and approval, focusing on:

- The medium term, providing a strategic overview of revenues and expenditures
- A performance basis showing the performance to be delivered with the approved funds
- A programme focus showing the broad functions of the budgeted expenditures
- Meeting international accounting, statistical and fiscal transparency standards
- Ensuring that the budget information and presentation is comprehensive, i.e. all government and donor funds are included
- Making budget documents more user friendly while taking into account the needs of the various stakeholders

The improvements in budget information should also enable a more thorough analysis and approval of the budget based on whether government funds are being allocated in line with priorities over the medium term.

Budget Implementation

Budget implementation is a crucial stage in the PEFM cycle, but often is not given sufficient attention in PEFM reforms, which have tended to focus on improving budget planning (MTEF) and accounting and reporting (IFMIS).

Existing budget implementation systems in many MEFMI countries are still focused on line-item controls, which are very cumbersome and do not give managers the freedom to manage their funds effectively. At the same time existing rules and sanctions are not always applied when funds are misused.

At the same time there has been limited emphasis on performance in the way that the budget is implemented and managers are not being held accountable for delivering improved levels of performance and service delivery.

Strengthening budget implementation involves:

- Linking the implementation of the budget (cash planning, release of funds and use of funds) to a well developed plan of action and outputs
- Reviewing existing financial regulations, the use of incentives to reward good performance and the use of sanctions to discourage misuse of public funds
- Streamlining budget implementation procedures to provide more managerial freedom and to speed up service delivery
- Requiring the regular reporting on both financial and physical implementation

In addition to these technical reforms it is even more important to encourage the creation of a new culture of budget implementation-one that encourages managers to manage scarce resources so as to deliver effective services to the public, rather than simply focusing on expenditure control.

Accounting and Financial Reporting

Accounting and financial reporting systems have faced a number of serious weaknesses in developing countries resulting mainly from the use of manual or out dated computerised accounting systems, which have led to delays in the provision of financial reports as well as inaccurate financial data.

In addition the common weaknesses in budget preparation and implementation have an impact on the accounting and financial reporting processes. These include:

- Some major areas of revenue and expenditure remain outside the government systems, including some donor funds
- Lack of integration between the various types of revenues and expenditures makes it difficult to have a strategic overview of key issues during budget implementation and in financial reports
- The by-passing of internal controls and transactions may not be correctly recorded
- The information presented in the financial reports is not always user friendly and does not always meet international standards

Recent reforms to accounting and financial reporting have focused on the introduction of computerised financial management systems, which need to be accompanied by related improvements such as updating the legal framework, reforms to budget classification and chart of accounts, making financial reports more user friendly as well as strengthening the process of holding line ministries accountable for performance.

Performance Monitoring and Evaluation

The introduction of a performance focus into budget planning and management is one of the key areas of PEFM reform. Performance information can be introduced throughout the PEFM cycle including budget preparation, budget implementation and reporting.

Although most MEFMI governments have introduced a performance focus in budget preparation, in many cases the systems and processes have not been established to monitor the implementation of the planned performance. This means that the efforts put into a performance based budget cannot be fully realised if it is not possible to measure the actual achievement of performance. At the same time separate performance information systems may be established which are not linked to the performance as set out in the budget.

Thus it is important to establish effective performance monitoring and evaluation systems and processes which involves the following steps:

- Line Ministries identify the appropriate performance indicators that will best measure their performance
- Existing systems are assessed and the need for new systems identified for collecting the appropriate information, in the form required and at the time required
- The appropriate institutional framework is established including defining who is responsible for collecting and reporting the information on performance, to whom and how often, agreeing on whether there will there be any sanctions and incentives for good or poor performance, etc
- Developing new systems and reporting procedures
- Undertaking regular monitoring and evaluation processes linked to the financial management cycle and integrating these with the financial monitoring and reporting processes

Introducing a performance monitoring and evaluation system also involves developing a performance management culture: i.e. a move to a focus on outputs and outcomes rather than control of detailed inputs. This involves providing key stakeholders with useful information, creating the capacity to produce and analyse information, a willingness to hold officials accountable for performance and changes in incentives to encourage greater performance. All of these issues require strong political commitment to changing the ways in which governments operate.

External Audit

External audit is a key stage in the PEFM cycle which involves an independent assessment of:

- Whether the appropriate processes and regulations have been followed in the implementation of the budget
- That the funds spent by the government are in line with the approved budget and revenues collected as planned
- That the expenditures have led to the planned improvements in services provided to the public

Having an independent body to audit government accounts is usually defined in the Constitution and is an important part of the oversight of the Executive, as described in Chapter 2: Institutional and Legal Framework.

There are various types of audit:

- The audit of government accounts at the end of the financial year in which the Auditor General will give an opinion on whether the financial statements are true and fair
- More specific audits which can include performance audits, financial audits, compliance audits, controls audits, forensic audits, and computer audits

Some of the common weaknesses faced by external audit organisations in developing countries include:

- Procedures are not always followed where these are available, or clearly defined
- Difficulties of retaining well qualified and motivated staff
- Audit findings are not always acted upon

Recent reforms to external audit processes include focusing on improving audit procedures and capacity building initiatives.

External Resource Mobilisation and Management

Developing countries have received varying levels of external resources for several decades. The form in which these funds have been provided has been changing in recent years:

- Initially most donor funding was provided through development projects largely managed and controlled by development partners and external consultants
- This was followed by the introduction of Balance of Payments support and policy funding to provide macroeconomic support to governments in fiscal crises, linked to a range of conditionalities, including most recently poverty reduction strategies
- In recent years some Development Partners have started to channel their funds into governments' own budget priority areas using government systems and procedures

This most recent change to the provision of external resources (General Budget Support) is linked to a wider initiative known as the Paris Declaration in which development partners have agreed to make more use of recipient government systems and to harmonise their assistance so as to reduce the burden for recipient governments in managing a large number of Development Partners each with their own requirements.

Making the most of this initiative is a key challenge for developing countries and requires having effective Public Expenditure and Financial Management systems in place. Without such systems development partners will be less willing to channel their funds through government systems and are likely to return to project based funding.

This requires having systems in place that enable governments to demonstrate that scarce resources (both domestic and donor) are efficiently allocated and effectively used in line with agreed priorities, and that governments can report on a regular basis with accurate information on the use and impact of these funds.

Introduction

This introduction sets out the objectives and content of the Public Expenditure and Financial Management (PEFM) Handbook, its target group and ways in which it can be used.

The Macroeconomic and Financial Management Institute (MEFMI) contracted Consulting Africa Ltd to develop this Public Expenditure and Financial Management (PEFM) Handbook for its member countries. This Handbook has been developed in collaboration with MEFMI Member States to ensure it meets the needs of and has ownership of the users.

A workshop was held in September 2008 at which member countries' representatives reviewed the draft document and provided detailed comments which have been incorporated into the final document.

Rationale for the PEFM

What is Public Expenditure and Financial Management?

Public Expenditure and Financial Management covers the processes and institutional arrangements (stakeholder roles and responsibilities) involved in the planning, budgeting, management and reporting of public sector resources, both financial and non financial.

In the past public sector financial management has focused mainly on the control of funds in line with financial regulations. This meant that financial management was seen mainly as an administrative function in which line ministries were held responsible for spending funds within the approved budget levels and in line with financial regulations.

Starting in the mid 1990s Governments and development partners recognised that the significant levels of resources that have been spent on public services in most developing countries have had limited impact on development outcomes, i.e. improvements in economic growth, health, education, etc.

Most governments in the MEFMI region have undertaken a number of economic reforms under agreements with the donor community such as the Structural Adjustment Programmes starting in the 1980s and more recently the Poverty Reduction and Growth Facility (see Chapter 13: External Resource Management). However most governments have failed to achieve their growth targets and improve the delivery of public services.

Thus, reforms are being introduced to PEFM systems with an expanded scope from control of funds to improving the impact of public expenditures. These reforms focus on ensuring that funds are allocated and used in line with agreed priorities and that governments plan for and monitor improvements in the performance of government programmes and the impact of expenditures.

The emphasis is now on ensuring that limited funds available are spent on improving service delivery and achieving government objectives. This is sometimes referred to as improving the "quality" of public expenditures, i.e. that funds will lead to the planned improvements in services to the population.

The new approach recognises the importance of strengthening not only the technical processes of planning, budgeting, accounting, and audit, but also on establishing the necessary legal and institutional framework for encouraging effective use of limited resources.

This means ensuring that all stakeholders have clearly defined roles in the PEFM system, that effective coordination mechanisms are in place and that the legal and institutional framework has appropriate sanctions and incentives to ensure that funds are spent in line with government priorities and deliver the planned performance. The Institutional and Legal Framework is described in detail in Chapter 2.

The Rationale for the PEFM Handbook

MEFMI currently runs Public Expenditure and Financial Management courses for its member countries which provide an overview of the issues and techniques in effective PEFM systems, whilst also providing an opportunity for member countries to share their experiences in this area.

Most MEFMI member countries are implementing a number of Public Expenditure and Financial Management reforms and the Handbook seeks to provide information on the approaches to and practical suggestions for the implementation of PEFM reforms.

There have been a number of documents produced on Public Expenditure and Financial Management, including the Public Expenditure Management Handbook produced by the World Bank and most recently Managing Public Expenditures produced by the OECD. These documents and others provide very useful background to PEFM principles and issues and references are provided throughout this Handbook to these documents.

The MEFMI PEFM Handbook is a reference document for officials responsible for all aspects of PEFM and provides a framework for reviewing and strengthening PEFM systems drawing on experiences of successful reforms, rather than providing a blue print that all governments should follow.

Through the use of the Handbook MEFMI member countries will be able to:

- Increase their understanding of PEFM issues, and of international and regional experiences in this area;
- Assess existing PEFM systems, as well as their strengths and weaknesses;
- Develop actions for strengthening these systems;
- Develop practical systems and processes based on the suggested approaches in the Handbook;
- Analyse and strengthen their institutional and legal frameworks; and
- Develop capacity building programmes for strengthening PEFM systems.

The preparation of the Handbook highlighted that there has been limited documentation of the MEFMI member countries PEFM reforms apart from the documents produced as part of the PFM Performance Measurement Framework (PEFA) and in seminars such as those organised by the Collaborative Budget Initiative (CABRI).

The representatives of MEFMI member countries attending a workshop in September 2008 at which the draft Handbook was reviewed, agreed there is a need to undertake case studies of MEFMI member country reforms and develop best practice in the implementation of these reforms.

Target Group and Scope of the Handbook

The target audience for the Handbook is:

- Senior managers in the central Ministries of Finance, Accountant General's Departments, Auditors General, Civil (or Public) Service Ministries
- Planning, budget, aid management and accounting staff in these central Ministries with responsibility for overseeing sector ministry PEFM
- Senior Managers in line Ministries
- Planning, budget, accounting, personnel staff in line Ministries
- Departmental heads in line Ministries.

The Handbook focuses on Public Expenditure and Financial Management and therefore does not cover issues relating to revenue management. It does not attempt to provide detailed technical information on issues such as macroeconomic planning and management (this is covered in other MEFMI programmes and documents) nor on issues such as detailed approaches to public sector accounting, audit, procurement etc.

If readers are interested in further information on these subjects references are provided to other more detailed documents.

Each Chapter contains the following elements:

- An overview of and conceptual framework for a particular topic
- Common weaknesses in MEFMI member countries and other countries
- Recent reforms in the specific area
- Practical suggestions on improving PEFM systems and processes

The PEFM Handbook is written as a reference guide and the reader can select particular topics they wish to read without the need to read the entire document. Each section is cross referenced to other sections of the handbook and to related materials and websites.

Summary of Contents

Chapter 1: Overview of Public Expenditure and Financial Management

This Chapter provides an overview of Public Expenditure and Financial Management, the Public Financial Management Cycle and emphasises the importance of not only the technical approaches to PEFM, but also the roles of effective institutions, information and sanctions and incentives. The MEFMI Assessment Tool is presented in Annex 1.

Chapter 2: Institutional and Legal Framework

This Chapter describes the roles of the key stakeholders in the PEFM system and the importance of coordination between the stakeholders. The Chapter also sets out the Legal Framework for PEFM including details of the requirements of effective financial legislation, issues to consider in reforming the legal framework and the importance of recognising the role that informal rules play in the functioning of the PEFM system.

Chapter 3: Reforms to PEFM

This Chapter provides an overview of PEFM reforms in OECD and MEFMI countries, the roles of the various stakeholders in the reform process and implementing reforms at the local government level. The last section of the chapter focuses on change management issues.

Chapter 4: Planning Approaches

This Chapter describes the various approaches to planning at all levels: national, sector, local government and community with a summary of government experiences of these approaches. The Chapter also describes project planning including the various techniques used in project appraisal. Detailed suggestions on preparing a national or sector plan are included in Annex 2.

Chapter 5: Policy Analysis

This Chapter describes the processes and issues in policy analysis, highlighting the importance of recognising and estimating the expenditure implications of policy choices. Practical examples are provided for reviewing and costing policies.

Chapter 6: The Medium Term Expenditure Framework

This Chapter provides an overview of the Medium Term Expenditure Framework (MTEF) one of the reforms to planning and budgeting being implemented in most MEFMI member countries. It describes the processes involved in setting ministry ceilings, including an overview of matching the top down availability of funds with the bottom up requirements from line ministries.

Chapter 7: Budget Preparation Principles and Processes

This Chapter describes the budget preparation process including different approaches to budget preparation, common issues that MEFMI countries face, reforms to budget preparation such as performance budgeting. Detailed suggestions on preparing a performance based budget are included in Annex 3.

Chapter 8: Budget Coverage, Presentation and Approval

This Chapter describes the importance of ensuring that budgets are comprehensive, setting out the types of expenditures that need to be included in the budget estimates. It also explains the functions of budget classification and ways in which budget presentation can be improved to make budget documents more meaningful and user friendly. The importance of budget analysis is explained along with weaknesses and suggested improvements in budget scrutiny and approval. Practical examples of analysing public expenditures are presented in Annex 4.

Chapter 9: Budget Implementation

This Chapter describes the processes in implementing the budget including common weaknesses in MEFMI member countries' systems. Specific details are provided on cash management systems, procurement and expenditure tracking studies. The last section highlights the attributes of an effective budget implementation system.

Chapter 10: Accounting and Financial Reporting

This Chapter describes the processes of accounting and financial reporting, highlighting some of the weaknesses in these processes and the importance of presenting and using financial information to improve the management and functioning of governments. The last section presents an overview of an Integrated Financial Management Information System (IFMIS) and key lessons that can be drawn from the recent experience of implementing an IFMIS.

Chapter 11: Performance Monitoring and Evaluation

This Chapter describes the importance of collecting and using performance information to improve the quality of budget planning and implementation. It provides detailed suggestions for undertaking performance monitoring and evaluation and describes how a performance monitoring and evaluation system can be established and used in measuring an organisation's performance as part of a planning and budget process.

Chapter 12: External Audit

This Chapter describes the various types of audits, common weaknesses in external audit in developing countries and the practical steps that are followed in an audit process.

Chapter 13: External Resource Mobilisation and Management

This Chapter presents a history of the types of donor flows and an overview of the various aid instruments and donor organizations (development partners). It describes how aid flows need to be incorporated into the stages of the PEFM cycle and the issues that are of concern and interest to the development partners at each of these stages. The final section presents suggestions for strengthening aid management capacities within the MEFMI region.

Chapter 1 Overview of PEFM

Introduction to the Chapter

Summary of Contents

In this chapter we cover:

- Public Expenditure and Financial Management (PEFM) and how it differs from previous approaches to financial management
- The three objectives of PEFM: aggregate fiscal discipline; improved allocation of resources; and efficiency and effectiveness of expenditures
- An overview of the Public Expenditure and Financial Management systems and processes
- The Public Financial Management cycle
- Current thinking and Approaches to PEFM
- Principles of effective PEFM systems
- Approaches and tools for assessing PEFM systems

Key Issues

Traditional financial management in the public sector focused on ensuring that government expenditure and revenue were controlled in line with the overall approved budget levels and also that ministries abide by the financial legislation and regulations.

This approach to managing public finance has not delivered the key requirements of improving the quality and impact of the use of public resources. In recent years governments and their development partners have focused on the introduction of Public Expenditure and Financial Management reforms with the intention of:

- Ensuring that limited resources are allocated to priority areas over the medium term
- Ensuring that all resources are planned and managed together, i.e. Recurrent and Development (Capital), government and donor, so that they are all targeted at the same priority areas
- Increasing transparency in the use of public funds
- Introducing a performance focus in planning and budget management so that the results of public expenditure are more clearly identified at the planning stage and can be reported on during and after implementation
- Ensuring that the planning, management and reporting of public funds meet international standards

Addressing these issues involves widening the scope of financial management to include considerations of:

- Ensuring that the various stakeholder roles support these principles
- Introducing and implementing appropriate sanctions and incentives
- Providing increased freedoms and flexibility for managing public funds, while also holding managers accountable for the delivery of improved performance

Public Expenditure and Financial Management (PEFM)

This Chapter explains the difference between the traditional approach to managing public funds and the new approaches introduced through reforms to Public Expenditure and Financial Management (PEFM).

The broad functions of Public Expenditure and Financial Management are:
- To control public funds
- To plan for future allocation and collection of public funds
- To manage public funds and other resources such as human resources

In addition to these three functions of PEFM, the Budget is a major macroeconomic management tool for a government. The levels of taxation and expenditure, and the size of the government deficit, will have a significant impact on an economy, particularly where the private sector is relatively small. It is important to realise that:
- Taxation is used to provide incentives to the private sector and also to distribute the benefits of economic growth from the more wealthy in society to the poor
- Government spending can have a major impact on the economy, particularly through the implementation of large capital projects
- The size of the deficit and need to borrow from the private sector can have a significant macroeconomic impact through changes in the interest rate and monetary policies.

The traditional approach to budget preparation and management has a narrow emphasis on a set of standard rules and procedures, and on controlling expenditures. Traditional budget approaches focus mostly on ensuring that funds are spent and revenues collected as planned.

By comparison reforms to Public Expenditure and Financial Management (PEFM) focus on improving the efficiency and effectiveness of public expenditures, i.e. improving the delivery of services funded through government expenditures.

Thus the focus of PEFM is not only on the technical processes involved in allocating and managing scarce resources, but also on the roles, responsibilities, institutional incentives and information required for making the best use of these resources.

This change in focus is in response to the recognition that the traditional approach did not lead to the achievement of government objectives including poverty reduction. Both governments and development partners are concerned that public funds should be allocated, controlled and used for their intended purposes and lead to improvements in government services particularly those that are focused on poverty reduction.

The Public Expenditure and Financial Management System

The Public Expenditure and Financial Management system refers to the processes and systems as well as to the legal and institutional frameworks through which public finances are allocated and managed which include:

- The processes in the Public Expenditure and Financial Management Cycle (see below)
- Roles and responsibilities for PEFM including Parliament, Cabinet, central agencies (such as Ministry of Finance), sector ministries, local government and civil society
- The legal framework for PEFM: the constitution, Finance Act and Financial Regulations including incentives and sanctions
- Capacities of all stakeholders to implement effective PEFM systems. These include the capacities of Parliamentarians for example, to review and assess budget proposals

Overview of PEFM Processes

The Public Expenditure and Financial Management system consists of a number of sub-systems and processes to be followed by the various stakeholders in the system. This section provides a brief overview of the components of the system which are covered in detail in the remaining chapters of the Handbook.

Policy Analysis and Formulation

Policies set the framework in which government objectives are achieved. For example the introduction of free primary education is a policy, through which governments aim to increase access to primary education. Thus free primary education is not the objective: it is a means to achieving an objective.

Policies can have a significant impact on the budget, for example the introduction of free primary education will result in increased demand and enrolment of pupils leading to increased budget requirements. Therefore policies need to be assessed to ensure that they are the most appropriate and cost effective means of achieving government objectives.

Planning

The planning process takes place at various levels including the national level, the sector level, project level, district or local government level and even the community level. The planning process usually results in the preparation of a plan document which covers a specific time frame such as a Five Year Development Plan, or focuses on a specific issue such as a Poverty Reduction Strategy, a Growth Strategy etc.

The purpose of the planning process is for an organisation to define its goals and objectives, set out the strategies through which the goals will be achieved and plan for the specific actions that will be required to implement the strategies over the life of the plan period. The development of the plan should involve the setting of targets against which progress can be measured as explained in Annex 2: Preparation of Plan Documents.

Ideally these plan strategies and activities should be costed and prioritised to fit within the total resources available over the plan period, to ensure that the implementation of the plan is affordable. Government plans that are not costed and prioritised tend to be overly ambitious and unlikely to be implemented, as explained in more detail in Chapter 4: Planning Approaches.

Mechanisms also need to be established for monitoring the implementation of the Plan and for linking the plan to the budget (see Chapter 11: Performance Monitoring and Evaluation).

Macroeconomic Planning and Forecasting

The Ministry of Finance is responsible for developing and implementing policies which will have an impact on the performance of the economy including fiscal policies, levels of taxation, expenditures, debt, and the size of the deficit. The Ministry of Finance also has a major influence on sector specific policies such as trade policies, industrial policies, employment policies, agricultural subsidies, etc.

These policies will be translated into macroeconomic plans and detailed forecasts of economic growth and other macroeconomic variables. These estimates are usually developed through the use of macroeconomic models and fiscal frameworks.

Budget Preparation and Approval

This involves a number of stages as illustrated in the Public Financial Management Cycle discussed later in this Chapter. The major stages in Budget Preparation and Approval are:

Development and updating of a macroeconomic and fiscal framework: by forecasting levels of economic growth and other macroeconomic variables over a period of time, usually 3-5 years and updating the fiscal framework which includes the estimated levels of revenues, expenditures, (including both government and external resources), the deficit, and financing of the deficit. This provides the total expenditure levels to be allocated between the various types of expenditures such as statutory expenditures (i.e. spending for which government has a legal commitment such as debt payments, pensions) and discretionary spending which are allocated to line ministries.

Setting of ceilings (levels of budget allocations): recent improvements to budget preparation processes have introduced a more participatory and transparent process of determining the budget ceilings for each ministry. These improvements involve ministries undertaking a review of their previous performance in a Public Expenditure Review (PER) process or preparation of a Budget Framework Paper (see Chapter 6: MTEF).

These ministry reviews are used to set ministerial ceilings and ministries are able to start their budget preparation with an indication of the total funds that they will receive and can therefore prioritise their activities and spending to fit within the ceiling.

Ministry Budget Preparation: once ministries have received the ceilings, usually issued in a Call Circular, detailed budget preparation takes place. A number of different approaches can be used for budget preparation as explained in Chapter 7: Budget Preparation. The expenditure estimates are usually divided into two budgets: the recurrent budget which funds the personnel, operating costs and service delivery costs of a ministry, and the capital or development budget which is made up of capital projects, many of which are funded with external resources.

Review and approval of budget estimates by the Ministry of Finance: budget estimates will be reviewed by the Ministry of Finance to ensure that the estimates are within the ceilings and that the activities to be funded are in line with government priorities.

Submission to and approval of Estimates by Parliament: the final estimates are usually submitted to Cabinet for approval prior to submission to Parliament for debate and approval. Parliament will enact an Appropriation Bill which provides the legal authority for the government to spend the approved funds and collect the planned revenue.

Budget Implementation

Once Parliament has approved the Budget Estimates, the Ministry of Finance will issue a Warrant which provides authority for line ministries to incur expenditures. The exact procedures for providing authority for expenditures will differ between countries and usually between the recurrent and capital budgets.

At the start of the financial year, the Ministry of Finance will draw up a cash flow plan which sets out the planned timing of the revenue inflows, expenditure outflows and the level of borrowing that will be required to meet the shortfall of funding when revenue is lower than expenditure. This cash flow plan will then be updated on a regular basis during the financial year and be used for monitoring and managing the cash position of the government and deciding on its borrowing requirements.

Ministries implement the budget through the purchase of goods and services to undertake the planned activities, and are required to follow a set of procedures for the procurement and payment of these goods and services, to ensure that funds are spent according to the approved budget figures and to avoid any misuse of public funds.

Internal Audit systems and procedures will be used to check that public funds are being spent as approved by Parliament during the budget implementation process. This differs from the external audit process which takes place at the end of the fiscal year by the Auditor General who reports to the Public Accounts Committee of Parliament.

The procedures that guide the use of public funds will be set out in detail in the Financial Legislation and regulations as described in Chapter 2: Institutional and Legal Framework.

Accounting and Monitoring

As part of the budget implementation process, ministries will be required to record information on the commitments and payments they make and revenues they collect and this information feeds into the accounting system. Regular reports are provided by line ministries to the Ministry of Finance for monitoring the implementation of the budget and at the end of the year the government's financial statements will be produced indicating the total levels of revenue, expenditure, borrowing etc.

In recent years governments have introduced computerised financial management systems to speed up and better control transaction processing and to improve the accuracy of government financial information.

In addition to the preparation and presentation of regular financial reports, line ministries should also monitor and report on the physical implementation of the activities funded through the budget and the achievement of planned targets or outputs.

Audit and Evaluation

At the end of the financial year, the government will submit the government's financial statements to the external audit organisation, usually the Auditor General for an independent audit and assessment of the accounts. The purpose of the audit is to ensure that the funds have been spent in line with the approved amounts in the budget, whether the correct procedures have been followed in budget implementation and also in some cases whether the expenditure has led to the planned levels of services.

Ideally line ministries and the Ministry of Finance will evaluate the impact of the funds spent on the activities implemented during the previous year. In practice evaluations tend to be undertaken by development partners of their projects and programmes and there are usually no government systems and procedures in place that require line ministries to undertake evaluations on a regular basis.

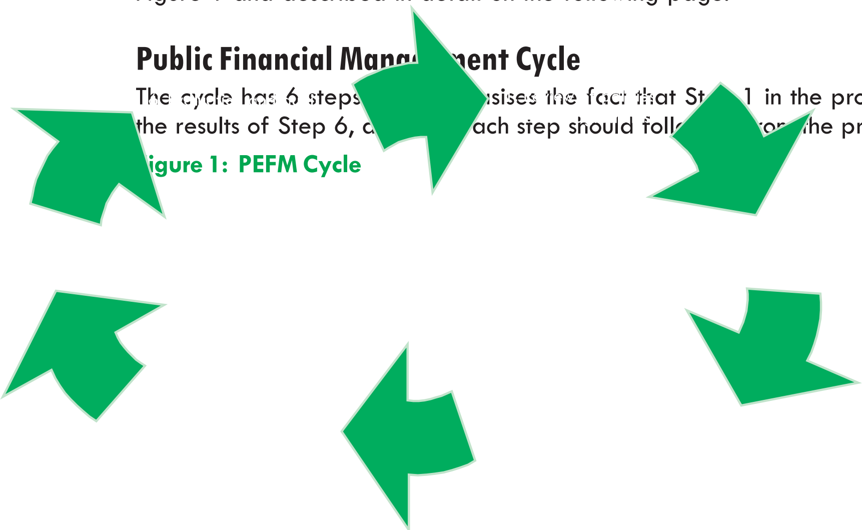
Within each of these stages, Parliament will play an oversight function in the approval of budget estimates, in some cases through the review of quarterly or mid-year financial and performance reports and of government financial statements through the reports of the Auditor General. The roles and responsibilities of the various PEFM stakeholders are described in Chapter 2.

Each of these sub-systems form part of the Public Financial Management Cycle as illustrated in Figure 1 and described in detail on the following page.

Public Financial Management Cycle

The cycle has 6 steps which emphasises the fact that Step 1 in the process should be informed by the results of Step 6, and that each step should follow on from the previous step.

Figure 1: PEFM Cycle



Step 1: the Cycle begins with a review of macroeconomic and sectoral policies and programmes. This involves the Ministry of Finance and line ministries reviewing existing policies to assess whether they are still appropriate given the experience of implementing these policies in the previous year and the results of the evaluations in the final step in the cycle.

Step 2: this involves the Ministry of Finance updating the macroeconomic and fiscal frameworks. The macroeconomic projections are updated to assess the likely availability of funds (both domestic and donor) over the forthcoming budget period (usually 3 years under a Medium Term Expenditure Framework (MTEF) and decisions are made about how to allocate these resources among ministries' spending programmes based on government priorities. This is a major part of the MTEF process and is described in more detail in Chapter 6.

Step 3: once the funds are allocated between line ministries each ministry prepares its budget for both revenue and expenditure.

Step 4: when the budget is approved by Parliament, the Ministry of Finance provides the authority (by Warrant) to line ministries to spend the funds, and ministries follow processes of procuring goods and services, making payments and collecting revenue.

Step 5: during the budget implementation period, ministries are required to report on revenue and expenditure, bank reconciliations as well as providing information on the physical implementation of programmes and activities.

Step 6: at the end of the financial year ministries finalise their financial accounts, which are submitted to the Accountant General and presented to Parliament and audited by the external audit organisation, the Auditor General. Ideally ministries should also undertake evaluations of their programmes to assess their performance in terms of achieving the agreed objectives and targets during the budget cycle.

The results of these evaluations should feed into Step 1 for the following cycle.

As stressed throughout the Handbook, it is important that reforms focus on all stages in the Public Expenditure and Financial Management Cycle as illustrated in the diagram. For example if performance budgeting is introduced only at the planning and budget preparation stage and not carried through into implementation, monitoring and evaluation, it will not be possible to assess whether the planned performance is being achieved and the full benefits of the reforms will not be realised.

In a number of countries all the steps in the PEFM Cycle are being strengthened through a sector wide approach to PEFM Reforms as described in the Box below and in more detail in Chapter 3: Reforms to PEFM.

Box 1. Sector Wide Approach to PFM reforms

The sector wide approach or integrated approach to PEFM reforms aims to develop and implement a comprehensive programme of improvements to all the aspects of the PEFM system, i.e. all stages in the cycle.

- Planning and budgeting
- Budget implementation and accounting (often through the implementation of an IFMIS)
- Internal and external audit.

In addition, these comprehensive reforms will focus on the institutional and capacity building aspects of PEFM as well as reforms to the legal framework. The development of such reform programmes has been linked to reviews of PEFM systems and usually form part of the conditionalities and agreements with donors as part of Budget Support (See Chapter 13: External Resource Mobilisation and Management).

The intended benefits of this approach are that all systems and processes are considered at the same time, taking into consideration linkages and sequencing of reforms. However experience of the integrated approach has not always led to the intended benefits, usually because of poor project management.

The next section summarises the recent literature on Public Expenditure and Financial Management.

PEFM Approaches and Literature

The reforms to Public Expenditure and Financial Management and their rationale are described in a number of documents. The key ones are summarised below.

World Bank PEM Handbook

Much of current thinking on Public Expenditure Management is set out in the World Bank Public Expenditure Management Handbook. The PEM Handbook provides a framework for focusing on three objectives for Public Expenditure and Financial Management:

Objective 1: Maintaining aggregate fiscal discipline, at the aggregate level (overall government level) and by spending ministry level. This means having a clear target for the levels of government expenditure and ensuring that these levels are maintained during budget implementation. Lack of fiscal discipline can result in unplanned increases in expenditure which have to be financed by increased domestic borrowing leading to macroeconomic instability.

Fiscal discipline involves two issues: firstly developing realistic revenue and expenditure forecasts, which requires capacity and systems in place to set clear targets for revenue, expenditure and borrowing.

Secondly, this requires ensuring that the necessary controls are in place and are followed to maintain expenditure levels within the agreed targets. Line ministry expenditure needs to be within the agreed levels through controls from the Ministry of Finance and at the same time there needs to be the necessary political commitment and ownership of the budget so that there is no pressure to increase expenditure beyond the agreed targets.

Objective 2: Allocation of resources in accordance with strategic priorities, between and within sectors. This means that the government as a whole will allocate funds according to its objectives and priorities, and that individual ministries will also allocate their budgets within their organisations to their priority areas.

Ensuring that resources are allocated in line with priorities requires that governments have a clear set of priorities, which are usually defined in a national plan document such as a Poverty Reduction Strategy (see Chapter 4: Planning Approaches). It also requires effective systems for translating these priorities into budget allocations and this is one of the main areas of focus for the Medium Term Expenditure Framework (MTEF) approach as described in Chapter 6.

Objective 3: Efficient and effective use of resources so as to ensure that governments are able to provide least cost, but effective services to the public that enable the achievement of government objectives and targets.

In most governments, improving efficiency and effectiveness of government services has been addressed through the introduction of a programme or performance focus in budget preparation. Thus the budget is planned and implemented on the basis of achieving agreed levels of performance, such as the number of pupils to be educated, farmers trained, kilometres of road rehabilitated.

Emphasis is placed on the need to address all three objectives at the same time. Lack of fiscal discipline will result in overspending and macroeconomic instability. Instability may mean that resources would not be allocated to priority sectors, thus reducing spending ministries' ability to use resources efficiently and effectively. Similarly only focusing on fiscal discipline will not necessarily result in improvements in service delivery to the public and the performance of the public sector.

This MEFMI PEFM Handbook focuses on ways in which existing PEFM systems are being reformed in order to better achieve the above objectives. It is important to note that it is possible to have a perfectly functioning Public Expenditure and Financial Management system in place but that the actual allocation and use of funds do not match stated priorities. As explained further in Chapter 3 on PEFM Reforms, a PEFM system can provide the processes and tools for improving the use of public resources, but it is the choices made by politicians and the implementation of the systems that will determine whether the reforms lead to better service delivery and achievement of government objectives.

A Contemporary Approach to Public Expenditure and Financial Management

The World Bank Institute: A Contemporary Approach to Public Expenditure and Financial Management, Allen Schick, World Bank Institute, April 1999

This document also emphasises the importance of considering PEFM from the perspective of the three objectives in the World Bank PEM Handbook. A distinction is made between "due process" i.e. the traditional approach to budget preparation with emphasis on a set of standard rules and procedures, and the elements of Public Expenditure and Financial Management which focus on wider issues of institutional and managerial frameworks.

The emphasis is on the behavioural aspects of expenditure management, and how these need to be managed so as to achieve the optimal outcomes from limited resources.

Three elements of the behavioural aspects are identified:

Appropriate incentives for effective use of scarce resources: these are not financial incentives for individuals, rather appropriate institutional incentives and sanctions for performance. Thus PEFM reforms have focused on changing the incentives and rules for managing resources, not simply the procedures for controlling expenditures.

Better Information: all stakeholders require relevant information for making the best decisions on the allocation and use of resources. Reforms focus on reducing the level of detail required by the centre, and moving to the provision of information on the costs of achieving agreed objectives and outcomes.

Changing Roles: PEFM reforms have focused on changing the roles of the various stakeholders in expenditure management, with increased authority and accountability of line ministries for achieving agreed objectives and delivering planned outputs. The Ministry of Finance and Cabinet focus on the larger issues of allocations between sectors and achievement of agreed performance.

This document has become well known for its emphasis on a gradual approach to reforming PEFM systems, known as "Getting the Basics Right".

International Monetary Fund: Code of Good Practices on Fiscal Transparency

The International Monetary Fund Code of Good Practices on Fiscal Transparency – a Declaration of Principles and related Manual on Fiscal Transparency, Fiscal Affairs Department, IMF, Revised Edition 2007.

This Code was developed in recognition that fiscal transparency can meet the three aims of achieving:

- macroeconomic stability by highlighting potential fiscal risks
- increased access to international capital markets with improved transparency leading to higher economic growth

- good governance by providing citizens with better information about how government funds are spent.

The Code has four principles of fiscal transparency which are relevant to all countries:

Clarity of roles and responsibilities within governments and between government and the private sector in the management of resources and delivery of services.

Public Availability of Information. The public should be provided with comprehensive information on past, current and projected fiscal activity and major fiscal risks. The information should be timely, i.e. without delays, and should be presented so as to facilitate policy analysis and accountability, i.e. so that the public has a comprehensive picture of governments' plans and can hold governments accountable for performance.

Open Budget Preparation, Execution and Reporting through the use of internationally acceptable standards for budget preparation and accounting.

Independent Assurances of Integrity emphasises the need for independent evaluation of expenditures, revenues and performance.

The Code and Manual were first produced in 1998 and have been updated in 2007. *See www.imf.org/external/standards*

Similar codes have been produced for assessing budget transparency:
- OECD Best Practices for Budget Transparency www.oecd.org
- Open Budget Initiative which provides rating of the openness of budget materials in 59 countries www.openbudgetindex.org

Managing Public Expenditure

Managing Public Expenditure: A Reference book for Transition Countries, OECD, 2001 and Asian Development Bank, Managing Public Expenditure, Schiavo-Campo and Tommasi 1999.

These two documents provide comprehensive coverage of all aspects of the Public Expenditure and Financial Management with additional focus on developing countries and Asia in particular (in the Asian Development Bank document) and on governments entering or seeking entrance into the European Union (transition countries). Experience from OECD countries is also discussed.

Some of the areas of particular interest in these two documents are:
- The elements of effective legal and institutional arrangements
- Improving budget coverage i.e. that all funds are included in government PEFM systems
- Experiences of medium term budget planning including projects/ capital budgeting within multi-year budgets and the need for integration of project/ capital budgeting with recurrent/ operational budgeting
- Descriptions of budget implementation processes, including cash management, personnel and payroll management, and internal controls and internal audit

- Issues to consider in improving public accounting, financial reporting and audit including the introduction of an Integrated Financial Management Information System (IFMIS)
- The rationale for and development of performance management and evaluation systems.

Recent Literature from the MEFMI Region

The Collaborative Budget Reform Initiative (CABRI) was formed in 2004 and is a self organising network of senior budget officials from 24 countries, including MEFMI member states. Since 2004 CABRI has run annual seminars to discuss PEFM issues facing their member states across Africa. Each seminar has resulted in a publication of the papers presented at the seminar which provides useful information on country approaches and experiences. A summary of these publications is presented below.

2004: the first seminar covered 4 themes of budget credibility, multi-year budgeting, improving the quality of expenditure, reform design and implementation. Nine case studies were presented at the seminar.

2005: Managing complexity: from fragmentation to coordination. This covered issues of fragmentation in the budget process such as separate recurrent and development budgets, off-budget aid flows, debt relief, aid management and decentralisation.

2006: Bridging the Gap: from policies to budgets explored the disconnection between planning and budgeting systems.

2007: Are we asking the right questions? This publication focuses on the approaches to medium term budgeting and also provides a summary of the study commissioned by the SPA on bringing aid on budget. *See www.cabri-sbo.org.*

One of the recommendations of the MEFMI member states representatives at the workshop at which this draft Handbook was reviewed was that case studies should be undertaken on MEFMI member states' experience of PEFM reforms. These case studies could be used to develop PEFM best practice for MEFMI member states.

Principles of Effective PEFM Systems

The emphasis of reforming PEFM systems is to improve the characteristics or attributes of these systems, based on a set of common PEFM principles, many of which are commonly used but not always clearly understood. They are briefly described below.

Comprehensiveness: all resources are included in all stages of the financial management cycle, i.e. in planning, budget preparation, monitoring and evaluation (audit). This includes all government and external resources and means that there is no expenditure or revenue which is managed through special accounts outside the government budget or accounts. Increasing the coverage of external resources in government budgets is of particular interest and is covered in more detail in Chapter 13: External Resource Mobilisation and Management.

Having complete coverage or comprehensiveness is important to ensure that when decisions are made on allocation of resources between sectors or programmes that these decisions take account of all the funds available to a ministry. For example if a ministry is receiving significant external resources which are not included in the government budget, Cabinet and Parliament can decide to allocate additional funds to this ministry without having information on the total funds already received by that ministry.

Similarly if there are special accounts that are outside the control of the Ministry of Finance, the use of these funds will not be controlled by government's financial procedures (see Chapter 8: Budget Coverage, Presentation and Approval).

Discipline: this means that ministries adhere to budget ceilings and that financial regulations are followed. Discipline is important to ensure that funds are spent according to government financial regulations (ensuring that government receives value for money, and that wastage and corrupt practices are avoided) and that spending is kept within agreed targets, i.e. fiscal discipline is maintained. This needs to occur at two levels: within line ministries and for government as a whole so that unplanned deficits or over-expenditure does not occur.

Flexibility: Ministries are provided with flexibility to reallocate resources (i.e. change the use of funds from one type of expenditure to another: virement as described in Chapter 9) so that they can make the most efficient and effective use of resources. Many budget implementation systems and regulations involve a high level of control over the use of funds by Ministries of Finance. For a line ministry to change spending from say Operating Costs to Purchase of Equipment requires approval from the Ministry of Finance.

Recent reforms are focusing on providing line ministries with greater freedom or flexibility in the use of funds. This does not mean that ministries can reallocate resources as they wish, but that the degree of flexibility is increased over time, particularly if governments are moving to performance focused systems which hold ministries accountable for delivering agreed levels of performance.

The level of flexibility is linked to the level at which the Budget is appropriated or approved by Parliament and the degree of control exercised by the Ministry of Finance over ministries' ability to switch funds (See Chapter 2: Institutional and Legal Framework).

Predictability: Ministries are given some predictability or reliable indication of the resources they will receive over the medium term so as to improve their planning of activities. This is the rationale for introducing a medium term perspective in the budget-ministries are able to plan ahead for the implementation of their programmes and this should encourage ministries to phase the implementation of activities over the medium term rather than attempting to implement all activities within one year.

However, as explained further in Chapter 7 on budget preparation, the estimation of resources over a medium term has its challenges including ways of encouraging ministries to focus on the medium term rather than on only the next budget year.

Accountability: Ministries and Accounting Officers (Principal/Permanent Secretaries) in particular are held responsible for the delivery of the outputs as defined in the budget. At present they are held accountable for remaining within the approved budget, but the introduction of a performance focus means that ministries are accountable or answerable for delivering the agreed number of patients treated, pupils educated etc.

One of the key aspects of accountability is that there should be consequences for an organisation or an individual's ability to deliver the agreed performance through the use of sanctions and incentives, i.e. there is little point in an organisation reporting on performance if there are no consequences of either poor or good performance.

There are two types of accountability: internal within organisations, and external to other organisations within government, to Cabinet, Parliament and the public.

Transparency: the process and documentation of the budget is more open and informative in that it is clear how decisions are made and the basis that has been used in the allocation of resources. This involves providing useful information in a timely manner so that all stakeholders are informed about the use and impact of public funds.

Consultation: the new approach to PEFM involves increased consultation within governments and between governments and their stakeholders. For example the development of ministry ceilings includes wider consultation and enabling line ministries to have an input into the setting of the ceilings.

Inter-linkages between systems: many elements of the PEFM systems operate in isolation. For example recurrent and development budgets are often prepared and managed quite separately, and development partner funds are usually managed outside government systems. Reforms to PEFM systems focus on improving the integration of the various systems.

Legitimacy: most aspects of the budget preparation and management processes will be ruled by the Financial Regulations and Laws which gives the process its legitimacy as described in Chapter 2. Thus the budget presented to and approved by Parliament is a legally binding document.

Efficiency: whether the process of using inputs translates into the highest number of outputs, e.g. whether the inputs procured (text books, equipment, school maintenance and teachers) will lead to teaching the planned number of primary school pupils.

Effectiveness: whether the outputs will have the desired impact or outcome, i.e. whether the teaching of the primary pupils will result in improved pass rates, literacy, transition to secondary and tertiary education and ultimately to a more educated and economically productive society.

Approaches to Assessing PEFM systems

A number of approaches and tools have been developed to provide a systematic assessment of PEFM systems. These are described below in a number of boxes.

Box 2. Report on Observance of Standards and Codes (ROSC)

A ROSC summarises the extent to which countries observe certain internationally recognised standards and codes. The IMF has recognised 12 areas and associated standards which comprise: accounting; auditing; anti-money laundering and countering the financing of terrorism (AML/CFT); banking supervision; corporate governance; data dissemination; fiscal transparency; insolvency and creditor rights; insurance supervision; monetary and financial policy transparency; payments systems; and securities regulation; (AML/CFT was added in November 2002).

Reports summarising countries' observance of these standards are prepared and published at the request of the member country. They are used to help sharpen the institutions' policy discussions with government authorities, and in the private sector (including various rating agencies) for risk assessment. Short updates are produced regularly and new reports are produced every few years.

See: *http://www.imf.org/external/np/rosc/rosc.asp*

Box 3. Public Expenditure Reviews

Public Expenditure Reviews (PERs) are core diagnostic studies prepared to review the allocation of public funds and the budget processes to assess the extent to which these promote economic growth and reduce poverty.

PERs are undertaken by the World Bank with the aim of providing information to the Bank's borrowers and to contribute to the World Bank's own country assistance strategy. Most PERs focus on the efficiency and efficacy of resource allocation and can include analysis and projection of revenue, determination of the level and composition of public spending, inter and intra sectoral analysis, financial and non financial public sector enterprises, structure of governance, and the functioning and efficacy of public institutions.

In recent years the World Bank has worked closely with governments to undertake joint PERs and some governments now undertake their own regular PER processes as part of the budget process, for example Tanzania, Uganda and Kenya.

See WorldBank *Website:www.worldbank.org/external/topics/publicsectorandgovernance/publicfinance*

Box 4. Country Financial Accountability Assessment (CFAA)

A CFAA is a diagnostic tool to enhance understanding of financial accountability arrangements in the public and private sectors. The CFAA aims to identify strengths and weaknesses in a country's PFM systems and to facilitate a common understanding among the government, the World Bank and development partners on the performance of the systems and institutions. This is used to identify priorities for reform, and the design and implementation of capacity building programmes.

See World Bank website and Country Financial Accountability Assessment Guidelines to Staff

Box 5. Country Procurement Assessment Review (CPAR)

Undertaken by the World Bank to assess procurement processes, including the legal framework, operation of tender boards, level of transparency in the system, and the systems within ministries for effective procurement. A second round of CPAR can be undertaken to assess the extent to which World Bank recommendations have been implemented.

Other donor organisations such as the UK Department for International Development (DFID) have developed a tool for assessing Fiduciary Risk (see Managing Fiduciary Risk When Providing Poverty Reduction Budget Support DFID Policy Division, September 2004).

Box 6. Country Policy and Institutional Assessment

The CPIA is a World Bank diagnostic tool that assesses government's policies and institutional arrangements i.e. its focus is on the key elements that are within the country's control, rather than on outcomes (such as growth rates) that are influenced by elements outside the country's control. The CPIA measures the extent to which a country's policy and institutional framework supports sustainable growth and poverty reduction, and consequently the effective use of development assistance. The outcome of the exercise yields both an overall score and scores for all of the sixteen criteria that compose the CPIA.

The World Bank undertakes the CPIA exercise to determine the relative size of the Bank's concessional lending and grants to low income countries. As explained in Chapter 13: External Resource Mobilisation and Management, International Development Assistance (IDA) resources are allocated in per capita terms on the basis of a country's IDA country performance rating (CPR) and, to a limited extent, per capita gross national income (GNI). Use of the CPR ensures that good performers receive, in per capita terms, a higher IDA allocation i.e. allocations are performance based. A country's overall CPIA score is the main element of the CPR.

The CPIA consists of 16 criteria grouped in four equally weighted clusters: Economic Management; Structural Policies; Policies for Social Inclusion and Equity; and Public Sector Management and Institutions. For each of the 16 criteria, countries are rated on a scale of 1 (low) to 6 (high). The scores depend on the level of performance in a given year assessed against the criteria, rather than on changes in performance compared to the previous year. The ratings depend on actual policies and performance, rather than on promises or intentions.

See www.worldbank.org/ida/performanceassessments/

(PEFA) PFM Performance Measurement Framework

In 2005 the donor community realised that there was a need to develop one tool that would be recognised by all donors and governments and thus the Public Expenditure and Financial Accountability (PEFA) was established, a multi-agency established by a group of donor organisations. Through the PEFA initiative a PFM Performance Measurement Framework was launched.

The PEFA PFM Framework has been developed to allow for the measurement of a government's Public Expenditure and Financial Management (PEFM) systems over time. Secondary objectives include providing feedback to governments on their reform processes and facilitating the harmonisation of government and donors to use a common framework for measuring PFM performance.

The aim is to reduce the transaction costs for the government of dealing with many donors with differing views and concerns in reviewing PEFM systems.

The assessment of a government's PFM systems using the Framework is usually undertaken by a team of external consultants in partnership with government using the detailed indicators in the PEFA Framework Manual. The team will interview all stakeholders (government, civil society and donor organisations) as well as collecting information and documentation from which to assess systems against specific indicators. These indicators measure performance on a scale of A-D, with an A score being the highest and D the lowest. These ratings are then presented in a report which also includes a description and assessment of recent and ongoing reforms.

In some cases the results of an assessment using the Framework can influence donors' decisions on whether to provide additional support to a government, as they will indicate the readiness of a government's systems to absorb and effectively manage donor resources.

Content of the Framework

The Performance Measurement Framework identifies the critical dimensions of an open and orderly PFM system as follows:

- Credibility of the budget - whether the budget is realistic and is implemented as intended.
- Comprehensiveness and transparency - whether the budget and the fiscal risk oversight are comprehensive and whether fiscal and budget information is accessible to the public.
- Policy-based budgeting - whether the budget is prepared with due regard to government policy.
- Predictability and control in budget execution - whether the budget is implemented in an orderly and predictable manner and there are arrangements for the exercise of control and stewardship in the use of public funds.
- Accounting, recording and reporting - whether adequate records and information are produced, maintained and disseminated to meet decision-making control, management and reporting purposes.
- External scrutiny and audit - whether appropriate arrangements are in place for scrutiny of public finances and whether the government follows up these views.

In addition to the Performance Indicators measuring government performance, the PEFA Framework also captures Donor Practices using 3 further Indicators.

The main focus of the assessment is on central government, oversight institutions (Auditor General, Public Accounts Committee and Parliament) and autonomous agencies. Local government and public enterprises are only considered to the extent to which they affect central government operations.

The Framework does not measure the factors that hinder effective performance such as the legal framework or capacity issues, nor does it focus on the content of fiscal policies or whether funds are allocated in line with stated government objectives. Instead the Framework assesses whether the systems and processes enable effective resource allocation etc.

For each of the areas listed above there are a set of indicators that are used to assess and measure performance which are defined as those that are critical to achieving sound PFM.

See: www.pefa.org

MEFMI Assessment Tool

Annex 1 includes the MEFMI PEFM Assessment Tool which was developed at a workshop in 2002 and can be used by member institutions to assess their PEFM systems, identifying quick wins for reform, developing an effective reform agenda and involving key stakeholders at various stages in the reform process.

The next Chapter sets out the institutional and legal framework within which Public Expenditure and Financial Management operates.

ANNEX 1: MEFMI PEFM ASSESSMENT TOOL

This PEFM Assessment Tool was developed in collaboration with the Macroeconomic and Financial Management Institute (MEFMI) and its member countries at a workshop in Uganda in 2002. The aim of the PEFM Assessment tool is to facilitate the assessment of PEFM systems for use by MEFMI member countries. This is a first draft and will be further refined during subsequent MEFMI Workshops.

Purpose of PEFM Assessment Tool

The purpose of the Public Expenditure Management (PEFM) Assessment Tool is to assist governments to assess their own systems, so as to identify their strengths, weaknesses and gaps in processes and capacities. Based on this assessment governments can then identify a range of interventions and improvements to their systems, processes and capacities.

In many cases governments are in the process of implementing some elements of PEFM reform and the tool can be used to assess whether these improvements are:

- Appropriate to the needs and strengths/weaknesses of their particular circumstances
- Comprehensive in coverage: some reforms may be focused only on a particular area of PEFM
- Integrated: PEFM reforms need to be developed and implemented in an integrated manner
- Sustainable: are reforms being implemented in a manner that will ensure their sustainability?
- Building ownership, confidence and commitment: are reforms involving all appropriate stakeholders so as to build commitment?

The aim is to provide a tool that governments can use themselves with support from MEFMI if required in order to assess their own strengths and weaknesses and develop appropriate solutions. Thus the problems and solutions will be "owned" by governments rather than being imposed from outside.

The results of the Assessment can be used with MEFMI to draw up a programme of support and for discussion with donors on the reliability of their PEFM systems and areas where further support would be required for strengthening their systems.

Scope of Assessment Tool

As explained in the Chapter 1: Overview of PEFM, current thinking on PEFM reforms emphasises the need to review not only the technical processes, but also the related roles, responsibilities and information that are required to ensure effective allocation and use of scarce resources.

Thus the PEFM Assessment Tool aims to provide a comprehensive review of all aspects of PEFM, including a review of systems and processes, institutional and legal issues, and capacities for PEFM.

Assessing Macro Planning and Sectoral Allocations

Using the Table below, review each indicator and assess your country's performance against the indicator. For example, the first indicator is that a government macroeconomic framework is in place and is being used. If there is a framework in place, the country status would be that it is in place, but, if for example, it is not being used, this would be indicated in the box. The reasons are then shown in the next column, e.g. lack of skills, and recommended actions are then shown in the final column, e.g. capacity building required.

Performance Indicator	Country Status	Reasons	Recommended Actions
Macroeconomic Planning and Forecasting			
There is a government macroeconomic framework in place and is being used for development of macroeconomic forecasts			
The macroeconomic framework is comprehensive: all donor funds are captured in the forecasts, reliable estimates of other statutory expenditures such as pensions and contingent liabilities			
Realistic macroeconomic forecasts are produced: the deviation between forecasts and actuals is not significant			
There is a close link between macro and sectoral policies: sectoral policies are based on macroeconomic policies, such as trade liberalisation, etc.			
Developing Sectoral Requirements			
Sectoral allocations are policy driven: there is a clear policy framework with costs of policy estimated			

Performance Indicator	Country Status	Reasons	Recommended Actions
There is a close link between the policy planning undertaken for the sectoral allocations and the activities and expenditures included in the detailed budgets			
Sectoral plans are comprehensive: they include all components of a sector, e.g. the education sector plans include all levels of education			
Participation: there is effective participation of all stakeholders in discussion of sectoral priorities			
Sectoral plans cover the medium term and include both recurrent and development funded policies and programmes, as well as focusing on personnel issues			
Sectoral plans take account of donor funded programmes			
Discussion and Approval of Sectoral Allocations			
Information on Sectoral requirements and choices is presented clearly to central agencies and Cabinet			
Sufficiently detailed Cabinet discussion of policy/budget choices and options			
Political commitment to policy choices			
Rationale for choices and allocations between sectors communicated clearly to sector ministries			

Assessing Budget Preparation, Presentation and Approval

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Budget Preparation			
Policy driven: there should be a clear link between the policy framework developed for the sectoral allocations with the detailed estimates			
Comprehensive: the estimates should include all donor funded activities and those activities funded from internally generated funds			
Participation: there should be active participation of all key stakeholders in the process, including managers at the field level. Budget preparation should not be left to accounting staff but other stakeholders should have the same level of understanding of budget preparation processes			
Management tool: the preparation of the budget should be seen as an opportunity to review ongoing programmes and activities and to identify ways of improving efficiency and effectiveness			
Medium term: the estimates need to be prepared within the context of a medium term ceiling, but with flexibility to respond to changing circumstances			
Integration of recurrent and development: the preparation of the budget should consider the recurrent and development budgets at the same time			

Performance Indicator	Country status	Reasons	Recommended actions
Integration of personnel planning: personnel costs should not be treated as a given, but the budget planning process needs to consider personnel issues and manpower requirements			
Efficiency of budget preparation process: the timing should be appropriate and realistic, the budget circular should be clear in terms of instructions, and the Ministry of Finance should provide sufficient follow up to sector ministries			
Clear and consistent Budget: Classification and Chart of accounts, ideally with common codes across the recurrent and development budgets, and use of programme or performance classification			
Performance focus: the estimates should be linked to agreed objectives and/or targets.			
Budget Presentation			
Clarity in presentation of budget information: the budget presentation should provide information on the agreed objectives, policies, targets.			
Integrated and comprehensive: the information should be presented in an integrated and comprehensive manner, showing recurrent and development estimates together, as well as all donor funds			
Level of detail: the level of detail presented in the budget presented should be appropriate to the needs of the stakeholders receiving the information and the use of the information			

Performance Indicator	Country Status	Reasons	Recommended Actions
Presentation of previous years' outturns should be presented			
Medium term perspective, even at an aggregate level			
The budget statement should cover the elements prescribed by the IMF Code: (1) fiscal policy objectives and sustainability; (2) fiscal rules; (3) the macroeconomic framework; (4) separating existing commitments from new policies; and (5) major fiscal risks."			
Budget Approval Process			
Focus on large policy issues: the budget hearings at all levels (MOF, Cabinet and Parliament) should focus on a discussion of policy/budget choices and options, rather than the main focus being on detailed items			
The process should build political commitment to policy and budget choices			
Civil society should be actively involved in debate on budget issues and policy choices			

Assessing Budget Implementation

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Cash Management			
Ministries prepare realistic work plans and cash flow forecasts			
Government prepares public sector borrowing requirement and borrowing plans			
Effective mechanisms for cash management and monitoring public sector borrowing			
Release of Funds			
Ministries request funds in line with spending requirements, rather than equal instalments			
Ministries of Finance provide information on releases and explanations if funds differ from amounts planned			
Funds are released in line with priorities as agreed in the budget			
New priorities only introduced during the year with Cabinet approval and revenue raising measures or lower priority areas to be cut back			
Systems are in place for tracking release of funds to ministries and within ministries to lower levels			
Donor funds released in line with agreed government requirements			
Information on releases provided to relevant stakeholders			

Performance Indicator	Country Status	Reasons	Recommended Actions
Use of Funds			
Internal Audit and controls used effectively and efficiently			
Clear procedures for use of funds, widely understood and avoiding duplication of processes and delays			
Effective management of government bank accounts: links with government accounting systems and proliferation of special accounts avoided			
Maintenance of priorities in the use of funds in centralised treasury systems: where there are district treasuries, systems are in place to ensure funds are released in line with priorities			
Virement rules: enable some flexibility in use of funds, but prevent misuse			
Effective implementation of procurement procedures: minimal “leakages”, delays and cost escalations			
Personnel and Payroll Management			
Personnel and payroll management: no “ghost” workers, effective recording and management of information on recruitment, retirements, secondment, pay increases, etc.			

Assessing Accounting and Monitoring Systems

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Accounting Systems			
Effective accounting systems: produce timely, accurate, sufficiently detailed and clear information			
Chart of accounts linked to budget classification			
No need to have parallel expenditure tracking system			
Regular reports produced in accordance with legal and other performance management requirements			
Comprehensive information provided to relevant stakeholders			
Final accounts produced within the time specified in Financial Legislation/ Regulations			
Reporting formats user friendly based on needs of various stakeholders			
Reported information widely available, e.g. on website			
Monitoring Systems			
Physical performance monitored as well as financial performance			
Regular reports produced on performance as well as ad hoc reports			

Performance Indicator	Country Status	Reasons	Recommended Actions
Action is taken to follow up on issues raised through monitoring systems			
Monitoring and accounting for donor resources is undertaken through government systems rather than separate systems			
Capability to track poverty expenditure or any other specific type of expenditure			
Ability to track expenditure at specific levels within government (Chart of Accounts provides for required level of reporting and systems)			
Systems in place for monitoring outcomes (impact) as well as physical progress (outputs)			
Central agencies (Ministry of Finance, Planning Commission, Cabinet Office) has capacity for monitoring performance			

Assessing Audit and Evaluation

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Audit Office is independent			
Audit should be composed of an internal & external group of auditors			
Auditor General should have power equal to that of the minister			
AG should report to the PAC so that the head of government 's office can be audited as well			
Audit Office has necessary skills and logistics to operate effectively			
Audit queries are acted upon and necessary sanctions imposed where required as defined within financial laws and regulations			
Sanctions to enforce compliance should be clearly spelt out			
Audit should be in accordance with GAAP Standards			
Audit report should cover areas of economic, efficiency & effectiveness of the financial management of the institution			
Comprehensive i.e audit process and audit report should cover all revenues and expenditure			

Performance Indicator	Country Status	Reasons	Recommended Actions
Donor programmes/projects should be audited by the Auditor General			
There should be periodic and random checks/audit			
The report of the Auditor General should be made available to relevant stakeholders and should be user friendly			
Reports should recommend improvements to systems and actions to be taken against non-compliance			
There should be other checks and balances including the organisations listed below			
Ombudsman or inspector general of government			
Anti Corruption Organisation			
Reformed Central Tender Board			
Audits procurement entities			
Performance monitoring and evaluation			
Central agencies and sector ministries have capacity for evaluation			
Evaluation must be comprehensive: financial and performance			
Findings from evaluations are built into planning of subsequent programmes/projects			

Assessing Legal and Institutional Frameworks

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Legal Framework			
Well defined rules of the game and responsibilities spelt out in legal framework covering all aspects of PEFM: budget preparation; implementation, procurement; accounting and audit, for all revenue and expenditure			
Incentives for performance and sanctions applied for not following rules			
Consistency between constitution, finance act and financial regulations			
Relevant institutions should exist for checks and balances, e.g. Anti Corruption Boards, institutions governing integrity and ethics			
Financial laws and regulations should be clear and easy to comprehend, clearly defining responsibilities and activities			
No parallel regulations set up for specific purposes, e.g. use of donor funds, except where consistent with existing legislation			

Performance Indicator	Country Status	Reasons	Recommended Actions
Procurement regulations should be updated and governed within PEFM laws and regulations, including disposal of government assets			
Financial laws and regulations updated in line with PEFM reforms, e.g. performance management should be included in laws and regulations if introduced into PEFM systems			
Fiscal decentralisation clearly defined and understood by all stakeholders			
Role of Parliament, Executive and civil service clearly defined in regulatory framework and followed			
There should be a clear separation of powers between the Executive, Legislature and Judiciary			
Degree of controls and freedom/ flexibility should be clearly defined			
Institutional framework			
Clarity of purpose for organisations involved in PEFM: the roles and responsibilities of all stakeholders should be clearly defined and understood by all to avoid duplications and conflict			
Responsibilities in line with PEFM processes: the roles and responsibilities should be updated with the introduction of PEFM reforms			

Performance Indicator	Country Status	Reasons	Recommended Actions
Clear boundaries of responsibility: the areas of responsibility between the Ministry of Finance and Planning Commission are clear, or between Ministry of Finance and sector ministries are clear			
Clear areas and mechanisms for integration/coordination between agencies			
Transparency and accountability: the institutional framework and code of conduct should ensure transparency and accountability			
There should be a clear code of conduct and disciplinary procedures			
Integration of reform programmes: PEFM reforms should be integrated within the PEFM system and with other related reforms, such as civil service reform			
The Cabinet Office and Cabinet itself should play an effective role in PEFM, i.e. Cabinet should be responsible for approval of sectoral allocations			
Parliament should play an effective role in PEFM i.e. there needs to be an effective debate within Parliament of sectoral allocations and budget appropriations			
Civil society should play an effective role in budget debates			

Performance Indicator	Country Status	Reasons	Recommended Actions
The role of Civil Service Commission and Public Service Commission needs to be clearly defined, such as responsibilities for approving new recruitments			
The roles of central and Local government, including fiscal decentralisation need to be clearly spelt out, with local government roles and responsibilities in terms of revenue raising and spending clearly defined			
Parastatals: there needs to be a particular body with responsibility for managing parastatal activity, including monitoring any fiscal liabilities for government such as loan guarantees			
Effective donor coordination mechanisms need to be in placed at the central and sectoral levels			

Assessing PEFM Capacities

Using the Table below, review each indicator and assess your own country's performance against the indicator. Identify the reasons for strengths and weaknesses and develop recommended actions for building on the strengths and addressing the weaknesses.

Performance Indicator	Country Status	Reasons	Recommended Actions
Appropriate numbers of staff for the requirements of an effective PEFM system: may be either insufficient or in excess of actual requirements			
Appropriateness of skills to PEFM requirements: there may be sufficient staff, but they may not have the necessary skills			
Appropriate pay levels and other incentives to attract and retain staff			
Skills being used effectively			
Appropriate and effective capacity building programmes may be in place			
Local training institutions offering appropriate courses in PEFM			
Technical assistance focused on building local capacity			
Effective mechanisms for integrating capacity building programmes into reform programmes			
Effective mechanisms in place for managing technical assistance so that government needs are met, particularly in developing appropriate, sustainable systems and capacity			

Developing A Comprehensive Set Of Actions

Based on the above assessments it should be possible to develop a comprehensive set of actions for each stage in the financial management cycle, the legal and institutional framework and capacity building.

The matrix below can be used to develop the action plan. There can be a number of actions against each component, and for each action identify which organisation should take the lead responsibility, the timeframe in which the action should be implemented, identify whether this is part of an ongoing reform programme and if additional support would be required to implement the action, the type of support required.

Identifying Possible Risks

In developing the Action Plan for PEFM Reform it is also necessary to identify any risks that may undermine the effectiveness of the proposed reforms.

Identify all the possible risks and then categorise them into high, medium and low risks and ensure that specific actions are developed to address at least all the high risks and that these actions are included in the Action Plan.

Action Plan for PEFM Reform

Component	Action	Who should take the lead responsibility	Timeframe	Part of ongoing reform	Additional support required
Macro and Sectoral Planning					
Budget Preparation, Presentation and Approval					
Budget Implementation					

Component	Action	Who should take the lead responsibility	Timeframe	Part of ongoing reform	Additional support required
Monitoring and Accounting					
Audit and Evaluation					
Legal Framework					
Institutional Framework					
Capacity Building					

CHAPTER 2 INSTITUTIONAL AND LEGAL FRAMEWORK

Introduction to the Chapter

This Chapter sets out the institutional and legal frameworks for Public Expenditure and Financial Management (PEFM) systems, describing the systems as they operate in most countries in the MEFMI region as well as experiences from OECD countries. It also sets out the issues to consider in reforming these frameworks.

Institutional Framework

The institutional framework for Public Expenditure and Financial Management consists of the key stakeholders who have an interest in the PEFM system, both within and outside government, the roles of the stakeholders, the information provided to them and how they interact with each other.

As explained in Chapter 1 of the Handbook the importance of a clear and well functioning institutional framework is now seen as a key component of an effective PEFM system. It is possible that sound processes, regulations and controls may be in place but the impact of these can be undermined if the institutional issues are not addressed at the same time.

This Chapter starts by explaining the roles of the key stakeholders in the PEFM system, including civil society groups, a number of which have been established in the MEFMI region.

Key institutional issues and challenges in the MEFMI region include ensuring that there are clearly defined roles and responsibilities for PEFM, and that these are followed in practice. One of the most common issues faced by MEFMI member states is the merging and separation of the Ministries of Finance and Planning. While there is no correct institutional structure for these two functions, it is important that they are closely integrated and managed.

Capacity building is a key issue to be addressed in reforming and strengthening PEFM systems, and the reform process itself needs to include capacity building programmes. This first section of the Chapter ends with brief suggestions for undertaking a training needs assessment.

Legal Frameworks for PEFM Systems

All countries have a legal framework within which the PEFM system operates. In many countries the Constitution will include requirements for effective PEFM, with the more detailed requirements being covered in financial laws, regulations and operational procedures.

In many countries even the Constitution will include requirements for effective PEFM and detailed regulations will be covered in more detail in financial laws, regulations and operational procedures.

Although all governments will have these regulations in place, often these are not complied with thereby severely undermining the effectiveness and credibility of PEFM systems.

The Chapter concludes with suggestions on the key principles to take into account when reviewing and updating a government's financial legislation framework.

Overview of Institutional Arrangements

The institutional framework for Public Expenditure and Financial Management (PEFM) includes:

- The roles and responsibilities of all stakeholders: Parliament, Cabinet, Ministry of Finance, planning commission, sector ministries, local government, civil service commission, etc
- The operating rules which bind the way in which each stakeholder can behave
- The ways in which the various organisations coordinate with each other and with other stakeholders outside the system

Definitions of Government

Governments collect revenue resources and spend these resources on the delivery of services to the public. Governments can be classified into four categories:

Central Government: responsible for activities that affect the country as a whole, e.g. national defence.

Local Government: lower level of government responsible for revenue collection and expenditures for a specific area within a country and has a level of independence from higher levels of government. In some countries there are several levels with the local government structures, such as provinces, regions and districts.

State Government: these have responsibility for certain functions in a significant part of a country. This level of government usually exists in a federal constitution.

Social Security Funds: these are the organisations that manage the funds that provide benefits to the population through a compulsory contribution scheme. Often these schemes are separate from the rest of government revenue and expenditure.

Public Sector: in addition to government ministries the public sector includes non-financial or financial organisations (parastatals, or state owned enterprises) owned by the government which operate on a commercial or semi-commercial basis.

Responsibilities of Key Stakeholders in PEFM

The various roles of the key stakeholders in the Public Expenditure and Financial Management system need to be clearly defined so as to ensure that stakeholders are aware of their roles, that overlapping roles are avoided and that the necessary controls, or checks and balances are in place. The roles of the key stakeholders are described in the following section.

The Organs of the State

The state comprises the Executive (Government), the Legislature (Parliament) and the Judiciary. The relationship between the organs of state and their degree of independence affects the quality of the governance system including Public Expenditure and Financial Management. Each of the organs of the state should work independent of the others and should result in a strong system of "checks and balances" for the overall benefit of the nation.

An effective system of checks and balances requires the following:

- Independence of the Legislature and the Judiciary from the Executive so that they can independently monitor the performance of the Executive
- Effectiveness and efficiency of the Legislature and the Judiciary to provide oversight of the Executive: i.e. they should have sufficient capacity to play their roles
- Effective governance arrangements, systems, procedures and processes for the Executive so that the government can be held accountable
- An active role for non-state actors (civil society) to also hold the state accountable to the population

Parliament

The elected Parliament holds the "power of the purse" which means that Parliament makes the ultimate decisions on how revenue should be collected, how government funds should be spent and how funds borrowed for use by the government are spent. Parliament also holds the Executive accountable for the use of government funds and delivery of agreed services. Parliament can therefore control the Executive by ensuring that the budget reflects national priorities but also has to rely on the Executive to make the most efficient and effective use of public funds.

The power of Parliament to change the content of the proposed budget varies between countries as does the level of detail at which the budget is appropriated, i.e. approved by Parliament. These different arrangements can be classified as one of the following:

- Unrestricted power to either increase or decrease revenue and expenditure without the consent of the Executive
- Restricted power which allows for some changes to the budget within limits, defined as a maximum increase or decrease
- Balanced changes to the budget, i.e. it is possible to increase expenditure but a balancing increase in revenue would also be required

In some countries, Parliamentary Committees exist with the responsibility for scrutinising the budget in more detail. These can include a Budget and Finance Committee which reviews the revenue and expenditure proposed by the Executive; sector or ministry specific committees which review the budget estimates of the line ministries; and the Public Accounts Committee which provides oversight on the implementation of the budget.

It is important that these committees have the necessary capacity to scrutinise the budgets, which includes effective briefing and research support on issues within a sector, and sufficient time to review the estimates in detail. Such capacity does not exist in many countries although in recent years there have been a number of efforts to increase Parliamentary capacity.

One particular initiative in this area is the Parliamentary Centre in Africa under the Parliamentary Centre, a Canadian not-for-profit, non-partisan organisation devoted to improving the effectiveness of representative assemblies around the world.

The Parliamentary Centre in Africa supports Parliamentary organisations in developing their capacities through assessment missions, programme development and management, technical assistance and workshops. The Centre runs programmes in Ethiopia, Ghana, Kenya, Sudan, Southern Africa as well as pan African programmes.

Cabinet

The Cabinet is the key decision making body in government. In terms of the budget it is responsible for approving the fiscal framework (i.e. total resources based on fiscal policies, divided into line ministry ceilings) and draft estimates before they are submitted to Parliament. This involves

- Agreeing on the macroeconomic and fiscal policies and targets
- Agreeing on government priorities and how these should be translated into ministry ceilings
- Approving the final budget estimates prior to submission to Parliament

The Ministers in Cabinet will represent the views of the Executive to Parliament and ideally will present the collective priorities of government. If the Cabinet system is not well developed stronger Ministers can tend to dominate the prioritisation process and the budget will reflect the interests of these few Ministers rather than the government as a whole.

The Cabinet is also responsible for making policy decisions and as explained in Chapter 5: Policy Analysis, policies can have a significant impact on the budget. For example a decision to introduce free primary education will require substantial additional funding. Therefore it is important that Cabinet is fully briefed and informed on the expenditure implications of new policies, and that these proposals should be assessed in detail by the Ministry of Finance to provide their inputs and recommendations on the financial implications of new policy proposals.

In some countries specific research support is provided to Cabinet on policy and budget proposals in the Cabinet Office. This office is staffed with professionals who review policy proposals and provide recommendations to Cabinet.

Auditor General

In most countries the constitution requires the setting-up of independent audit institution (Supreme Auditing Institutions (SAIs)) to audit and review government financial statements, to assess whether procedures have been properly followed, funds spent as approved by Parliament and activities implemented as planned. The office of the Auditor General is also responsible for ensuring that government ministries follow internationally accepted accounting standards as described in Chapter 10: Accounting and Financial Reporting.

Audit Institutions are answerable to Parliament and their reports are submitted to Parliament through the Public Accounts Committee (PAC) of Parliament. The roles and functions of the head the Supreme Audit Institutions will normally include the following:

- Audit of Public Accounts, i.e. the government's financial statements
- Audit of financial statements of Local Authorities
- Audit of foreign exchange transactions
- Examination of accounts and financial statements of projects and programs financed fully or partly with public funds
- Auditing of statutory commissions, corporations, parastatals and public enterprises
- Submission of special audit reports to Parliament
- Submission of Auditor-General's report to Parliament

Ombudsman and Anti-Corruption Organisations

In addition to the oversight role played by Parliament, the judiciary and external audit organisations, many governments have established organisations that monitor, investigate and report on cases of corruption or malpractice in public administration.

These organisations can include an Ombudsman and/or an anti-corruption body. The Government of Uganda has combined these two functions in the Inspectorate of Government as described in the Box below.

Governance and anti-corruption has become of increasing interest to the donor community and there are a number of initiatives focused on this issue.

One example is the World Bank CommGAP: *a global program at the World Bank, promotes the use of communication in governance reform programs and supports the building of democratic public spheres. Through its three program areas: Research and Advocacy, Training and Capacity Building, and Support to Development Projects and Programs, CommGAP is demonstrating the power of communication in promoting good and accountable governance and hence better development results.*

www.worldbank.org/topics/developmentcommunications/

Box 7. Functions of the Government of Uganda - Inspectorate of Government (IGG)

Article 225 of the constitution sets out the functions of the Inspectorate and provides as follows:-

"(1) The functions of the Inspectorate of Government shall be prescribed by Parliament and shall include the following:-

(a) to promote and foster strict adherence to the rule of law and principles of natural justice and administration;

(b) to eliminate and foster the elimination of corruption, abuse of authority and of public offices;

(c) to promote fair, efficient and good governance in public offices;

(d) subject to the provisions of this Constitution, to supervise the enforcement of the Leadership Code of conduct;

(e) to investigate any act, omission, advice,decision/ recommendation by a public officer or any other authority to which this article applies, taken, made, given or done in exercise of administrative functions; and

(f) to stimulate public awareness about the values of constitutionalism in general and the activities of its office, in particular, through any media and other means it considers appropriate."

See: www.igg.go.ug

Ministry of Finance

The Ministry of Finance is responsible for overseeing and maintaining fiscal discipline, allocating resources between ministries and ensuring that budgets are implemented in line with the legal and regulatory requirements of the government.

The head of the Ministry of Finance will play two roles:

- The oversight and management of all government funds as described above
- Oversight and management of the resources (financial and human) of the Ministry of Finance

In some countries these two roles are played by the Permanent/Principal Secretary, while in others the two roles are the responsibility of two officials.

The specific functions of a typical Ministry of Finance are the responsibility of the following departments and divisions:

Macroeconomic Division or Unit

- Developing and managing macroeconomic policies
- Developing and updating on a regular basis macroeconomic projections of revenues, expenditures and government borrowing

Debt Management Division or Unit

- Recording of and reporting on debt data, both domestic and foreign
- Payment of debt: principle and interest
- In some cases debt units are also responsible for recording and management of information on grants from donor organisations, using the systems that are available for managing this information

Aid Management Division or Unit

- Coordinating donor or development partner activities within the country
- Liaison with individual donors or groups of donors on funding including negotiation of agreements,
- Acting as liaison between the Ministry of Finance, donor organisations and line ministries to follow up on all stages in donor support, i.e. identification, negotiation, budget preparation and implementation, release of donor funds, monitoring and evaluation
- Preparation of reports on donor funded programmes and expenditure

Sector Planning (sometimes this function is under a planning ministry or planning commission)

- Review of macroeconomic and sector policies
- Preparation of national development plans, Poverty Reduction Strategies or Growth Strategies
- Monitoring and evaluation of implementation of national plans
- Collection, analysis and reporting on macroeconomic and sector performance

Budget Department

The Budget Department is responsible for overseeing both budget preparation and budget implementation.

Budget Preparation

- Overseeing preparation of national budgets: provision of call circular, ceilings, guidance to line ministries
- Scrutiny of budgets submitted by ministries
- Consolidation and presentation of ministry budgets into a national budget document for submission to Cabinet and Parliament

Budget Implementation

- Warrants provided to ministries to authorise expenditure
- Specific approval for capital projects
- Approval for virement or reallocation of funds during the year, within agreed limits

- Monitoring implementation of the budget
- Preparation of Supplementary Budgets

Treasury or Accountant General

- Implementation of cash management systems including management of government bank accounts
- Monitoring budget implementation in conjunction with Budget Department
- Overseeing implementation of accounting and internal audit procedures in line ministries
- Overseeing the preparation of financial statements by line ministries on a regular basis, monthly or quarterly
- Preparation of regular reports presented to Cabinet and Parliament on government revenue and expenditure
- Preparation of annual accounts and financial statements

The Internal Audit function is usually within the Accountant General's office however in some countries this function has become more independent of the Accountant General through the establishment of a separate office. Internal audit functions are also being decentralised to line ministries as explained in Chapter 9: Budget Implementation.

Revenue Collection

Most governments in the MEFMI region have established semi-autonomous organisations (Revenue Agencies) which are responsible for tax collection including income, corporate tax and VAT. Non–tax revenues (i.e. fees and charges) are collected by line ministries.

Bureau of Statistics

This organisation (usually part of the Ministry of Finance) is responsible for the collection, analysis and reporting on national statistics, such as the national census, economic data such as trade figures, etc. Sector specific data will usually be collected by line ministries.

Planning Ministry or Planning Commission

The responsibilities of these organisations varies between countries and many MEFMI countries have experienced the merging and separation of Planning and Finance ministries.

Generally a planning organisation has the following responsibilities:

- Macroeconomic planning over the medium to long term
- National development planning particularly preparation of National Development Plans, Poverty Reduction Strategies, Growth Strategies etc
- Assessment of capital projects submitted by line ministries and preparation of the capital budget and in some cases the Public Investment Programme (see Chapter 4)
- Monitoring and evaluation of capital project implementation
- Coordination and management of external resources (aid funds) can also be the responsibility of a planning ministry.

Line Ministries

Principal (Permanent) Secretary: Accounting Officer

- Responsible or accountable for delivery of services with funds provided by government
- Responsible for overseeing the preparation and implementation of the budget and preparation of financial reports
- Planning Unit
- Usually responsible for capital project planning, preparation and monitoring
- Planning units should also be responsible for initiating review of existing policy and formulation of new policies (Chapter 5)

Finance or Accounting Sections

- Responsible for overseeing preparation of recurrent budget
- Responsible for overseeing procurement of goods (unless there is a separate procurement section)
- Initiating expenditures through agreed procedures as set out in Financial Regulations (see Chapter 11)
- Recording payments and preparation of financial reports on a regular basis
- Recording revenue collected
- Briefing senior management of the ministry on financial management issues

Technical Departments

- Responsible for delivery of services and creation of new infrastructure
- In some cases where budget processes have been reformed technical departments now play a more significant role in budget preparation, implementation and monitoring.

Civil Service Ministries

The management of civil service recruitment, employment terms and conditions, salaries, changes to ministry structures and staffing levels will be the responsibility of a civil (or public) service ministry. These ministries will be responsible for managing civil service reforms including pay reforms, ministry restructuring and introduction of performance management systems such as strategic planning and monitoring, performance contracts etc.

Regional Organisations

In addition to these national government organisations Public Expenditure and Financial Management operates within international and regional systems such as the United Nations, International Monetary Fund, Southern African Customs Union (SACU), East African Community, etc.

These international systems will have institutional and legal frameworks which can have a significant impact on the operation of PEFM systems in individual countries.

Civil Society Involvement in the Budget

As countries have become more open and democratic, there is a growing demand from the public to hold governments accountable for good governance and for the delivery of effective service with public funds. Civil society groups have been formed and a number of these are focusing on the budget in particular as the mechanism through which governments can be answerable to the public.

Their functions include:

- analysis of government budgets to assess the impact on poverty reduction
- monitoring the implementation of the budget, for example release of funds to poverty reduction priority programmes
- developing user friendly documentation to present budget information to the public
- undertaking an advocacy role to put pressure on governments to allocate funds in line with national priorities
- educating the public and specific stakeholders on budget issues

In order to support these groups the International Budget Project (IBP) was established in 1997 (See www.internationalbudgetproject.org for more information about their work, manuals and studies, and information on Civil Society Groups working on budget issues).

According to the IBP, budget work is advancing in every region, in both middle and low income countries, among think tanks and grassroots organisations, and within individual organisations and across coalitions. The work first took root successfully in middle income countries, such as Brazil, India, Israel, Mexico, Poland, Russia, and South Africa, predominantly among NGOs and think tanks.

More recently, a second wave of organisations, typically more community based or grassroots in nature, has emerged in low income countries in Africa (Malawi, Nigeria, Tanzania, Uganda), South and Central America (Ecuador, Honduras, Nicaragua, Peru), Southeast Asia (Indonesia), and Central Asia (Azerbaijan, Kazakhstan).

The role of civil society in improving and monitoring public expenditure systems, revenues and expenditures is being increasingly recognised on the international stage. Donor organisations now frequently support budget groups as a way of complementing the support they provide to national governments.

There are a number of civil society groups in the MEFMI region who focus on improving understanding of and debate on PEFM issues in their respective countries, as listed in Table 1 below.

Table 1. Civil Society Budget Groups in the MEFMI Region

Country	Organization	Website
Kenya	Institute of Economic Affairs (IEA)	www.ieakenya.or.ke
Malawi	Malawi Economic Justice Network	
Mozambique	Centro de Integridade Publica	www.integridadepublica.org.moz
Namibia	Institute for Public Policy Research (IPPR)	www.ippr.org.na
Tanzania	Hakikazi Catalyst	
Uganda	Uganda Debt Network	www.udn.org.ug
Zambia	Civil Society for Poverty Reduction (CSPR)	www.cspr.org.zm

Effective Institutional Arrangements for PEFM

Recent thinking in the area of PEFM reforms is placing increased emphasis on the institutional side of management of government resources.

This has encouraged greater focus on ensuring that there is
- Clarity in roles and responsibilities
- Appropriate institutional arrangements such as coordination mechanisms
- Clear “Rules of the Game” as defined in the legal and administrative framework.

Clear Stakeholder Roles

Ensuring clarity in PEFM roles and responsibilities involves answering the questions in the Box below.

Box 8. Clear PEFM Roles and Responsibilities

A clear definition of roles and responsibilities would cover the following:

- **purpose**: what is the role of the organisation in the PEFM system?
- **boundaries of purpose:** different parts of an organisation are clear on where their responsibilities begin and end
- **accountabilities**: what each organisation and individual can be held responsible for
- **authority:** how much control each organisation or individual has over the use of resources
- **delegation of authority for all stages:** how much authority has been delegated to all levels of the system
- **linking incentives and sanctions to roles and responsibilities:** what incentives and sanctions go along with responsibilities and who is responsible for imposing incentives and sanctions
- **information and communication:** about roles and responsibilities, and changes to these

Coordination between Organisations responsible for PEFM

Lack of effective coordination between and even within organisations can be a major constraint to the use of scarce resources including the use of human resources. Although steering committees and other mechanisms for improving coordination can be established to improve coordination, these do not always lead to the intended benefits.

Improving coordination is therefore dependent on:

- Having clearly defined roles of all stakeholders in the specific function, programme or activity that requires coordination
- Ensuring that there is no overlap in these responsibilities and no confusion about who is responsible for which function
- Having a clear and detailed action plan of what is to be achieved, by whom and when
- Ensuring that the committee meets on a regular basis and that the appropriate officials from each organisation attend, i.e. that junior staff are not sent to represent the senior staff and are therefore unable to contribute to the decision making process
- Ensuring that there are mechanisms for members to coordinate with each other between meetings
- Ensuring that the committee reports to a senior level within government so that they are held accountable for their performance

Coordination of functions can also be supported through the establishment of programmes that cut across line ministries, for example a Rural Development Programme implemented by several ministries such as agriculture, trade, local government etc.

This was one of the objectives of the US Programme Budgeting implemented in the 1960s (see Chapter 7). However the experience of this approach has not always been successful as it means that there is no single organisation which is held accountable for the performance of the programme.

In the Australian Government this has been addressed by establishing super-ministries ("portfolio ministries") which were made responsible for defining priorities in the sector and for making the trade-offs within a sector.

The sector review process described in Chapter 6: Medium Term Expenditure Framework (MTEF) is also an opportunity to bring together ministries within a broad sector such as the social sector and can provide a very useful mechanism for discussing issues which cut across the sector.

Restructuring of Roles and Responsibilities

When new systems are introduced or existing systems and processes modified, there is a need to review the current stakeholder roles and responsibilities to ensure that they are aligned with the new processes.

Examples of where changes to PEFM process can have implications for the roles and responsibilities of the key stakeholders are presented in Table 2 below.

Table 2. Organisational implications of Changing PEFM Processes

Change to process	Process Implications	Responsibilities or organisational structures
Integrating planning and budgeting under an MTEF	Previous separate processes of preparing plans and budgets are now integrated into one process	There is need for closer collaboration or even merging of the functions of planning and budgeting in Ministries of Finance and in line ministries
Integrating preparation of recurrent and capital budgets	Previous separate processes of preparing recurrent and capital budgets are now integrated into one process	Closer collaboration or even merging of the functions of budget preparation and implementation in Ministries of Planning and Finance and in line ministries
Introduction of a performance focus in the budget	Performance information needs to be collected to be linked to financial information	Line ministries need to have capacity within their departments to collect performance information

Merging Ministries of Finance and Planning

Many governments in the MEFMI region have undergone the restructuring of central ministries, in particular merging and separating Ministries of Finance and Development Planning.

The rationale for merging Ministries of Finance with Planning Ministries was the need to increase the linkages between:

- Macroeconomic planning which was sometimes in a planning ministry and the fiscal management role of Finance
- The processes of development planning, usually through the preparation of National Development Plans, and the preparation and execution of the budget
- The capital budget (often in a planning ministry) and the recurrent budget (usually in the Ministry of Finance).

Experience has shown that simply merging two organisational charts without reviewing and integrating the actual processes does not result in the intended benefits.

In some countries, the processes have remained separate while others have attempted to move the macroeconomic planning function into the Ministry of Finance and have integrated the responsibility for both recurrent and capital budgets within one department. Recently some governments, although having made these mergers, have established a separate Planning Council and the separation of functions is gradually re-emerging.

The lessons to be learned from these experiences:

- It is important to be clear about the objectives of the merger: is it a simple institutional merger, i.e. for efficiency reasons or is it to merge the functions and processes of planning and budget
- To have a clear view about the scope of an integrated planning and budget system
- To define clear roles for all departments in a merged ministry or where there are two separate systems, to avoid overlap and duplication of functions.

Professional Cadre System

Many MEFMI governments also operate a cadre system in which groups of professionals belong to a particular cadre such as the planning or economists cadre, the accounting or financial controller cadre, and internal auditor cadre.

There are two ways in which these cadre systems operate:

- The cadre is managed by the relevant department in the Ministry of Finance, e.g. the planning cadre will be managed by the planning department and the officials within the accounting cadre belong to the Ministry of Finance
- The responsible department does not employ the staff in the cadre, they will be employed and managed by the relevant line ministry, but the head of the cadre will provide professional support to the staff in the cadre such as ensuing that sufficient training is provided and that the members of the cadre meet on a regular basis to share information.

Each approach has its positive and negative implications. The centralised cadre approach means that officials in the cadre can be promoted by transfer between organisations, but this then limits the management of the cadre officials by the line ministry where they are posted.

For the devolved approach, the opportunities for promotion within government can be more limited as officials will have to wait for vacancies in other ministries in order to be promoted. For the line ministries, the senior management can hold the economists or accountants more accountable for their performance if they are appointed within their own ministry.

Devolving Responsibilities

One of the key elements of the "New Public Sector Management" approach is devolving responsibilities to managers, while also holding them more to account for delivering agreed performance (see Chapter 3: PEFM Reforms).

In governments such as New Zealand and Australia, line ministries have complete freedom to recruit their own staff, agree salary levels and use funds as they require in order to produce agreed performance. In return Parliament approves the ministry budgets in terms of the outputs to be delivered and senior staff are employed on performance contracts, i.e. their pay and promotions are linked to their performance and the performance of their ministry.

In the MEFMI context it may not be possible to reach these levels of devolving responsibilities to line ministries, but the following issues could be considered:

Reducing the level of Control

- Enabling line ministries to recruit their own staff within the professional cadres
- Providing additional flexibility in the use of funds: i.e. changing the virement rules so that ministries do not need Ministry of Finance approval to change the use of funds at a detailed level (see Chapter 9: Budget Implementation).

Increasing the Level of Accountability

- Requiring ministries to present performance information in the budget, including both a review of past performance and planned performance
- The budget discussion with line ministries and the Ministry of Finance as well as in Cabinet and Parliament to focus on performance rather than line item details
- Requiring line ministries to explain or be held accountable for differences between planned and actual performance, both physical (e.g. number of classrooms constructed) and financial performance
- Ministry of Finance providing reports to Cabinet and Ministry of Civil Service on each line ministry's performance both in terms of spending discipline and service delivery achievements

Legal Framework for PEFM

The legal framework for Public Expenditure and Financial Management includes:

- The Constitution
- Finance Act/Law
- Financial Regulations
- Some countries are introducing a specific Budget Law

The Constitution

The Constitution will cover the broad issues of PEFM including:

- The requirement that all funds should be paid into a Consolidated Fund and that these funds can only be spent with the approval of the Legislature
- The relationship between central and local government
- The roles and authority for budget preparation and management for the Executive and the Legislature

Finance Act/Law

The Finance Act/Law describes the key roles and relationships that determine the implementation of PEFM systems and procedures. In most MEFMI countries the Finance Act will provide a comprehensive basis for defining the implementation of the PEFM system while the detailed procedures are defined in Financial Regulations which are updated on a regular basis to reflect changes in budget and accounting processes.

Some MEFMI countries are in the process of introducing a Budget Law that covers the requirements of the budget preparation process although in some other cases financial legislation reforms cover all aspects of PEFM systems as described below.

The Finance Act/Law should cover three areas:
General Principles: principles of good budget preparation, concepts and definitions, scope of the budget, accounting and classification, appropriations and cash limits, roles and responsibilities, relationship with other budget laws, powers of the Ministry of Finance

Budget Formulation: budget timetable, period of budget, setting ceilings, budget calendar, procedures for budget preparation, analysis of budget requests, preparation of draft budget law, submission to Parliament, content of budget documents, rules for supplementary budgets

Budget Execution and Audit: treasury/cash management function, in-year cash limits, internal control, incentives and sanctions, fiscal impact analysis, end of year accounts, periodical financial statements, external audit procedures, management of government debt, fiscal risks, contingent liabilities, fiscal rules for extra budget funds and sub national government.

The Finance Act should define the requirements as follows:

Payment of Funds into and Withdrawal of Funds from the Consolidated Account

- Authorise the payment of all public funds into one account, disbursements from which can only be approved by Parliament
- Enable the Ministry of Finance to delegate the management of additional accounts to line ministries but these funds should be shown in the consolidated government accounts
- Stipulate that the creation of special accounts or extra budgetary funds (or EBFs see Chapter 6: Budget Preparation) should only be authorised by law and that these revenues and expenditures should be included in the government accounts
- Set out the basis for budget and accounting classification of revenues and expenditures
- Define the deficit/surplus and that the deficit/surplus should be included in the annual Appropriation Act
- Define the powers of the Ministry of Finance

Authorisation or Appropriation of Funds

This should set out the authorisation of use of public funds or appropriation by Parliament including:

- the levels of the budget which are authorised by Parliament
- rules for reallocation of funds by line ministries or virement
- time limit for use of funds: most systems limit the spending of the current fiscal year although in more advanced countries particularly capital budgets can be carried over into the next financial year
- the inclusion of contingencies in the budget and the rules that govern the use of the contingency. Contingencies should be restricted to specific uses, form only a small percentage of the total budget and their use should be reported to Parliament
- provisions for continuation of spending if Parliament is unable to approve the budget before the beginning of the financial year. In some countries this is a routine occurrence in which the Finance Act provides an automatic approval for the government to spend a certain percentage of the current year's budget and is known as the "Vote on Account" or "Supply Warrant"

Revenues: the powers of the government to collect revenues should be defined in the Finance Act

Presentation of the Budget to Parliament should include:

- The time by which the estimates must be presented to Parliament
- The time by which Parliament must approve the estimates
- The form and contents of the Budget
- Specification of fiscal targets in budget documentation and the medium term economic strategy of government
- Provisions to regulate Parliamentary debate and powers to amend the budget
- Provisions that control increases in expenditures and presentation of supplementary budgets

Budget preparation processes should be defined in broad principles in the Finance Act although the detailed procedures are usually set out in the annual Call Circular which guides the preparation of the budget by line ministries.

Budget implementation provisions should cover the following issues:
- No expenditure can be incurred without authorisation of the Minister of Finance, which is provided through the issue of a warrant
- Control of virements or reallocation of funds between items of expenditure by line ministries
- Provision for the Minister of Finance to report back to Parliament on the implementation of the budget, and that monitoring reports on revenues, expenditures and borrowing should be provided regularly to Parliament, including a mid-year report
- Definition of the responsibility of the treasury for financial execution of the budget
- Definitions for the implementation of internal control procedures and internal audit.

Government Borrowing and Issue of Guarantees

- Limiting the authority to borrow and grant loan guarantees to the Minister of Finance
- The amounts to be borrowed are limited by the amounts indicated in the annual Appropriation Act
- The Minister can issue loan guarantees
- The government has no liability for the debt of autonomous agencies except for loans it has guaranteed
- Controls on local government borrowing

Banking and Financial Assets

The Minister of Finance should be responsible for the opening, closing and operating the bank accounts of central government. These accounts will be held by the central bank operating as the government's banker. As described in Chapter 9: Budget Implementation, government accounts can also be held in commercial accounts and some governments have experienced problems managing the large number of government accounts that have been opened to manage special funds and external resources.

Financial Reporting and Audit of Financial Statements

The Minister of Finance should ensure that appropriate reports are prepared and submitted to an external auditor, usually the Auditor General. The provisions should include:
- the scope of the reports to be submitted to Parliament
- independence of the Auditor General from the Executive and the responsibility for auditing all public moneys, assets, financial statements, and other financial records
- the timeframe for Ministry of Finance to submit the financial statements to the Auditor General and for the Auditor General to issue an audit opinion on the financial statements
- the agreed accounting practices for the preparation of government financial statements

Accountability and Sanctions: the Finance Act should set out the procedures and administrative sanctions to be applied in cases of misuse of public funds.

Local Government PEFM Systems: the Finance Act should define the principles and procedures to be used at the local government level.

Definition of government entities: the Finance Act should define the difference between agencies of central government and those that function in their own right, and should define the different types of public sector entities and the financial management rules that should apply to each category of public sector entity.

Manuals, Circulars and Financial Regulations

The detailed implementation of the above issues will be defined in a set of more detailed documents that may be updated or even produced on an annual basis to reflect detailed changes to PEFM systems and procedures. These will include:

Planning Manuals: particularly focused on preparation and implementation of development or capital projects.

MTEF/Budget Manuals: the introduction of new budget processes such as the MTEF will usually involve the preparation of a detailed manual describing the processes and formats to be used in the process in each country.

Budget Call Circulars: these will be produced each year to set out the policy and priority guidelines, processes and formats to be used, timetable and budget ceilings to guide the preparation of the budget.

Financial Regulations: these will provide detailed instructions (rather than the principles set out in the Finance Act) on the roles and responsibilities, procedures to be followed, formats to be used in the budget implementation and accounting processes.

Treasury Circulars providing detailed and regular guidance on specific issues e.g. annual closure of accounts.

Effectiveness of the Legal Framework

The effectiveness of PEFM systems will depend on having a clear and consistent set of rules and regulations that define the roles and responsibilities of the stakeholders and are in line with the PEFM systems in use.

Therefore the legal framework needs to be:

- Consistent without conflicting rules or regulations, i.e. the requirements as defined for budget preparation need to be consistent with those in the accounting processes
- Clear in their definition of stakeholder roles
- Consistent with any changes/reforms to PEFM systems, e.g. if a performance or three year focus is introduced the legal framework may need to be revised
- Clearly define the incentives/sanctions used to enforce laws and regulations

The principles to guide effective financial legislation are indicated in Box 9 below.

Box 9. Principles of an Effective PEFM Legal Framework

- Feasible and forward-looking, and can be developed further and implemented in conjunction with continued progress on reforms.
- Clear and easy to understand by professionals and political appointees.
- Contains separate sections for major activities.
- Consistent internally, and with related laws (unless they are subject to change).
- Comprehensive, and includes all areas of public financial management, such as: budgeting, financial management, public borrowing and debt (including budget deficits), auditing, analysis, and reporting.
- Transparent, and does not include "hidden" powers or responsibilities.
- Sustainable, and can remain in place for many years.
- Stipulates specific accountability by public officials for various activities.
- Balances responsibility and authority on the part of government agencies and officials.
- Conforms to international standards in relevant technical areas, especially regarding budgeting and financial management and control.
- Strengthens and clarifies the functions of the Ministry of Finance.
- Has the support of the Minister of Finance and the government (especially the President/ Prime Minister).
- Mutually supportive of National Objectives and Priorities.

Clear Rules of the Game

The legal framework should clearly define the powers/authority, responsibilities and control for stakeholders in the PEFM system, i.e. the "Rules of the Game" that define the PEFM system.

This should set out:

- The levels of autonomy granted to spending ministries: the level of freedom that ministries have in the use of funds.
- Controls imposed by the central agencies such as the Ministry of Finance over the way in which funds are used, e.g. the level at which ministries require approval from the Ministry of Finance to change the use of funds.
- Responsibility for performance: whether ministries are only responsible for keeping spending within the approved Budget Estimate levels or are also responsible for delivering the agreed performance as defined in performance indicators (see Chapter 7: Budget Preparation).
- The sanctions and incentives framework for use of public funds: the measures that will be taken against individuals and organisations for mis-use of public funds, and the benefits that will be provided for good performance.

These rules will usually cover a wide range of issues in terms of:

- **Budget preparation**: coverage, scope, presentation formats and approval processes
- **Budget implementation:** release of funds, control over use of funds, flexibility in changing the use of funds, authority for making commitments and spending, internal audit procedures
- **Budget reporting and monitoring:** accounting procedures and reporting, responsibilities and timeliness of reporting, monitoring procedures
- **Budget evaluation and audit:** the roles and responsibilities, scope of audit (i.e. performance or value for money audit)

Use of Sanctions and Incentives

The scope and application of sanctions, which are applied against officials who misuse public funds, are usually described in the Financial Legislation. The misuse of public funds can take various forms with different degrees of severity:

- Not following correct procedures for procurement or use of funds
- Corrupt practices such as influencing the award of tenders etc

Such practices can be uncovered at various levels and stages in the PEFM cycle:

- As part of the tendering process, the procurement authority can identify possible weaknesses
- During budget implementation, problems relating to following correct procedures and inappropriate tendering processes can be found during the internal audit process (see Chapter 9: Budget Implementation)
- Misuse of public funds can also be identified by the Auditor General (see Chapter 12: External Audit)

The sanctions to be applied will depend on the severity of the misuse of funds and can take various forms: (see the section on Fraud and Corruption in Chapter 12: External Audit). However the use of the legally binding sanctions and prosecution of government officials for corrupt practices will depend on the political commitment of a government and attitudes to fighting corruption. Thus the existing legal framework may have sufficient provision for the use of sanctions, but it may be the lack of political will to implement these sanctions that is the cause of the breakdown in fiscal discipline.

Incentives: in most governments there are no explicit incentives for good performance in the use and management of public resources. However recent reforms to PEFM systems have introduced a performance focus to the planning and management of public funds and these provide for incentives for good performance at two levels:

- **Institutional level:** ministries can be rewarded for good performance in the use of public funds through additional funds being provided to implement priority activities

- **Individual level:** some countries are introducing performance contracts for civil servants through which pay increases and promotions are linked to an individual's performance. These performance criteria can include effective management of funds.

Bypassing Formal Rules

Although a wide ranging set of formal rules will be in place in many countries, these will be bypassed in certain situations. Decisions on budget allocations and actual expenditures may take place outside the formal budget preparation and management procedures, and sanctions are not applied for breach of the financial regulations etc.

As noted in *Institutional and Incentive Issues in Public Financial Management Reform in Poor Countries, Mike Stevens, October 2004, PEFA* in developing countries there is a mismatch between the formal rules as defined in the financial legislation and the way they are implemented in practice.

The reasons for the collapse of the formal rules are:

- The collapse of civil service pay structures, which means that civil servants are unable to survive on government salaries and need to rely on other means such as seeking additional allowances, supplements through donor projects, private earnings through consultancy work etc.
- The difficult working conditions (lack of well maintained offices, equipment and operating budgets) which hamper effective management and service delivery
- Scarcity of funds and effective working environment increases the potential for patronage or institutional conflicts that prevent the effective operation of the existing rules
- The influence of large donor inflows and the establishment of parallel systems and procedures which have undermined the operation and adherence to the existing formal rules
- Lack of experience and capacity of the oversight organisations such as the Public Accounts Committee, Parliament and civil society to hold the Executive accountable for the proper use of public funds

The above issues result in the formal rules being bypassed as sanctions are not imposed for not adhering to the formal rules and officials are able to make use of donor funds using parallel systems.

Interest in government compliance with existing financial legislation and regulations is increasing for a number of reasons,

- Recent improvements in democratic processes and civil society efforts to hold governments more accountable for use of public funds are beginning to increase pressure for compliance with existing rules and regulations.
- As development partners seek to make use of government PEFM systems compliance with best practice and financial regulations are now under detailed scrutiny through assessments of government systems using instruments such as the PEFA PFM Framework (see Chapter 1).

Updating and Revising PEFM Legal Framework

As governments introduce reforms to PEFM systems and new procedures and international guidelines are developed, it is important to review and if necessary update the existing legal framework for PEFM.

As noted above, many developing countries have effective Financial Legislation already in place that guide the budget preparation and management processes. It is the poor implementation of these regulations that is the cause for concern.

However there are some areas where existing financial legislation may require review and updating to conform with recent reforms to PEFM systems. These include:

- Improving the level of transparency in the budget processes and documentation to provide better information to Parliament and the public about the services or performance to be delivered with the approved funds, including improving the presentation of budget documents as described in Chapter 8: Budget Coverage, Presentation and Approval
- Improving the information in the budget on the economic assumptions underlying the budget estimates
- Improved reporting throughout the year on budget implementation to Parliament
- Introducing a medium term focus in the budget estimates
- Requiring line ministries to produce a report which describes their physical and financial performance.

In reviewing existing legislation it is important to consider the following issues:

- To have a clear understanding of the existing financial legislation: often existing legislation does provide for changes to PEFM systems; rather the problem is that the existing legislation is not being implemented
- To assess the gaps between existing legislation and the areas where improvements are being introduced and changes are required
- To identify the timeframe required for introducing a revised Finance Act based on when the new systems and procedures are to be implemented
- To ensure that there is effective consultation with all stakeholders during the review and revision of the legislation to take account of the various stakeholder requirements
- The related financial procedures and regulations will also need to be updated to ensure conformity with the new legislation
- To ensure that once the legislation is amended that there is sufficient training and awareness of the new laws and how they are to be implemented in practice.

Ministries of Finance will need strong legal departments to assist in reviewing and drafting revisions to financial legislation.

Reforms to the Legal Framework in OECD Countries

New Zealand's Fiscal Responsibility Act (FRA) of 1994 is a benchmark piece of legislation, which sets legal standards for transparency of fiscal policy and reporting, and holds the government formally responsible to the public for their fiscal performance.

The FRA principles and standards

The FRA sets out five principles of responsible fiscal management: reducing public debt to prudent levels; requiring an operating balance to be maintained on average over a reasonable time; maintaining a buffer level of public net worth; managing fiscal risks; and maintaining predictable and stable tax rates. The government is permitted to depart from these principles temporarily, provided such departure is clearly justified and a clear plan and time to return to the principles are given.

The FRA then specifies clearly how the government is to report on proposed policies and actual achievements to assure the Legislature and the public that the fiscal management principles are being followed. The FRA requires the government to:

- publish a “Budget Policy Statement,” containing strategic priorities for the upcoming budget, short-term fiscal intentions, and long-term fiscal objectives, no later than March 31 for a July 1 fiscal year
- disclose the impact of fiscal decisions over a three-year forecasting period in regular “economic and fiscal updates”
- present all financial information according to generally accepted accounting practices
- refer all reports required under the Act to a Parliamentary select committee.

See http://www.treasury.govt.nz/pubs/bmb/fra/details.htm)

Similar legislation, the Charter of Budget Honesty (CBH), has recently been enacted in Australia; and the United Kingdom has enacted a Code for Fiscal Stability (CFS). Standards of fiscal transparency under such national legislation are generally more demanding than those suggested under the Code.

CHAPTER 3 REFORMING PEFM

Introduction to the Chapter

Overview of the Chapter

This Chapter sets out the approaches to reforming PEFM including a summary of OECD and developing country experiences.

The Chapter includes the following:

- A summary of the common weaknesses in developing country PEFM systems
- A summary of recent reforms to PEFM systems and common issues faced by developing countries
- A summary of PEFM reforms in OECD countries
- A brief description of wider public sector reforms including civil service and parastatal reform
- Planning and implementing PEFM reforms including the need to take account of the interests of various stakeholders
- Implementing PEFM reforms at local government level
- The importance of change management in the reform process.

The final section of the Chapter briefly describes the issues involved in managing a major reform or change to the way in which governments operate, i.e. change management, along with suggestions on how to make use of change champions.

Key issues

In developing countries reforms to Public Expenditure and Financial Management systems have focused on improvements in the following areas:

- Fiscal discipline which was a significant driver of reforms in some countries such as Uganda starting in the 1980s
- Improved allocation of resources in line with priorities between and within sectors
- Improved efficiency and effectiveness of expenditure
- Additional objectives include improving transparency, accountability, and predictability on the availability of funds, wider participation of stakeholders and legitimacy of the PEFM system.

Specific reforms to PEFM systems include:

- **The Medium Term Expenditure Framework (MTEF):** seeks to improve the links between planning and budgeting, ensure that limited resources are allocated within a three year hard budget constraint, and improve the services delivered with public funds and their impact on the population

- **Integrated Financial Management Information System (IFMIS):** the introduction of computerised accounting systems with emphasis on improving the accuracy, timeliness, control and management of public funds
- Strengthening management processes such as **procurement reforms, payroll and personnel management reforms**
- Bringing systems in line with **international standards** such as internal and external audit
- Reforms to the **legal framework** through introduction of new legislation and roles of the oversight organisations.

In some countries reforms have been implemented as a single reform. In other countries they have been introduced as part of a comprehensive PEFM reform programme, with a number of reforms being implemented at the same time in an integrated programme. While there is no single correct way of implementing PEFM reforms it is important that they are government led, and take account of stakeholder roles and interests.

Common Weaknesses in Developing Country PEFM Systems

All developing country governments have the necessary legal and institutional systems in place for the collection and spending of public resources. These systems were established in the early part of the twentieth century and usually provide a comprehensive and robust system for the control of public resources.

These systems will differ in their exact implementation and legal framework depending on:
- The colonial administration under which they were introduced, i.e. whether a country was a former British, French or Portuguese colony
- Current regional arrangements such as Francophone countries' participation in the Franc Zone
- Current thinking in PEFM reforms, which tends to lead to the introduction of similar PEFM principles and systems across countries in the MEFMI region.

While the PEFM systems introduced in the colonial period were effective in the 1960s and 1970s, from the 1980s onwards these systems have faced a number of constraints which are described below, along with the lack of integration between systems and the impact of these weaknesses.

Table 3. Common PEFM Weaknesses and their Impact

Weaknesses in PEFM Systems	Impact
Planning and Policy Analysis	
Long term and medium term plans (including, more recently, Poverty Reduction Strategies) are not always based on a realistic resource envelope and are not linked to the annual budgets	National plans may be overly ambitious and unaffordable. Therefore plans are not implemented in practice with targets and objectives not being achieved
New policies are introduced without sufficient analysis of their budgetary requirements	Unaffordable and technically weak policies may be implemented, and therefore the effectiveness of government services is undermined
Donor led policy changes	These have undermined government capacity for effective policy formulation
Lack of government capacity to develop macroeconomic forecasts and suitable models for the development of such forecasts	Unrealistic fiscal framework which leads to the need to reduce expenditure during budget implementation and predictability of funding
Budget preparation	
Line item focus of processes and documents i.e. on inputs (e.g. how much is to be spent on fuel)	There is no planning of the outputs (the goods and services to be produced with the funds)
	Expenditure usually increases on all items of expenditure causing under funding of priority activities to worsen
	There is little emphasis on alternative means of achieving objectives nor on cost efficiency and effectiveness
The focus of the budget was on an annual basis, so that government and line ministries were not planning ahead for the implementation of activities	Line Ministries attempt to implement activities within one year rather than planning realistic implementation plan

Weaknesses in PEFM Systems	Impact
Within the annual budget, lack of integration between recurrent and development (or capital) budgets	The future recurrent costs of capital projects are not planned for and there may be some duplication of activities in both budgets
Budget Implementation	
Insufficient accountability and transparency in the use of public funds	Spending ministries are not held accountable for achieving objectives and spending funds as approved by Parliament
Insufficient fiscal discipline within government systems	Funds and activities approved in budgets may not be implemented in practice: new low priority activities may receive funding
Weak implementation of existing budget execution systems and poor cash management, often resulting in the introduction of cash budgets	Spending ministries will not receive the funds as budgeted and are therefore unable to implement approved programmes
External Resource Inflows	
PEFM systems were developed before the large inflows of external resources following independence, which combined with a lack of accountability has led donor organisations to put in place parallel systems to meet their own accountability requirements	Governments were not aware of or in control of funds which had been approved for supporting government projects and services
Wider Institutional Issues	
Problems of retaining staff: both in terms of numbers of staff and qualifications/skills	The quality of PEFM implementation will not reach planned levels
The parallel processes of civil service reforms which are often not linked to the budget process	Line ministries will be responsible for implementing parallel processes such as performance budgeting and performance management. Civil service ministries may increase establishments or approve restructures without regard to the impact on the budget

Recent PEFM Reforms in Developing Countries

Overview of PEFM Reforms in Developing Countries

The above weaknesses in PEFM are being addressed through a number of reforms in developing countries which focus on three objectives:

- Maintaining fiscal discipline
- Improving sectoral allocations
- Improving efficiency and effectiveness of expenditure

The specific reforms to PEFM systems being implemented in MEFMI countries include:

The **Medium Term Expenditure Framework (MTEF)** in its simplest form is a process of matching limited funds with unlimited needs within a hard budget constraint over the medium term, usually three years. The process involves:

- Ministry of Finance developing a three year macroeconomic and fiscal framework which sets out the total resources including government and donor
- Line ministries identifying their requirements based on agreed government priorities
- Ministry of Finance and Cabinet making decisions on how limited resources will be allocated between ministries and programmes based on achieving government objectives.

The MTEF is described in more detail in Chapter 6.

Programme or Performance Based Budgeting has been introduced in a number of countries in the MEFMI region, usually as part of the MTEF process. This approach focuses on developing a stronger link between government objectives and priorities and the preparation of line ministry budgets. These budgets will usually be based on the setting of specific performance targets such as the number of primary school pupils to be educated.

Integrated Financial Management Information System (IFMIS) is an integrated system for managing government funds using a computerised financial management system. The system usually covers all aspects of budget preparation and management: government budget preparation, commitment control, purchasing, expenditure management (cash management, payments, cheque writing etc), and production of regular financial reports and government public accounts.

Experience has shown that it is important to focus as much on the preparatory and institutional issues in the introduction of an IFMIS:

- Reviewing existing processes so that weak systems are not simply computerised, including any necessary changes to the Chart of Accounts
- Implementing an effective change management and capacity building plan
- Ensuring that the focus is not simply on the technical issues but on improving transparency, accountability and performance.

In addition to these major reforms, a number of governments are also strengthening;

- The legal and institutional framework,
- Procurement, internal and external audit,
- Systems for coordination and management of external resources.

PEFM Reforms in OECD Countries

Reforms to Public Expenditure and Financial Management systems in OECD countries have focused on increased managerial freedom within a hard budget constraint as a key incentive for improved performance. This is based on the move to a more market based approach called the New Public Management (NPM) model which separates the functions of the person (principal) who engages another person (the agent) to provide a particular service. The relationship in the NPM model becomes a contract in which there are incentives for effective delivery of the service therefore avoiding the weaknesses of bureaucratic systems.

This approach led to the creation of agencies in the public sector, in countries such as the United Kingdom and New Zealand, in which the aim was to ensure that these agencies were given clearly defined roles, performance targets and staff who were accountable for the agencies' performance. These agencies operate on a semi-commercial basis with their own financial management systems and accounts.

This involves the following principles:

- Increased flexibility of managers
- Increased emphasis on restraint
- Focus on performance and accountability
- Three year framework for resource planning.

The exact form of PEFM reforms in OECD countries varies as described below.

New Zealand is considered to be at the forefront of the move to performance or output based budgeting. Departments produce their estimates on the basis of the outputs and are then held accountable for the production of the outputs, through sanctions for non-performance. Chief Executives of Departments sign performance contracts and the renewal of their contracts will be based on their performance in achieving the outputs.

The **Australian Government** uses a system of Forward Estimates which focuses Departments on considering policy changes within a hard budget constraint over a three year period. They have been given a high degree of flexibility and incentives to identify savings options themselves.

The **United Kingdom** started with the reforms to government institutions, through the creation of Next Steps Agencies, and recently introduced reforms to the PEFM system through the introduction of Resource Accounting.

Wider Public Sector Reforms

Many governments have embarked on a wide-range of reforms of the public sector with the emphasis on improving efficiency and effectiveness in service delivery and meeting government objectives. These reforms tend to cover a set of initiatives usually including Public Expenditure and Financial Management reform, civil service and parastatal reform.

They are often managed from within the Office of the President or Prime Minister where the main function is the coordination of the specific reform initiatives, which are implemented by the relevant technical ministry such as the Ministry of Finance.

Civil Service Reforms

Civil service reforms have tended to focus on two broad issues:

Reducing the total costs of government through;

- Improving payroll systems and removing ghost workers (i.e. non-existent staff for whom existing employees will claim a salary) from government establishment lists
- Civil service pay reforms.

Restructuring government ministries, usually with the aim of downsizing ministries so as to reduce costs and streamline functions.

However, the benefits of those downsizing or restructuring exercises can quickly disappear if the civil service ministry can approve the creation of new positions or the increase in establishments without regard to Budget constraints.

More recently the focus has been on improving the performance of the civil service through;

- Preparation of strategic plans so as to improve the operation of ministries and the achievement of government objectives.
- Introducing a performance focus in the management of civil servants through performance management systems, performance contracts etc.

The second focus of civil service reform is linked to the New Public Management (NPM) Reforms as described in the summary of PEFM reforms above. Within the MEFMI region there are some elements of these civil service reforms that are being implemented such as the introduction of a performance focus in the budget and contracting out of some government services.

Parastatal Reforms

Parastatals or state owned enterprises have also been the subject of reform in most developing countries as they had tended to be less productive than private sector firms resulting in significant losses which then have to be covered by government budgets. Thus the aim of parastatal reform has been to improve the productivity of these organisations and thereby reduce the losses borne by governments.

Parastatal reforms have focused on:

- privatisation of parastatals
- commercialisation of parastatals where the organisations remain within government ownership but are required to operate on a commercial basis, i.e. do not require subsidies from government
- use of public private partnerships
- introduction of performance contracts between government and those organisations that are not privatised to hold them accountable for delivery of effective services
- improvements in the management and oversight of parastatals by government through the establishment of units or divisions within a Ministry of Finance or a specific organisation established with this responsibility. Their main responsibilities are to monitor parastatals' service delivery, and to ensure that government fiscal risks are limited by supervising the parastatals' borrowing and financial management more closely to avoid the creation of liabilities for the government.

Planning and Implementing PEFM Reforms

Effective reforms to Public Expenditure and Financial Management systems need to be led by governments rather than development partners and/or consultants. This section provides suggestions on planning for the reform, identifying the issues to be addressed through the reform and involving key stakeholders in the reform process.

Addressing Common Constraints to Effective Reform

Most governments in the MEFMI region have already started the implementation of PEFM reforms either as individual reforms such as the Medium Term Expenditure Framework (MTEF) or Integrated Financial Management Information System (IFMIS), or as a comprehensive reform programme addressing all aspects of the PEFM system.

Experience of PEFM reforms has shown that there are a number of common constraints to the implementation of effective reforms which can undermine the success of the reform programme. In governments where these issues are addressed the reforms are more likely to be successful. For example the governments of South Africa and Uganda have demonstrated a high level of political commitment to PEFM reforms which has accounted for the relative success of the reforms in these countries.

While these reforms have been introduced in many MEFMI countries, a number of constraints have prevented the reforms from reaching their full potential as described in Table 4 below.

In planning the implementation of PEFM reforms or strengthening existing reform programmes the above issues need to be addressed, i.e. increasing political commitment, defining a clear and comprehensive reform programme, and ensuring that the reforms are government led.

Table 4. Summary of PEFM Reforms and Constraints

PEFM Objective	Issues	Reforms	Constraints
Maintaining fiscal discipline	Credible macroeconomic forecasts	Developing forecasting and macroeconomic management skills and tools	Difficulties of retaining qualified staff Difficulties of developing and sustaining country led macroeconomic models
	Ensuring commitment at all levels to agreed targets	Increased participation in discussion of targets and political commitment to targets (MTEF)	Where political commitment to reform is lacking this is difficult to address
	Budget implementation systems to ensure adherence to targets	Existing budget implementation systems may need to be strengthened: this can be part of an IFMIS	Lack of political commitment to ensuring adherence to budget implementation rules
Improving sectoral allocations	Ensuring clear national and sectoral objectives	Preparation of national and sector documents that set out priorities	Such documents may define priorities at such a high level that all government programmes become priorities.
			Lack of integration with budget process may mean that national priorities are not implemented in practice
	Preparation of three year estimates that reflect medium term priorities within hard budget constraint	Introduction of the MTEF through which ministries submit their requirements as an input into the setting of ministry ceilings	Ministries tend to focus only on first year of estimates

PEFM Objective	Issues	Reforms	Constraints
			Ministries of Finance may continue to use percentage increase in allocation of funds
	Linking plan and budget processes	Introduction of the MTEF	Where responsibilities are separate for planning and budgeting, these may remain separate
Improving efficiency and effectiveness of expenditures	Improving the basis for the budget	Introduction of a performance focus in the budget	Difficulties of defining appropriate performance indicators
	Lack of accurate and timely information for evaluating expenditures	Introduction of IFMIS to improve recording of and reporting on revenues and expenditures	Ensuring close link between planning, budgeting and accounting reforms
	Lack of monitoring and evaluation processes	Introduction of systems to monitor and evaluate performance	These systems may not be linked to budget and accounting systems
Improving Aid Management	Weak internal audit and external audit capacities	Strengthening audit systems and capacities	Difficulties of retaining qualified staff
	Large percentage of donor flows outside government systems	Donors agreements (Paris Declaration) to increasing capture of donor flows	Not all donors are willing and able to comply
			Governments do not have the necessary systems and capacity to capture the information

PEFM Objective	Issues	Reforms	Constraints
	Donors using their own systems creating significant administrative burden for government	Donors agreements to use government systems	Not all donors are willing and able to comply
			Government systems are not always able to capture donor funds

Planning for PEFM Reform

Table 5 below sets out some of the issues to be addressed in planning for a PEFM reform programme or strengthening the implementation of existing reforms.

Table 5. Planning a PEFM Reform

Establish a steering committee and sub-committees that are responsible for specific sub-systems such as budget preparation. The steering committee needs to be led by a senior civil servant with access to Cabinet ministers, to meet regularly and be able to take decisions and ensure that these are implemented. See the section below on Managing a PEFM reform and change champions.
Assessing existing systems or the implementation of an existing reform Existing systems need to be measured against "best practice", which is set out in the MEFMI Assessment Tool and can be used along with the other tools. Issues: Are the systems themselves weak or is it the implementation of the systems that is not effective? Detailed evaluations can be undertaken to involve stakeholders in assessing existing systems. See Chapter 11: Performance Monitoring and Evaluation for suggestions on evaluation methods.
Define the specific measures required to strengthen the systems Draw on experience from elsewhere to identify which processes have been successful and those that have not reached their full potential. Ensure that the focus of the reform is comprehensive and that effective linkages between the various sub-systems are strengthened. Study tours can be useful to assess other country experiences.

Develop a detailed action plan with milestones and responsibilities for implementation of the action plan The action plan needs to be linked to the budget cycle itself as well as to other key milestones and activities such as donor coordination meetings Project planning tools can be useful for developing detailed plans
Ensure that there is high level commitment to the reform through regular sensitisation and briefing of the Minister of Finance, Cabinet and even Parliament Briefing of Cabinet, Parliament and other stakeholders needs to be tailored to the different needs and levels of understanding of the issues. High level political commitment is critical when inter ministry issues or obstacles arise, or in quickly filling key vacancies important to the reforms. See the section below on communicating change
Ensure that capacity building plays a major role in the PEFM reform process, with a detailed training plan for all stakeholders The reform needs to be government led and owned and the process itself should build the capacities of all those involved. Training also needs to be an ongoing process rather than linked just to the introduction of a new system or process See the section below for undertaking Training Needs Assessment
Undertake regular monitoring and evaluation of the process It is important to assess whether the reform programme is on track, identify issues that need to be addressed in subsequent years and any additional capacity building or funding requirements that need to be met.

Deciding on PEFM Reform Strategies

The way in which PEFM reforms have been implemented in developing countries is the subject of much debate, i.e. whether to implement a reform such as the Medium Term Expenditure Framework (MTEF) across a government in one year or to introduce the new process on a more gradual basis through piloting the process.

However, it is not possible to state whether one approach is better than another as this depends on country circumstances. The advantages and disadvantages of the two approaches are listed in Table 6 below.

Table 6. Comparison of the Big Bang and Piloted Approaches to PEFM Reforms

Big Bang Approach: i.e. across the whole of Government	Piloted Approach
Advantages	
It sends a clear message that government systems are changing: it is no longer business as usual It is possible to make trade offs across the whole of government using the MTEF information which is not possible using a piloted approach	It allows for lesson learning from the experience of the pilot ministries Enables a government to develop its own internal capacity to manage the reform and develop internal training capacity
Disadvantages	
It does not allow for a government to gradually develop its own process, based on experience It can place an enormous capacity and management burden on government It is likely to be more risky particularly for an IFMIS It can result in rushed process with insufficient understanding of new systems which can take longer to build than if implemented more slowly	If implemented over a long period, can lead to apathy and lack of commitment or "reform fatigue" It is more difficult to see the full benefits within a short period

There are however some common issues that need to be taken into account:

- There needs to be a clear vision and objectives for the reform process, so that even if the reform is implemented over a number of years this takes place within the context of an agreed framework
- All elements of the reform need to be in place for the reform to reach its full potential
- Reforms need to be seen as a continuous process, so that each year it is important to review progress and make any changes to the implementation plans and even the approach based on the experience of the reforms.

Roles of Key Stakeholders in the Reforms

Much of the literature on PEFM reforms provides advice to governments on the "best practice" in terms of implementing a reform programme. However, governments are a group of stakeholders each with their own interests. Other factors such as the personalities of the key individuals involved in the reform process, institutional weaknesses, and the political environment also play a key role in the success or failure of PEFM reforms.

Thus when designing a reform programme or reviewing an ongoing reform programme is it necessary to understand the existing incentives of the various stakeholders and to assess the extent to which each stakeholder will support or hinder the success of the reform as listed in Table 7 below.

Table 7. Stakeholder Interests in PEFM Reforms

Stakeholder	Interests	Barriers
Parliament	Increased transparency in allocation and use of resources, better delivery of services	Vested interests in maintaining the status quo. Insufficient understanding of PEFM reforms
Cabinet	Increased transparency in allocation and use of resources, better delivery of services	Vested interests in maintaining the status quo. Insufficient understanding of PEFM reforms
	Can quickly remove barriers, especially those involving inter ministry "turf" issues	
Ministry of Finance	Able to focus on strategic issues rather than line item details and fire fighting activities	Inadequate capacity in MoF may constrain more strategic approach, particularly if there is political pressure to avoid increased transparency
Line Ministries	Deliver better service with limited resources and be more accountable to their stakeholders	Vested interests in maintaining the status quo. Insufficient understanding of PEFM reforms
Donors	Greater clarity on government priorities and more effective systems for allocating and managing total resources	Donor organisations may want to keep control of individual projects, lack of understanding of PEFM reforms
Private Sector	Increased transparency in allocation and use of public funds, efficiency in payment of suppliers	Some private sector companies may be benefiting from lack of transparency
NGOs/Civil Society	Increased transparency and accountability in allocation and use of public funds	Civil society organisations may not have capacity to hold governments to account

This means suitable entry points or groups of stakeholders need to be identified who will support the reform initiatives and can act as change champions:

- Parliament and Civil Society can put external pressure on a government to be more transparent and accountable where there is no internal commitment to the reform
- Cabinet can demand a more transparent process of allocating resources between competing needs and more useful information on the delivery of service by line ministries
- A strong Ministry of Finance can implement fiscal discipline measures, effective systems for allocating resources between ministries and improved reporting systems
- Strong line ministries can, in the absence of leadership from Ministry of Finance or Cabinet, begin to implement reforms within their own ministries and can act as a model of best practice for the rest of government.

Implementing PEFM Reform at Local Government Level

Many governments in the MEFMI region have implemented a programme of decentralisation in recent years. This has involved devolving greater powers to local government authorities for implementation of programmes and delivery of services that had previously been implemented at central government level. The main rationale for decentralization is to increase efficiency and accountability by bringing the decision making and delivery of services closer to the beneficiaries, i.e. the public.

Thus decentralisation can include:

- **Political decentralisation**: creating new levels of government at the lower level, with elected councillors
- **Administrative decentralisation:** creation of a new level of government at the lower level with responsibility for implementing programmes at the local government level
- **Fiscal decentralisation:** this includes the procedures, systems and responsibilities for revenue collection and budget allocations at the local government level.

Decentralisation will usually be implemented following these steps, starting with political decentralisation.

The difference between devolving responsibility and deconcentration of responsibility needs to be understood:

- **Devolving** responsibility involves handing over responsibility and resources to another level of government
- **Deconcentration** of responsibility involves central government ministries providing their services at the district level through their own offices rather than through local government. Thus deconcentration is quite different from decentralisation as central government does not hand over responsibility to local government, instead government services are provided through central government offices in districts.

Fiscal decentralisation requires that central government hands over responsibility for revenue collection and allocation of funds through a local government system for planning, budget and financial management. Fiscal decentralisation can take various forms and can include a range of revenue sharing arrangements and authority over budget allocation decisions including:

Revenue Sharing

- Assigning certain revenues to local government such as business rates
- Tax sharing agreements in which the taxes are shared between the various levels of government
- Providing a pool of specific tax revenues to local government

Expenditure Allocations

- Unconditional grants provided by central government to local government, i.e. funds which local authorities can spend on their preferred programmes and activities
- Conditional grants or transfers that are linked to specific standards in delivering services in specific sectors
- Targeted grants which are provided for specific purposes or projects.

However as experience in the MEFMI region has shown, decentralisation is a complex process and not all the intended benefits are easily realised. It is in the area of fiscal decentralisation where many governments have faced problems.

Some of these problems include:

- Lack of clarity at the outset regarding the various responsibilities and functions of the various levels of government
- Often there are institutional problems between the Ministry of Finance and Ministry of Local Government, particularly in the area of fiscal decentralisation and lack of clarity as to which ministry should lead on fiscal decentralisation
- Difficulties in deciding on which revenues are to be collected by central government and those to be collected by local government
- Lack of capacity at the local government level to implement effective PEFM systems
- Increased likelihood of misuse of funds, corruption and targeting of expenditure at politically motivated projects or on the administrative function of the local authority rather than on priority programmes
- Unwillingness of central government departments to hand over their functions to local government, partly because of the lack of capacity at the local level to effectively deliver services and the reluctance of some central government ministries to hand over control of their programmes.

Examples of fiscal decentralisation in Ghana and South Africa are described in the Boxes below.

Box 10. Ghana: District Development Fund

The Constitution of Ghana and the District Assemblies Common Fund (DACF) Act, (1993), Act 455 mandates Parliament to make provision for the allocation of not less than five per cent (5%) of the total revenue of Ghana to the District Assemblies' Common Fund for the implementation of development programmes in the Metropolitan, Municipal and District Assemblies.

Under the District Assemblies' Common Fund Act, the Administrator of the District Assemblies' Common Fund is required to propose annually for the approval of Parliament a Formula for Sharing the Common Fund to the District Assemblies.

Box 11. Fiscal Decentralisation in South Africa

The Constitution of South Africa requires that local government plays a key role in the provision of services to communities in a sustainable manner, promote social and economic development, provide safe and healthy environments, and encourage public involvement in matters of local government. Parliament enacted the Municipal Finance Management Act (MFMA) in 2003 which "supplements conventional procedural financial management rules with a performance based system focusing on outputs, outcomes, and measurable objectives. Page 12, A Guide to Municipal Finance Management for Councillors, National Treasury, Republic of South Africa, March 2006.

This Guide sets out the role of councillors in the planning, budgeting, accounting and audit processes, with the main emphasis on oversight and holding of the municipal management accountable for the delivery of services through formal structures.

In South Africa there are three tiers of government: National, Provincial and Municipal, with significant decentralisation of power, functions and processes for all aspects of financial management. Each Municipality has both political and administrative functions and the relationship between the three tiers of government is defined in the Intergovernmental Relations Framework Act (2005). Decisions on the allocation of resources between the three levels of government are made in the budget forum chaired by the Minister of Finance with representatives of the Department of Provincial and Local Government, provincial members of the executive councils and the South African Local Government Association (SALGA).

The National Budget documents show the total transfers to the two lower levels of government and these lower levels produce their own detailed budget documents setting out the programmes and activities to be implemented.

Guidelines for Effective Fiscal Decentralisation

Although there is no blueprint for the perfect fiscal decentralisation and each system has to be appropriate to the needs and circumstances of each government, there are a number of common principles that can be applied:

- The responsibilities of each level of government should be clearly specified and overlapping responsibilities should be avoided
- The fiscal and revenue sharing arrangements between the levels of government should be stable and predictable, i.e. not changing from year to year
- Local government authorities need to be informed of the likely revenues they will receive prior to starting their budget preparation processes so that they can estimate their expenditures with some degree of certainty
- Incentives for improved efficiency at local government level are important
- Medium term performance contracts between central and local government could provide a more predictable basis for revenue sharing and expenditure allocations for local government while also including some level of performance to be achieved by local government
- Common budget classification, accounting standards and reporting requirements should be agreed between central and local government. Local government budgets and accounts should be included in central government documents in separate tables to clearly show that these are revenue and expenditure at the local government level
- Local government should be assigned sufficient revenue for them to be able to deliver the budgeted services. If they are given new responsibilities additional revenue or grants should be provided to cover these costs
- Central government deficits should not be "downloaded" to local government, i.e. by reducing the levels of revenue passed to local government or by increasing the expenditure requirements at the local government level
- Where local government accumulates arrears or incurs budget overruns, central government should apply sanctions or emergency measures

The control of borrowing by local government is a key issue in relation to fiscal discipline, as uncontrolled borrowing can undermine any measures to ensure fiscal discipline at the central level. Central government will need to have specific ways of controlling borrowing at the local government level including:

- Annual borrowing ceilings
- Authorisation of local government borrowing by central government
- Centralisation of all borrowing through the central Ministry of Finance or Central Bank.

Managing the Change of PEFM Reforms

One of the key aspects of ensuring the effective implementation of PEFM systems and processes is changing not only the technical aspects but also the underlying institutional framework.

This includes assessing and strengthening:

- Roles and responsibilities to match the new processes
- Possibly restructuring organisations to match the new responsibilities and functions
- Changing, if necessary, the "culture" of the organisation, possibly from one of detailed control to one of managing performance and accountability.

Many governments will have experienced difficulties in these institutional changes which may have hampered the more technical aspects of PEFM reforms. Some of the key elements to implementing effective institutional change include:

- Ensuring that the senior managers of the change have a common vision of what they want to achieve in the medium to long term.
- Developing a plan of action that sets out the detailed steps to reach this vision, with the responsibilities of all key stakeholders defined
- Reviewing staff functions and responsibilities in light of new procedures, rather than the other way round
- Any restructuring of an organisation to be based on these new processes
- Identifying "change champions" who can lead the change process
- Identifying any barriers to change and risks and developing actions to limit these risks.

What is Change Management?

Change is inevitable and people need to manage change or change will manage them. There are several things that may cause or trigger change:

- changes in level of technology used
- change in stakeholder expectations
- government legislation or policy
- alterations in the economy
- a personal initiative
- changes introduced by superiors/subordinates within the organisation etc.

PEFM reforms can involve a fundamental change in the way organisations plan, budget and manage their funds. For this reason, change management needs to be a key feature when implementing such a major reform.

Types of Change

Change divides broadly into two types: i. e. **incrementa**l change and **transformational** change. Within these, a wide variety of types and combinations occur. Understanding the type of change one is dealing with helps to approach change effectively and to interpret others' response to it more rationally.

Incremental change requires people to do the same things a little better, a little faster, but remaining within the same mind set, i.e. the same assumptions, beliefs, norms, etc. So it is much easier for people to implement the change and less effort is needed to manage it. An example of this might be changing offices.

On the other hand, transformational change is where people are called upon to do things in a completely different way, for example the introduction of the MTEF. It requires people to invent solutions from outside their normal mind set i.e. 'thinking outside the box'. It thus demands much more effort from all concerned to get the change implemented successfully. An example of this might be when two separate ministries are merged during a Cabinet reshuffle. If not properly managed they will continue to operate separately.

When introducing a change such as a PEFM reform it is important to understand how people react to change and focus initially on those who respond positively to the reforms as described in Box 12 below.

Box 12. Dealing with Change

People react differently to change: some people are cautious and others see change as an opportunity. Empirically it has been proven that:

- 20% readily embrace change
- 60% are on the fence
- 20% reject it outright

When change occurs, people deal with it in three ways:

- by resisting
- by following
- by embracing the change.

Those who resist change want to maintain the status quo which is not possible in the ever-changing environment we live in. The majority of people who start by resisting eventually find that they have to follow, trying to catch up.

The question is which category of people does the manager concentrate his/her efforts?

The answer is on the 20% who embrace change, as they can act as disciples of the change and help to persuade the 60% of the people who are unsure of the benefits of the change.

Getting managers and all involved to recognise that change is inevitable, even in government, helps prepare them for effectively managing and sustaining change.

Change Champions

In order to implement effective change, it is important to identify change managers or champions to lead the reform process. Change champions do not need to be the most senior person in an organisation, but someone who has demonstrated that they are supportive of the change, understand the benefits and will be able to communicate and encourage others in implementing the change.

These change champions need to be responsible for ensuring:

- the need for change is identified, understood and expressed in a clear way and then communicated throughout the organisation. People are generally willing and able to deal with change if they know it is necessary and accept the need for it
- the existence of a shared vision which expresses where the government intends to go as a result of the change.
- a vision of the result of the change
- providing an effective response to the reasons why the change is being introduced
- identifying the desired future condition of the government etc.
- creating climate of enthusiasm and participation
- that everyone involved in making the change has to feel part of it and accept the vision and how it is to be realised.
- that aspects such as the future structure, patterns of work, and procedures etc. are explained in detail to all within the organisation
- that additional champions for the change are identified and charged with leading the reform within the organisation.

CHAPTER 4 PLANNING APPROACHES

Introduction

Summary of the Chapter

This Chapter describes the various approaches to national and sectoral planning, including project planning.

It starts with a definition and history of planning, followed by an overview of the various types of planning and brief descriptions of the planning processes and documents.

The types of planning processes include:

- National plan documents: long term and medium term plans, Poverty Reduction Strategies, Medium Term Expenditure Framework and growth strategies
- Ministry level plans: strategic plans
- Local government and community level planning including participatory approaches to planning
- Private sector approaches to planning

The last section of this Chapter describes the processes, approaches and issues in project planning, including:

- Project planning and appraisal, including techniques such as cost benefit analysis
- Public Investment Programmes
- Sector Wide Approaches.

Summary of Key Issues

Previous approaches to development planning tended to be separate to the budget process resulting in:

- a shopping list approach as the activities in the plan documents were often not limited by the level of funds available in the budget
- the plans not being implemented through the budget.

In addition development plans usually focused on the development budget, i.e. on individual development projects with insufficient emphasis on planning and assessment of the policies and services implemented through the recurrent budget.

Recent reforms to planning processes include increased focus on poverty reduction through the Poverty Reduction Strategy Paper (PRSP) process and more recently on economic growth as the means to reducing poverty through the preparation of growth strategies.

Increased emphasis is also now placed on:

- linking the planning and budget process through the Medium Term Expenditure Framework (MTEF) process so that ministry plans are developed within the framework of the funds that will be available in the Budget
- focusing the planning of individual projects within a wider framework of a ministry's programmes and policies
- linking the preparation of the recurrent and development budgets (as described in Chapter 7).

Detailed suggestions are provided in Annex 2 on preparation of a plan document, followed by suggestions for preparing an organisational plan which forms the basis of preparing a performance based budget as described in Chapter 7: Budget Preparation, Principles and Processes.

Overview of Planning

Box 13. Definition of Planning

Planning is defined as "the enhancement of rational choices for achieving goals or desired future conditions. It is an iteractive process that usually occurs between the public, elected or appointed representatives and professional planners and managers. It requires the analysis of both empirical information and values."

Planning is seen as a fundamental stage in developing strategies that evolve an organisation towards the anticipated goals/ targets. It is used both in government-development planning and in the private sector strategic planning.

Planning is both a process and the preparation of a document.

The planning process involves the same basic steps for all levels of planning:

Defining goals and objectives: what is the government, ministry, project or organisation aiming to achieve which forms the basis of the overall plan.

Undertaking an assessment of the issues facing the sector or organisation: this can be undertaken using various tools such as SWOT (strengths, weaknesses, opportunities and threats) analysis, stakeholder analysis, etc.

Defining strategies and activities: based on the opportunities facing a sector or organisation, the strategies and specific activities can be defined, ideally through consultation with all the relevant stakeholders.

Costing and prioritising the strategies and activities: the detailed activities are costed and then compared with the funds available. Usually the cost of the planned actitivities will exceed the funds available and the activities will need to be prioritised so that lower priority activities can be scaled down or dropped from the plan altogether.

Defining performance indicators for measuring performance in implementing the plan: specific and measurable performance indicators need to be developed which are used to measure performance in implementing the plan. These should include output (goods and services produced) and outcome (impact) indicators.

Monitoring and evaluation feeding into next planning cycle: systems need to be established to monitor the implementation of the plan ideally as part of an integrated budget monitoring system. The results of the performance monitoring would then feed into the next budget preparation round.

In this Handbook we stress the importance of linking the plan to the Budget, as described in more detail in Chapter 6 on the Medium Term Expenditure Framework (MTEF). The MTEF involves one continuous process through which governments plan and budget for priority programmes and activities, rather than having separate processes.

History of Development Planning

Development Planning can be defined as "A continuing process which involves the economic rationale of making choices between different approaches to delivering a defined service delivery output, whilst utilising the resources available in the most economically sound manner; that will help in the achievement of specific goals and objectives, this over a defined period."

For most African countries, development planning was formally introduced at the end of the colonial period, and it followed various stages:

1960-80s: preparation of detailed national development plans with a focus on investment projects, including the introduction of Public Investment Programmes in the 1980s.

1990s: move to sector wide approach which integrated policies and recurrent and capital budgets, donor and government funds into one sector framework but with each sector being planned separately.

Late 1990s/early 2000: introduction of Poverty Reduction Strategy Papers (PRSP) and Medium Term Expenditure Frameworks (MTEF) in which all sectors are planned together and plans are required to fit within available resources as defined in the fiscal framework.

2000 onwards: linking of PRSPs and MTEF, second generation PRSPs, increased awareness of the importance of Public Expenditure Management issues, the need for effective monitoring and evaluation, growth strategies which have a wider focus on overall economic growth, not only poverty reduction.

The Need for Development Planning

Development planning has been necessitated by:

- The recognition that specific interventions are needed from the public sector to promote social and economic development (in the case of market failure as explained in Chapter 5: Policy Analysis) and that these interventions need to be planned in an integrated manner
- The need for governments to plan sound macroeconomic policies and strategies in order to promote economic development that also leads to poverty alleviation
- The need to coordinate the activities of many stakeholders in the public and private sectors to better contribute to economic growth
- Ensuring that scarce resources are allocated to a priority government service with the aim of promoting economic growth and improved national welfare
- To address market distortions that result in market failures which necessitate government interventions.

Planning Levels and Approaches

Planning processes can take place at many levels:

- National level
- Sector level
- Ministry or organisational level
- Project level
- Local government level
- Community level.

Table 8 below summarises the various types of planning documents and their focus, which are described in more detail in the following sections.

Table 8. Summary of Planning Documents

Type of Plan	Description
Long Term Development Plans	10-20 year development plans setting out a longer term plan for a country.
National Vision Documents	Develop and present a shared vision or future of a country.
Five Year Development Plans	Plan a government's development strategy with particular emphasis on the capital budget or projects.
Poverty Reduction Strategy Papers (PRSPs)	Focus national development on poverty reduction and have been linked to the Debt Relief Initiative.

Type of Plan	Description
Growth Strategy	Focus on the policies and strategies required to increase economic growth.
Millennium Development Goals (MDGs)	8 MDGs which represent the overarching framework for PRSPs, and are used as performance indicators.
Medium Term Expenditure Framework (MTEF)	Main focus on linking planning and budgeting so as to improve fiscal discipline; sectoral allocations; and introduction of a performance focus in the Budget.
Strategic Plans	Focus on improving the internal capacity and management of an organisation
Sector Wide Approaches (SWAPs)	Focus on addressing the full range of issues within a sector both in the recurrent and capital budgets, used as a mechanism for a group of donor organisations to fund a particular sector.
Local Government (District) Plans	Identifying development priorities, strategies and costed activities
Community Based Planning	Various approaches used at the community level including Rapid Participatory Appraisal (PRA)

Common Weaknesses in Planning Processes

Although most if not all developing countries have produced and continue to produce some form of planning document, there are a number of weaknesses that governments face in the planning process:

- Planning processes and documents are often not linked to the budget: resulting in plans not being implemented
- Planning processes tend to result in a wish list or shopping list of needs, raising expectations of those involved in the process that all their needs will be met
- Planning processes do not always take sufficient account of the strengths and weaknesses, opportunities and threats (SWOT analysis) of a country, its economy and socio-economic environment, therefore plans may not be based sufficiently on a realistic estimation of the particular country situation
- The process of prioritising ministry plans to fit within the total resource availability is not always undertaken, therefore the activities within a plan may not be affordable

- Planning documents until recently tended to focus mainly on the investment or capital budget, with insufficient attention paid to the recurrent budget (through which many services are funded that contribute to meeting development objectives) or to policy issues which have a significant impact on the achievement of government objectives
- Plans have only recently included performance indicators which are used to monitor the implementation of the plan. However these performance indicators are not always linked to the financial performance of a ministry in terms of budget implementation and it is therefore not possible to monitor the progress of plan implementation through the budget. Recently systems have been established to track and monitor poverty expenditures (see Chapter 9 on Budget Implementation).

The next section presents an overview of the various planning approaches and developing country experiences of these types of planning processes and documents.

Long Term Plans and Vision Documents

Long Term Plans

Long term national development plans set out as vision statement(s) and long term objectives for a country which are used to set out a vision for the future of a country.

Long term plans are usually 20 years in duration, implemented in most cases through medium term plans. Long term plans have mainly been developed in Asia with particular emphasis being on development of infrastructure and road and communication networks.

Vision Documents

The rationale for the development of "Vision 2020" type documents is similar in most countries:

- To develop the long term shared future of a country
- To create a single common document that is used as a basis for all national development policies and plans. Ideally they should form the basis for all medium term planning processes
- To provide guidance and a reference point for all sectoral programmes
- To encourage and support prioritisation of development programmes, in light of the scarce availability of resources
- To develop a planning framework that allows for cross sectoral programmes to be planned and implemented more effectively, e.g. employment creation, HIV/AIDS and environment are key cross-cutting areas that need long term planning and the involvement of many government institutions and other non government institutions.

Vision 2020 documents have been developed by countries in Africa, notably those in the Sub-Saharan region. Ghana developed its own long term development plan called the National Development Policy Framework (NDPF). Asian as well as some Caribbean countries, notably Trinidad and Tobago, have also developed Vision 2020 type documents.

Some OECD countries such as the United States have developed a Vision 2040 document (Seattle Regional Review, Vision 2040 Draft Released), as a new long term development strategy.

Although many of these documents have been produced, there are some weaknesses in the process:

- It is not always possible to plan for unforeseen events and issues such as HIV/AIDS, drought etc that arise and can have a significant impact on the achievement of the vision goals and objectives. This has resulted in changes to the focus of programme implementation away from the plans and priorities set out in the Vision 2020 documents.
- Vision 2020 documents are not well translated into short and medium term development plans. Although general references may be made to a Vision 2020 document, the priorities are not always explicitly reflected in the annual and medium term recurrent and capital budget allocations

Medium Term Development Plans

Between the 1960s and 1990s many governments in Africa and Asia prepared fixed period National Development Plans. The main focus of these documents was on the capital or development budget as development was seen as being driven by government investment in infrastructure.

A typical format for national development plans would include:

- Macroeconomic framework and macroeconomic policies
- National objectives and priorities
- Development projects in each ministry (this was also linked to the Public Sector Investment Programme (PSIP).

Common Issues and Weaknesses

- Most of the focus of development plans is on the capital budget with insufficient attention paid to policy issues and services funded from the recurrent budget
- There is a lack of medium term policy planning and impact evaluations. Development plans are not explicitly derived from a comprehensive process of policy analysis and planning
- There are insufficient linkages with the annual budget which often means that the plans are not implemented in practice
- In many countries there is a high dependence on external financing for the implementation of medium term plans. Shortfalls in donor resources can lead to lack of progress in meeting the objectives set out in these plans
- Recurrent and capital budgets are not integrated in the medium term. Hence the cost of service delivery and the recurrent cost implications of the projects are not planned.

Most governments in the MEFMI region replaced the national development plan with the Poverty Reduction Strategy with the notable exceptions of Botswana and Namibia who have developed a parallel medium term development strategy to the Medium Term Expenditure Framework (MTEF), the Performance and Effectiveness Management Programme (PEMP). This strategy links development goals with operational plans, setting out performance targets for ministries.

The Republic of the Philippines has developed a 6 year medium term development plan - The Medium Term Philippine Development Plan (MTPDP). The plan is a strategic development plan that focuses on the promotion of livelihood, strengthening of education, attainment of fiscal stability, decentralised development and sustained national harmony.

Poverty Reduction Strategy Papers (PRSP)

Poverty Reduction Strategy Papers (PRSPs) were introduced in the late 1990s, as part of the global consensus on the need for a concerted effort to reduce poverty. This was also in response to the change of focus of the World Bank (WB) and the International Monetary Fund (IMF) that lending should be linked to poverty reduction actions in developing countries.

Therefore the preparation of a PRSP became a requirement for countries wanting to access donor funds (e.g. Poverty Reduction and Growth Facility). Countries would also need at least an interim PRSP before they could access debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) facility.

While not following a blue print approach, Poverty Reduction Strategies (PRSs) have common elements. PRSs are designed to be poverty focused, results oriented, country driven and to:

- Set out poverty reduction targets, with indicative time schedules in the medium and long term
- Define a detailed and plausible poverty reduction strategy with relevant action plans, that take account of the prevailing poverty situation, macroeconomic conditions and any future concerns
- Articulate the roles of the different stakeholders, whilst defining further the strategy at a sectoral level. In addition the strategy must provide for improved partnership with both external and domestic partners
- Define monitoring and evaluation systems that will provide feedback analysis on the achievements and hence impact of the strategy

Second Generation PRSPs

Some countries are now producing updated or second generation Poverty Reduction Strategies which are a significant departure from the first generation of PRSs, in the following aspects:

- There is a move away from prioritising sectors to an approach that prioritises outcomes, i.e. an approach that is results-oriented
- Recognition of cross-sectoral contributions to outcomes and their inter sectoral linkages and synergies
- Emphasis on mainstreaming cross cutting issues
- Integration of Millennium Development Goals (MDGs) policy actions into cluster strategies
- Expanding the time horizon from three to five years
- Placing greater emphasis on economic growth and governance in poverty reduction.

With second generation PRSs, the main poverty focus has been maintained but is to be approached through a broad-based economic growth strategy - an approach that improves the quality of life and the social well-being of the population, whilst also improving general governance.

The World Bank reports that there are currently 40 UN member states that have their PRS in implementation phase. Second Generation Poverty Reduction Strategies have been developed in Bolivia, Burkina Faso, Nicaragua, Tanzania and Uganda. Uganda having been defined as a "forerunner of the PRS approach" is already developing its third strategy.

Monitoring PRSPs and Tracking of Poverty Expenditures

One of the key elements of the PRSP process was to define monitorable targets so that progress towards the objectives defined in the document could be evaluated. Governments have or are in the process of establishing systems for PRSP monitoring and evaluation (M&E) (see Chapter 11 for more information on monitoring and evaluation).

Governments have also been required to establish systems for tracking poverty focused expenditures in the implementation of the budget: this is described in more detail in Chapter 9: Budget Implementation.

Planning for the Millennium Development Goals

The Millennium Development Goals (MDGs) were developed mainly as a result of the United Nations (UN) Millennium Declaration Summit, where all 189 UN Member States signed a declaration on September 08, 2000. The declaration embodies eight key strategic goals, which commit governments towards achieving significant measurable improvements on people's welfare in areas of: education, health, and food security, availability of basic public goods and services, employment and national security. These goals have a target date of being achieved by end of 2015.

The eight MDGs have been defined as follows:

- Eradicate Extreme Poverty and Hunger
- Achieve Universal Primary Education
- Promote Gender Equality and Empower Women
- Reduce Child Mortality
- Improve Maternal Health
- Combat HIV/ AIDS, Malaria and Other Diseases
- Ensure Environmental Sustainability
- Develop a Global Partnership for Development.

Because MDGs are broad targets, they need to be translated into action. To do this, governments have adopted different approaches of ensuring that these eight targets are implemented. One key approach is integrating the MDGs into Poverty Reduction Strategies (PRSs), to ensure that MDGs become central to national policy making and planning. Through the PRSs, the MDGs can be translated into the planning and budgeting framework of the government.

The United Nations MDG Report of 2005, reports that of the 189 member states that signed the declaration, 60 countries are not on target, of which the majority are in Sub Saharan Africa. However the report goes further to suggest that despite this shortfall, there is still room for every country to make significant progress towards the achievement of the MDGs.

The goals for Eradication of Extreme Poverty and Hunger and Combating HIV/AIDS, Malaria and Other Diseases remain the two major concern areas for the region. Whilst the environment remains of less concern in this region, advances in partnerships with developed and developing nations are being made in areas of economic cooperation, education, science and technology and medicine.

Growth Strategies

A number of governments in Africa have or are in the process of producing "Growth Strategy" documents which focus on initiatives that encourage employment creation, improve the GDP and GDP per capita, improve social outcomes, reduce poverty and even lower crime rates. Poverty Reduction Strategies (PRSs) and national development plans can be defined as broad based development plans. Growth strategies on the other hand are more narrow in focus and identify the specific actions required to promote economic growth in a country. They cover the specific role of government in promoting growth including ensuring macroeconomic stability, improving the policy and regulatory environment such as reducing the cost of doing business, through creating a conducive investment climate.

Ghana, Malawi and Uganda have developed Growth Strategies and the Republic of South Africa has developed a number of Growth Strategies, including GEAR and more recently Accelerated and Shared Growth Initiative for South Africa (AsgiSA), (see www.gov.sa).

In MEFMI countries, the challenges will remain of ensuring that these Growth Strategies are linked to the MTEF and budget process and therefore implemented through the annual budget cycle.

Medium Term Expenditure Framework (MTEF)

The MTEF approach to planning was introduced to strengthen the linkages between planning and budgeting. It aims to address the three objectives of Public Expenditure and Financial Management:

- **Fiscal discipline:** the Budget is based on a sound estimation of total resource availability through the development of a macroeconomic framework
- **Improved sectoral allocations:** through increased transparency in the setting of ministry ceilings and better analysis of ministry requirements
- **Improved efficiency and effectiveness of expenditures:** through a focus on performance in the Budget, integration of the planning of the recurrent and capital budgets and inclusion of all donor funds in the Budget

The detailed approach to an MTEF is described in Chapter 6: MTEF and in Chapter 7: Budget Preparation.

Strategic Plans

Strategic plans are usually produced at organisational or ministry level in order to improve the performance and management of the organisation. They have often been linked to civil service reforms and or the introduction of performance management systems.

A typical strategic plan will include the following elements (these are described in detail in Annex 2: preparation of a Plan document):

- Ministry Vision: where the organisation wants to be in the future
- Ministry Mission Statement: the core business and stakeholders of the organisation
- Environmental Scan: this is used to assess the Strengths and Weaknesses, Opportunities and Threats (SWOT) of an organisation and can be accompanied by Stakeholder Analysis
- Identification of Key Issues or Key Result Areas: the areas that the organisation will need to focus on
- Organisational Objectives: what the organisation aims to achieve
- Strategies: how these objectives are to be achieved
- Detailed Actions and Responsibilities: the specific actions involved in the strategies, usually with timeframes and responsibilities assigned for implementing the activities.

These documents are often used as the basis for developing annual work plans which set out the activities to be implemented by each department within an organisation. The annual work plans are also used as part of performance appraisal systems in which a department's and/or individual's performance is assessed on the basis of achieving the targets defined in the annual work plans.

Common Issues

- The strategic plan tends to focus mainly on internal functioning of an organisation, with less emphasis on improving appropriateness and quality of service delivery.
- The preparation of the strategic plan is usually not closely linked to other planning processes such as the PRSP.
- The strategic plan is not always costed and not linked to the budget
- The preparation is usually a parallel exercise to planning and budget processes thereby duplicating the efforts required by line ministries and creating confusion.
- The preparation of the strategic plans is often led by the department responsible for the civil service, usually in the Cabinet or Prime Minister's Office, and this can result in a lack of coordination between this department and the Ministry of Finance.

In order to address these issues it is important for ministries to make use of the existing strategic plans as the starting point for the preparation of the sector plans and budgets under an MTEF and for the Ministry of Finance and civil service department to work closely on these two processes.

Participatory or Community Based Planning

Community based planning approaches have been used for over 30 years mainly by non government organisations (NGOs) working directly with community level development projects. A number of tools and techniques have been developed for engaging with communities and ensuring that community needs are taken into account when designing and implementing community level projects.

Participatory Rural Appraisal (PRA)

The most well known approach is Participatory Rural Appraisal (PRA) developed in the 1970s and 1980s in response to the perceived problems of outsiders misunderstanding or mis-communicating with communities in the context of development work.

In PRA, data collection and analysis are undertaken by the communities themselves, with outsiders facilitating rather than controlling the process. PRA is an approach for shared learning between communities and outsiders, and can be used in a variety of settings and contexts, i.e. it does not need to be limited to rural projects.

PRA is an exercise in communication and transfer of knowledge. Regardless of whether it is carried out as part of project identification or appraisal or as part of country economic and sector work, the learning by doing and teamwork spirit of PRA requires transparent procedures. For that reason, a series of open meetings (an initial open meeting, final meeting, and follow-up meeting) generally frame the sequence of PRA activities. Other tools common in PRA are:

- Semi-structured interviewing
- Focus group discussions
- Preference ranking
- Mapping and modelling
- Seasonal and historical diagramming.

Community Based Planning: Community Action Plans (CAPs)

The Government of Lesotho is using the Community Action Plan (CAP) approach in the agricultural sector, which is a community led development road map for creating community change by specifying what needs to be done, who will do it and how it will be done. It is designed to address the needs of the community by developing a community initiated and led development plan that takes into account past performance and making realistic assessments of both the challenges and opportunities that the local community faces.

A Community Action Plan is prepared in situations where communities have or are planning for economic development activities such as horticultural production. In developing a CAP the following issues need to be addressed:

- Develop community networks among the people of the community
- Estimate the costs of implementing the project plan, in line with the proposed strategies and activities
- CAPs identify community programmes/projects which should be linked to the overall community vision and mission
- CAP is a development plan and cannot be expected to be a perfect representation of the situation and of communities needs. Rather it is a starting point of development interventions that the Community can periodically review and update as their needs alter.

Scenario Planning

Scenario Planning is a process that was developed in the private sector in the 1990 partly at Royal Dutch Shell. It involves the development of a number of possible alternatives for the future which allow an organisation to identify possible options, taking account of the rapid changes in which the global economy operates.

Scenarios are powerful planning tools precisely because the future is unpredictable. Unlike traditional planning, scenarios present alternative options of the future rather than drawing on the past. Creating scenarios can provide a common understanding of the issues facing an organisation and a way of discussing complex and sometimes conflicting conditions and options. Developing scenarios enables an organisation to break down stereotypes, and by being involved in the process, people will assume ownership and develop commitment and put them to work.

By anticipating possible futures an organisation can identify possible problems before they occur and can take action and adapt to changing situations which are outside the control of the organisation. Decisions that have been considered against a range of future options are more likely to stand the test of time, produce effective and robust strategies, and create a distinct competitive advantage.

Scenario Planning is mainly used in the private sector but there are examples of its use in the public sector. In 1991 Shell was invited to assist the African National Congress (ANC) in South Africa with a range of stakeholders to develop a set of alternative futures for South Africa following the introduction of democratic government. This process assisted in building a common view of the future of South Africa, across different interest groups.

Box 14. Royal Dutch Shell Scenario Planning

Scenarios planning was first used in 1971 at the Royal Dutch Shell group of companies to develop a range of possible futures in the oil industry. This proved to be very useful as the company had foreseen possible future events, including the Oil Shock which occurred two years later.

Shell has, since that time, led the commercial world in the use of scenarios and in the development of more practical techniques to support these. The part of the overall process which is radically different from most other forms of long range planning is the central section, the actual production of the scenarios. Even this though, at its most basic level, is relatively simple – as derived from the approach most commonly used by Shell – requiring just six steps:

1. Decide drivers for change/assumptions
2. Bring drivers together into a viable framework
3. Produce 7-9 initial mini-scenarios
4. Reduce to 2-3 scenarios
5. Draft the scenarios
6. Identify the issues arising

Scenario planning would prove a useful tool in the preparation of a national or sector plan where the government wants to engage with stakeholders in developing a common vision of the possible future of the economy or of a specific sector. The approach can result in the creation of a range of possible options that would not have been considered in a more traditional approach.

Preparing Plan Documents

This section presents a brief overview of the principles of preparing a plan document, while detailed suggestions on the processes for preparation of a national plan document are included in Annex 2.

In preparing a plan document there are a number of key issues to be addressed:

- To be clear about the scope of the plan: whether the plan only focuses on government programmes and activities or all the stakeholders in the economy, including the private sector, communities, NGOs, etc.
- To ensure that there is a link between the plan and the budget, i.e. that the activities in the plan fit within the level of available resources and that they are included in the line ministry's budget
- To ensure that the plan includes performance indicators which are linked to performance indicators in the budget so that the progress in plan implementation can be monitored through budget implementation.

The diagram on the following page presents a summary of an overall planning and budget process, and illustrates how there needs to be a link between the national objectives as defined in a national plan document such as a Vision 2020 document or a Poverty Reduction Strategy, and the medium term plan and budget prepared and implemented by line ministries through a Medium Term Expenditure Framework process. The figure shows three boxes representing:

Sector Plan: the box at the top of the diagram shows the national and sectoral issues that are addressed by government, the private sector, communities and all stakeholders and includes:

- Sector goals: i.e. the overall goal for a sector such as employment creation. These goals are usually defined in national plan documents.
- Sector outcomes are the results that the various stakeholders aim to achieve, such as increased levels of employment, which ideally should be quantified over the medium term, i.e. numbers of people in employment
- Analysis of sector constraints: it is important that having defined the desired outcomes, that there is an in-depth analysis of the constraints to achieving these outcomes. For example, that one of the constraints to increasing employment is lack of skills
- Sector objectives: what will need to be achieved at the sector level to address the constraints, e.g. the objective would be to increase skills. It is important to note that all stakeholders in the sector will contribute to the achievement of this objective, not only government

Ministry Plan: the second box below shows the issues that need to be defined at the ministry level, i.e. to specify what the ministry will achieve in order to contribute to the achievement of the national and sector objectives. These issues will be defined in a ministry plan or under an MTEF process in a document that defines the ministry objectives, priorities and expenditure requirements including:

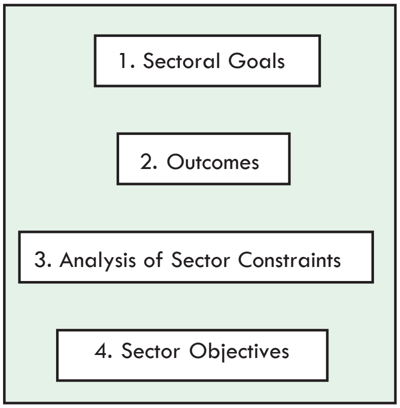
- Ministry objectives: what the ministry needs to achieve to contribute to the sector objective, e.g. improve the quality of education
- Ministry programmes: through which the objective will be achieved, for example curriculum development
- Policy framework: the policies that will guide the implementation of the programme, e.g. private sector companies will pay a levy to contribute to the cost of technical training.

Ministry Budget: the third box includes the costed plan and budget and provides the link between the national plans, and the specific actions and budget to be implemented by all line ministries.

- Ministry outputs: the specific goods and services the ministry will produce to meet the objective, e.g. revised curriculum
- Ministry activities required to produce the outputs, e.g. stakeholder review workshops
- Inputs and costs required to implement the activities which form the basis of the ministry's three year budget. The costed activities need to include both those in recurrent and development (capital) budgets and to fit within the available resources, i.e. the ministry's budget ceiling as explained in Chapter 6.

Annex 2 provides detailed suggestions on the processes for preparation of a national plan document and also for the preparation of an organisational plan.

Figure 2. Planning Framework

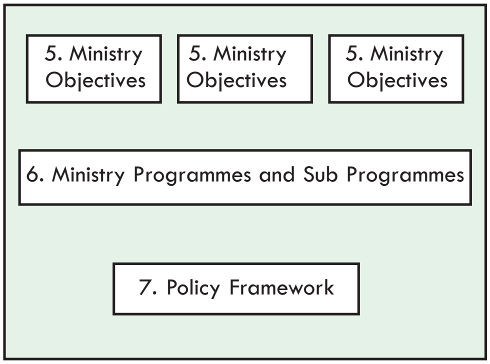


National Level Plan, e.g. Poverty Reduction Strategy
What is to be achieved in the sector as a whole: e.g. employment creation

The results of government and other stakeholder actions that measure the extent to which sector goals and objectives are being achieved

Analysis of key issues in the sector, e.g. lack of relevant skills

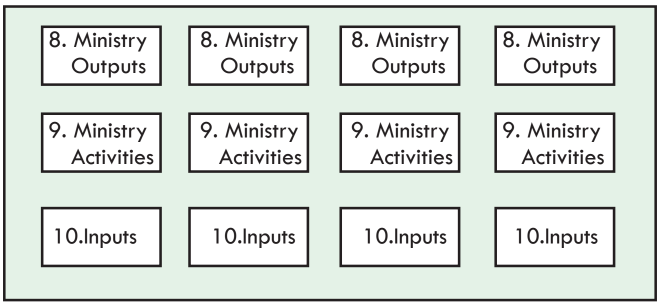
Sector objectives based on addressing key sector constraints, e.g. develop skilled workforce



Ministry Level Plan
Ministry objectives for which the ministry is directly responsible, e.g. improve the quality of education

The programmes and sub programmes through which the objectives will be achieved: Curriculum Development

The policies that guide the way the objectives are achieved and programmes implemented: better coordination with the private sector



Three Year Performance Based Budget
Goods and services produced by the cost centre, e.g. new curriculum

Activities implemented to produce the outputs, e.g. stakeholder workshops

Inputs required to implement activities, e.g. meals, stationery etc

Project Planning and Screening

This section focuses on planning for capital projects and the "Public Investment Programme" (PIP), while Chapter 7 covers the processes of preparing budgets for projects within the capital, (project or development) budget.

Rationale for Projects

Projects are seen as a group of activities with a specific starting point, end point, and objective. Thus a project is different from a service being provided in the recurrent budget, such as the provision of drugs, which is usually ongoing without a specific end date.

The reason for grouping activities into a project is to enable a more focused process of planning and management to ensure that the activities are effectively designed and implemented and project objectives are achieved. This is particularly important for large infrastructure projects such as road construction. Some project planning approaches are described further below.

Projects are usually established to implement activities which are capital or developmental in nature, i.e. they result in the creation of an asset such as a road. However many donor funded projects are not capital in nature. This is because projects have been set up to meet donor organisation (development partner) requirements to have separate project management and banking arrangements for the funding and management of their activities.

This has meant that in some countries a large proportion of the development (or capital) budget is not truly capital in nature, i.e. instead of funding activities which involve the creation of new infrastructure such as roads and buildings, donor funds are spent on activities which are recurrent in nature such as training, provision of extension services, drugs etc.

Projects were formerly the main focus in developing country planning and budget processes as they were seen as the major engine of economic growth. Projects formed a significant part of national development plans from the 1960-1980s. Experience has shown that other factors are equally important contributors to growth, including appropriate government policies, effective management capacity, good governance, as well as the services funded through recurrent expenditures. Thus, in previous plan and budget systems the recurrent budget was seen almost as a residual item, rather than as a major policy tool which needs to be given equal attention in the budget process.

In addition capital projects are usually designed and formulated outside the context of a wider programme, to which the projects make a significant contribution, thus reinforcing the separation between capital projects, policies and recurrent expenditures. Therefore current reforms to planning and budget systems emphasise the need to integrate the planning process with the budget process and to link the preparation of the recurrent and capital budgets.

Project Planning Approaches

This section covers the process and approaches to project planning and appraisal. The subsequent stages of capital budget preparation, implementation, monitoring and evaluation are covered in the remaining Chapters of the Handbook.

Box 15. Project Planning Stages

Projects will normally go through a set of phases prior to the actual implementation of the project. These include:

Project identification: assessing the needs of a particular sector such as education, e.g. are additional schools required?

Pre-feasibility study: e.g. an assessment of the number of schools, the locations, the construction processes, the initial costs, ideally the recurrent costs of additional teachers, materials etc.

On the basis of the pre-feasibility study, a decision would be made as to whether to proceed to a detailed feasibility study, at which point donor funding would be sought.

Feasibility study: detailed study of actual sites, costs of construction etc

Preparation of project document which sets out

- the objectives of the project
- the scope of the project, e.g. how many schools and their location
- the cost of the project
- the beneficiaries and benefits
- in some cases a full cost-benefit analysis, social impact assessment, environmental impact assessment

Appraisal of the project usually by the planning or finance ministry, in conjunction with the donors who will be funding the project.

Project Approval: if a decision is taken to approve the project, the project then becomes part of the list of projects to be implemented by the line ministry. In some countries this approval process takes place through a high level committee and is sometimes even presented to Cabinet and/or Parliament.

However the approval of the project is not the same process as the inclusion of funds in the annual budget to implement the project. This process then takes place as part of the annual budget preparation (see Chapter 7).

There are a number of techniques and tools used for project planning and appraisal depending on the size of the project and often on the involvement of donor organisations, some of whom have their preferred project planning techniques.

These include:

- Log Frame Approach
- Cost benefit analysis
- Social Impact Analysis
- Environmental Impact Analysis

Brief descriptions and practical steps to be followed in the use of these tools are described in the following pages.

The LogFrame Approach

The LogFrame Approach involves the process of defining and documenting a project's goal, outcomes, outputs, activities and inputs along with stakeholder analysis and risk assessment.

The Logical Framework Approach (LFA) was developed in the 1970s as a tool for strategic planning and is used by governments, non-government organisations and donor organisations.

The approach uses a 4X4 Logical Framework Matrix using the top-down, "waterfall approach" for identifying activities, and combines it with a detailed bottom-up checking process to check whether the logic also holds from the bottom up. The process also involves identifying the controls needed to monitor and manage the programme or project through to successful conclusion.

The Log Frame Matrix as a tool of the Log Frame Approach is shown in Figure 3 below. The matrix identifies seven key areas of the project to ensure that key issues regarding the project are addressed. The answers to these questions then become solutions/ outputs of the analysis exercise.

- Goal – why are we doing this?
- Purpose – what results do we expect?
- Outputs – what are the deliverables?
- Activities – what will we do to deliver the outputs?
- Indicators of Achievement – how will we know we've been successful?
- Means of Verification – how will we check our reported results?
- Risks and Assumptions – what assumptions underlie the structure of our project and what is the risk they will not prevail?

Figure 3. Logical Framework Matrix Format

Project Summary	Indicators of Achievement	Means of Verification	Important Risks and Assumptions
Goal:			
Purpose:			
Outputs:			
Activities:			

The Department for International Development (DFID) and the European Commission, among others, use this approach for most of their projects.

Cost-benefit Analysis of Projects

A cost benefit analysis is an analytical tool for assessing whether to proceed with a project, using similar financial decision processes as used in the private sector. This approach can be modified to take into account a broader set of benefits and costs (i.e. more than simply financial) that need to be taken into account in the public sector.

The purpose of a cost benefit analysis is to define and quantify the costs and benefits of a project in order to decide whether the government should proceed with the project. Traditionally a cost benefit analysis would concentrate on both financial efficiency (i.e. do the financial benefits exceed the financial costs), and the economic and social impact of projects.

One of the strengths of cost benefit analysis is that it takes into account the "time value" of money. It does this by using "net present value" (NPV) or "discounted cash flow" (DCF) analysis of all capital and recurrent costs and benefits over an extended period, i.e. beyond the life of the initial project itself.

Cost benefit analysis is a complex process and is not suited to all types of projects in the public sector. Therefore other approaches can also be used to assess whether to proceed with a project such as project efficiency and effectiveness.

Social Impact Assessments

Social Impact Assessments (SIA) focus on the social consequences of projects or other interventions on the population, assessing how communities will be affected and whether they will be able to respond to the changes resulting from the project.

A Social Impact Assessment is carried out as part of project or programme planning to:

- Analyse the social consequence of the planned interventions. For example, the construction of a dam will require the relocation of communities, what will be the consequences of this?
- Provide a social change feedback framework: enable the communities who will be affected to provide their views and ideas on how to manage this change and the impact on them
- Identify interventions that are required to counteract any potential adverse effects: identify ways of assisting communities to relocate to alternative locations

Over the past decade, development partners and other stakeholders have become increasingly interested in ensuring that Social Impact Assessments are undertaken prior to the implementation of large projects.

The detailed steps involved in undertaking a Social Impact Assessment are described in the Box below.

Box 16. Undertaking A Social Impact Assessment

1. Public Involvement: identifying and working with all potentially affected Stakeholders, starting at the very beginning of the planning process for the proposed action.

2. Identification of Alternatives: Describe the proposed programme/project action and possible alternatives.

3. Describe the Baseline Conditions: The conditions as they exist and past trends associated with the human environment in which the proposed activity is to take place.

4. Scoping: Identify the full range of probable social impact that will arise based on discussion or interviews with all of those potentially affected.

5. Projection of Estimated Effects: Based on analysis and comparison of impact in the past without the intended action, against impact in the future with the proposed intervention in place.

6. Predicting Responses to Impact: Attitudes and actions of individuals as a result of the impact, based on their attitudes before the intervention, as a basis for how they will respond after the implementation of the proposed action.

7. Predicting Indirect and Cumulative Impact: Determining the secondary impacts, these are a result of the direct impact, and only occur long after the direct impact has been realised.

8. Changes in Alternatives: Estimated effects are examined separately as per programme or project impact, and any changes noted.

9. Develop a Mitigation plan: A social impact assessment not only forecasts impact, it also identifies means to mitigate adverse impact. Mitigation includes avoiding the impact by not taking or modifying an action, or minimising, rectifying, or reducing the impact through the design or operation of the project or policy.

10. Develop a Monitoring Plan: Develop a monitoring program capable of identifying deviations from the proposed action and any important unanticipated impact.

Environmental Impact Assessment

Environmental Impact Assessment was developed as a tool to assess the impact of projects on the environment many years before the current global concern for the environment.

Environmental Impact Assessment (EIA) is a process which identifies the environmental effects (both negative and positive) of development projects or interventions. The process aims to prevent, reduce and offset any adverse environmental impact that these interventions might have. The EIA results in a report which can be used by decision-makers to make informed decisions about the proposed intervention, in the best interests of the community and the environment.

In addition to those listed below, the main focus of EIA is to predict environmental effects or impact at the earliest stage of the planning process, and hence find ways to mitigate against these potential adverse effects, before any actual development can take place.

Specifically, the purpose of an EIA is to:

- Include environmental issues at the planning stage of a project
- Predict consequences of a project or programme on the environment
- Provide an opportunity to involve the community in environmental planning.

In many countries environmental legislation has been introduced which requires that an Environmental Impact Assessment be undertaken before development projects can be implemented. The detailed steps involved in undertaking an Environmental Impact Assessment are included in the Box below.

Box 17. Undertaking an Environmental Impact Assessment

1. Describe the Proposed Action: This details what the proposed plan of action involves, the role of the various stakeholders is identified and explained, and the details of the programme/ project are described.

2. Predict the Nature and Size of the Environmental Effects: Predict individually each environmental effect, and for each, give the envisaged changes as a result, the rate at which the change will occur and whether or not the change is deemed reversible or not. The section should also include a description of the current state of the environment and probable future state with and without the proposed plan of action

3. Identify Relevant Human Concerns: Identify the sections of the population who will be affected by the environmental change.

4. List the Impact Indicators: Environmental impact must be measurable. This section should describe the environmental impact with their measurement, and what level of effect should be considered significant. This is where environmental standards are used to determine what environmental effects need to be measured. These indicators need to be ranked in order of significance.

5. Estimate the Total Environmental Impact: This is a summary evaluation that brings together the environmental effects, the human concerns and the impact indicators. Here these factors are normalised or converted to some common unit of measurement for comparison. The conversion is usually to monetary terms.

6. Recommendations: This section makes use of the evaluation conducted in Step 5. The recommendations are made on the proposed programme/project. An Environmental Impact Assessment is not the only part of the decision making process, but provides an input into recommendations on whether a project should proceed.

7. Inspection Procedures and Monitoring: procedures need to be established to monitor the environmental impact of the project during the establishment and implementation of the project.

Project Screening

In many countries governments have a large number of development projects which makes the management of the capital budget unwieldy and often results in the slow or only partial implementation of the projects in the capital budget.

Some of the reasons for this include:

- There is insufficient funding to complete existing projects

- The scope of existing projects changes over time and rather than completing the existing project, additional aspects are added
- Projects are designed as small activities and not grouped into larger more manageable projects or programmes
- Some projects are "parachuted" into the capital budget for political rather than technical reasons, often with little consideration of whether the implementing ministry has sufficient technical capacity or equipment
- Donors may introduce new projects which are not consistent with government objectives and priorities.

Governments have attempted to address this issue through a project screening exercise, i.e. identifying lower priority activities that could be reduced in scope or dropped altogether.

The issues to be considered in screening existing projects and appraising new projects are the same and include:

- Does the project contribute to the government and ministry objectives?
- Will the project design lead to the intended benefits. Would there be any negative impact from the project?
- Whether the feasibility study demonstrated the benefits of the project sufficiently
- Are the costs realistic and accurate based on knowledge of similar activities?
- Are the project activities already being implemented under another project, within the same ministry, another ministry, NGO etc?
- Are the project activities appropriate for the government to be implementing (e.g. should the government construct factories?)
- Is the project an appropriate size in terms of management, i.e. could the proposed activities be incorporated into another existing project, or would the proposed scope of the project be too large for management purposes and would be better divided into two or more projects?
- Have the recurrent costs arising from the project been identified and realistically estimated, and are they affordable given the existing recurrent budget of the ministry?

Project screening exercises have often attempted to use a numerical ranking of all existing projects and then used this ranking to make decisions on the lowest scoring projects from the project portfolio.

However this approach does not take account of the complexity of project benefits and resource allocation choices, and using a numerical ranking for such an exercise can result in the "wrong" choices. These choices ultimately are a matter of judgement and need to be based on assessing each project based on the issues listed above.

An Integrated Approach to Project Screening

Project screening tends to focus on the review of individual projects. However the current focus of improving PEFM system involves integrating recurrent and capital budgets, as well as considering a whole programme of activities, rather than improving individual project planning and implementation processes.

Thus it is important that projects are seen within the context of a programme of activities, both recurrent and capital funded. Chapter 7 focuses on integrating the preparation of the recurrent and capital budgets.

The table below presents an example of how to assess three separate projects which are implemented within the context of a Primary Education Programme with its objective of increasing access to primary education. In the example the projects are all assessed against:

- What are the constraints and issues within the programme? For example the recurrent budget does not cover all costs of storage for text books
- Are the project activities in line with the policies of the ministry? For example are new schools being constructed in line with planned enrolments and teacher recruitment?
- Are the donor funded activities in line with the priorities and policies of the ministry?

Table 9. Example: Assessing Projects within a Programme

Programme: Primary Education	**Objective:** to increase access to primary education	**Policy framework:** provision of free primary education
	Activities funded	Assessment
Recurrent Budget	Payment of teachers' salaries Provision of text books and supplies	Insufficient storage and logistics for distribution of text books and supplies
Existing Capital projects	**Project 1** Construction of schools Rehabilitation of classrooms	Planning of school construction not in line with pupil enrolment and teacher training
	Project 2 Renovation of classrooms in one specific district	This project is not linked to overall construction and renovation programme
	Project 3 Donor funded project to rehabilitate and construct classrooms and provide text books	The donor project is planned outside the programme of government construction and text books are provided directly by the donor.
Proposed revision to projects	All three projects should be grouped into one programme that is linked to the planned increases in enrolment, improvements in storage and logistics for distribution of textbooks and supplies. The recurrent costs arising from the new schools constructed need to be linked to future recurrent budgets.	

Common Weaknesses With the Project Approach

Whilst projects are a significant part of developing country Budgets, they also have common weaknesses:

- Projects are often seen as separate units outside the overall priorities and resource constraints of a government or ministry, particularly where they are donor funded. As described above, projects are often not linked to the services or activities implemented through the recurrent budget

- Projects are not always linked to the policy environment, for example a Ministry of Trade may change its policy focus to supporting private sector development, but may have existing projects in its budget which contradict this policy such as the development and management of marketing facilities

- Budgets for capital projects are often prepared separately from the recurrent budget and as a result the recurrent costs that will arise once a capital project is complete are not planned for. There are numerous stories of "white elephant" projects which have not become operational because the recurrent costs required to run a school, clinic or research station were not budgeted for

- There are often separate project administration units to manage project implementation, often at the request of donor organisations funding the project (see Chapter 13). However this approach has tended to increase the separation of projects from the government budgeting and accounting systems, thereby reducing the scope for considering projects within the context of a ministry's overall programmes and activities, and the importance of making trade-offs between all activities in the planning, budgeting and implementation processes.

Public Investment Programmes

A number of countries have prepared Public Investment Programmes (PIPs) as part of the national development planning process, which form the basis of the investment plans for the plan period.

A PIP is usually a document that sets out:

- A macroeconomic framework and resource projections for the PIP period
- An overview of government policies and priorities in terms of investment
- For each ministry the set of investment projects to be implemented over the PIP period
- For each project some PIP documents have project profiles which describe:
    - The objectives of the project
    - How they are consistent with national objectives
    - The funds required for the project for the project life, by source of funding, i.e. government funding and donor funding
    - The funds to be spent each year of the PIP period by source of funding.

The benefit of the PIP approach is that all investment or capital projects are shown together as an integrated investment plan for the government and they form a starting point for negotiations with donors on the government's investment requirements.

However in many cases the PIP became separate from the budget process, with the document often being prepared by the planning ministry without sufficient coordination with the officers responsible for capital budget preparation. In addition the preparation and updating of the PIP was often out of sync with the preparation of the Budget, and did not provide any additional information or add value to the budget process.

Recently there has been a move away from preparing PIPs as
- the emphasis has moved to looking at all resources and budgets together, i.e. recurrent and capital through a programme approach
- national development plans have been replaced with Poverty Reduction Strategies and more recently Growth Strategies, which also focus as much on policy issues and the importance of the recurrent budget.

Sector Wide Approach

The Sector Wide Approach (SWAp) seeks to address some of the problems described above in the planning and management of individual projects and the PIP approach. The SWAp is a means for all development partners operating in a sector and the relevant government ministries to plan and implement a joint and integrated approach to supporting the development of the sector. The aim of the SWAp is for the government to take the lead in the management and implementation of the sector development, and for development partners to fund a commonly agreed set of activities, sometimes also using common funding, reporting and management systems.

Thus this approach is intended to ensure that all resources are focused on achieving commonly agreed objectives and also to reduce the burden on government in terms of managing a number of donors, each of whom may have had their own reporting requirements.

The experience of SWAps has varied across governments and over time: some SWAps started very successfully and then have faced difficulties in subsequent years. However there appears to have been no systematic analysis of the recent experience of SWAps. The Box below summarises a review of Sector Wide Approaches written in 2001.

Box 18. ‘Best Practice’ Codes of Conduct, and current Status of SWAps

All activities will be under one common sector wide programme, fully costed, and integrated into a medium term budget framework.

Status: for most programmes there is an attempt at costing and integrating donor and government finance. In some cases, only the development budget is fully integrated and some projects may be outside the framework, although reporting of these funds is generally improving in Africa. MTEFs are increasingly important in rolling SWAps forward

Government takes responsibility and accountability for the performance of the sector as a whole, with all projects and components consistent with and contributing to agreed sectoral goals.

Status: Weak links to the activities of the private sector. Goals not always well linked to outputs and inputs. Hence sector performance cannot be sufficiently monitored nor evaluated. Donor financing also remains unreliable on timing and amount.

All partners aim to synchronise their own processes to joint cycles and systems for appraisal, programming, review, monitoring and evaluation. Procedures and mechanisms for joint missions and appraisals are defined.

Status: Generally good, though some problems remain. This is further exacerbated by lack of central information systems.

Reporting will be harmonised towards one common report system for all activities in the sector.

Status: For most countries lack of infrastructure and capacity result in deficiencies in reporting systems. Tanzania and Uganda have developed integrated reporting systems that include information from the decentralised planning authorities to central government.

Technical assistance should be demand driven, with preference for short term and local TA.

Status: there are examples of pooled technical assistance under government control, e.g. Ethiopia, Bangladesh.

Resources will be channeled increasingly through government systems and consolidated into joint accounts, with a view towards overall budgetary support. Common disbursement, accounting, reporting, auditing and procurement system are defined.

Status: The SPA pilot survey of 16 Sector programmes showed that more than 80 percent of aid is given in the form of projects with individual donor procedures, only 17 percent as sectoral budget support. However, with the use of General and Sector Budget Support as described in Chapter 13: External Resource Mobilisation & Management, is expected that these figures will have changed in recent years.

Partners are committed to openness, transparency, consultation, the sharing of information, and in the case of problems, dialogue before any interruption of support.

Status: Interruption for governance reasons is unavoidable (Ethiopia, Pakistan.) The Uganda PAF and education SWAps are model for true transparency. In the Uganda case, studies revealed that there were cases of funds being misappropriated, and this led to deployment of tracking systems and shorter funding routes.

Overseas Development Institute, Centre for Aid and Public Expenditure, Adrienne Brown, Mick Foster, Andy Norton & Felix Naschold, 2001, "Working Paper 142: The Status of Sector Wide Approaches

Annex 2 Preparation of Plan Documents

This Annex provides detailed suggestions on how to produce a national development plan.

Preparing a National Plan Document

This section sets out practical steps for preparation of a plan document, either a national development plan, a Poverty Reduction Strategy or sector level plan. Although the focus of these various plan documents will differ, the same principles and approaches can be used.

Detailed suggestions for the preparation of an organisational plan are described below.

Step 1: Deciding on the level and scope of the plan document

The possible levels are:

- National: which includes all stakeholder actions not only government
- Sector: which also includes all stakeholders but within a sector such as the agricultural sector
- Local government: this is focused on all the activities to be implemented at local government level
- Communities: this is a plan of activities to be implemented at the community level.

Step 2: deciding on the stakeholders and methods to be used

Having decided on the scope of the plan process and document, it is also important to decide on who is to be involved (i.e. the stakeholders) and the methods to be used in the process. Suggestions for ensuring effective stakeholder participation are listed in Box 19 below.

Box 19. Ensuring Effective Stakeholder Participation

- Ensure the appropriate stakeholders are involved, i.e. those who have an interest in the sector/issue/organisation
- Ensure the appropriate number of stakeholders are involved: too many will make the process difficult to manage, and too few will mean it is not representative of the full range of stakeholders. The appropriate size will depend on the scope of the exercise.
- Ensure that the stakeholders are fully briefed on the process that they will be involved with, how they will be involved and what will be expected of them
- Ensure that all stakeholders are involved through all stages of the process
- Use a variety of consultative, participatory approaches to stakeholder participation and avoid large formal meetings
- These approaches can include
- small focus group meetings on specific topics
- working groups that meet on a regular basis
- study or research groups with responsibility for researching specific issues
- workshops in which small working groups discuss particular issues
- Ensure that stakeholders are also involved in preparation and dissemination of the plan documents to ensure ownership of the final product.

Source: Stakeholder Identification and Mobilisation, D McCallum December 2000

Step 3: Developing a Vision

A vision is the future as seen by a country as a whole, sector, ministry, local government or community. The vision is the "dream" or goal of where the country should be or would like to be in the medium to long term, for example to be a middle income level country by 2020.

As explained in Chapter 4 in the section on "Scenario Planning" it is important that the process of developing the vision is a participatory process in which relevant stakeholders contribute to defining the vision and therefore have ownership and common understanding of the vision.

In defining the vision, while it is important to be positive and forward looking, the vision statement should also be feasible. An unrealistic vision will only lead to lack of stakeholder interest if it is clear that the vision cannot be achieved within the planned timeframe.

Step 4: Overview of the Sector/Organisation

The strategies for a sector or organisation need to be based on an assessment of the sector performance: e.g. trends in provision of services by government or other stakeholders, existing infrastructure, production within the sector. Ideally this historical information would cover a three to five year period so that trends can be assessed.

This overview of the sector or organisation provides the starting point for the next step: the SWOT analysis.

Step 5: Undertaking a Situation Analysis

SWOT is an acronym for strengths, weaknesses, opportunities and threats (challenges). A SWOT analysis is carried out to establish the issues facing the nation, sector or organisation as it aims to achieve its vision.

SWOT Analysis

Strengths and weaknesses are meant to reveal the internal environment of the organisation while the opportunities and threats reveal the external environment in which the organisation operates.

The analysis of the external environment in which the organisation (or country) operates helps to identify the key issues which ought to be addressed in the process of developing the sector or ministry strategies.

The primary focus of analysing the internal environment is to establish what factors influence performance of the organisation in meeting their stakeholders' expectations. It involves identifying what is done well or badly as a result of the organisation's institutional setting and/or organisational and managerial processes.

Other tools include:

- Stakeholders' analysis
- PEST: Political, Economic, Social and Technological environment
- Force-field analysis, etc.

As explained in the section above, many governments require line ministries to prepare strategic plans through the ministry responsible for public service and often linked to civil service reforms. Strategic plans usually make use of these tools.

A SWOT analysis can be used at any stage of an organisation's life, or at any level, applied to any problem. It creates a discipline of continuous self analysis, of organisation analysis and all the possible factors influencing the environment in which the organisation operates.

It is a valuable exercise even when a plan document is being developed, as it will give a fundamental understanding of the issues facing a sector or organisation and how they are perceived. Some of the issues to be considered are outlined in the Box below and can be used as a starting point in undertaking a SWOT analysis. However they are only a starting point or guide to some of the issues to be considered. Other issues also need to be considered.

It is important that a range of information is used to inform this analysis including:

- Government reports on sector performance
- Consultancy reports produced for the specific sector and also for other countries in the region

- Web based research particularly when researching the opportunities and threats facing a particular sector.

The primary responsibility for this initial research can be that of the relevant government ministries and departments, however it is important for this research to be shared with and validated by the relevant stakeholders in the sector.

The major components of a SWOT analysis are summarised in the box below.

Box 20. SWOT Analysis

Internal Review

The internal review of the organisation will reveal areas of both strengths and weakness. In this review it will be important to consider the strengths and weaknesses in a number of areas:

- core areas of business: service delivery
- internal management of the organisation
- the capacity of the organisation to deliver the services

Strengths: Those factors that give the organisation an advantage in the provision of services or help achieve the national or organisation's vision.

Weaknesses: Those factors which have been an obstacle to the organisation's performance but over which the organisation could exercise some control.

External Factors

In addition to the internal factors, it is as important to assess the external factors facing an organisation or economy.

Opportunities: Those factors that provide an opportunity for the organisation and which if capitalised on, could improve its chances in achieving its mission

Challenges: Those factors which if ignored, could significantly inhibit the organisation's chances of achieving its mission.

Step 6: Developing the Sector Strategy

Based on the identification of the key issues facing a sector, or organisation the next step is to develop a strategy to enable:

- The vision to be achieved
- The constraints (weaknesses/threats) to be minimised and opportunities/strengths to be built upon.

An example of an analysis and proposed strategies for the agro-processing sub-sector is shown below.

Table 10. Sub-sector Strategies: Agro-Processing Example

Issues	Agro Processing Sector	Strategies
Strengths	Cheap supplies of fruit and vegetables	Research ways of improving production of fruit and vegetables
Opportunities	Increasing demand in the region for processed fruit and vegetables	Assist in the establishment of agro-processing businesses
Weaknesses	Lack of skills and infrastructure	Provide training and support to SMEs in the establishment of agro-processing businesses
Challenges	Competition from other countries in the region	Research the market for processed fruits and vegetables to identify gaps in the market, new markets, speciality products

In defining the sector strategy it is important to identify the roles of the various stakeholders so that it is clear which organisations are responsible for which activities, making it possible to monitor the progress in the implementation of the plan and hold each stakeholder accountable for the implementation of their activities. This is illustrated in the table below.

Table 11. Defining Stakeholder Roles in Sector Strategies

Sector: Agro-Processing	Specific actions	Stakeholder responsible
Strategy 1: Increase production of raw fruit and vegetables	Provide extension support to farmers to increase production Increase production of fruit and vegetables	Ministry of Agriculture Farmers
Strategy 2: Research the market for processed fruit and vegetables	Undertake web based research on markets for processed fruit and vegetables Coordinate with NGOs in the region to assess markets	Ministry of Trade NGOs supporting poverty reduction programmes
Strategy 3: Support SMEs in the establishment of agro-processing businesses	Develop training programmes for SMEs Provide finance for agro-processing businesses Develop branding/marketing strategies for products	Ministry of Trade Local banks and other finance organisations Local NGOs supporting poverty reduction

Step 7: Costing and Prioritising the Plan

The actions in the strategies need to be costed particularly those to be implemented by the government. Developing country governments produce costed plans, either at the national level (e.g. a PRSP should contain a costed plan) and at the sector level through a sector investment programmes which have been prepared most commonly in the education, health, agriculture and roads sectors.

Costing a sector plan or national plan involves

- Defining the sector strategy and identifying the specific activities to be implemented as in the table below
- Costing the activities to be implemented over an agreed period, which can cover up to ten years.

Each stakeholder would need to define in detail the activities required to implement their contribution to the sector strategy and then to cost the activities. The example above is costed in Table 12 below.

Table 12. Costing Plan Activities

Ministry of Agriculture	Specific activities	Target group numbers	Activities	Cost Per Activity	Total Cost
Provide extension support to farmers in fruit and vegetable production	Train extension workers	100 extension workers to be trained	3 training sessions	2,000	6,000
	Establish demonstration plots	20 demonstration plots to be established	20 plots	500	10,000
	Hold training sessions for farmers	Quarterly training workshops to be held in each of the 10 regions	40	500	20,000
Total Cost					36,000

The same approach would be followed for the costing of a national plan, which would need to be prepared by sector and then aggregated to one national costed strategy.

The costing of a sector strategy is different from the preparation of a ministry budget in that:

- The sector strategy sets out the interventions and activities required to further develop a sector, including new investment in infrastructure, operating costs etc. These costs will usually exceed the funds that are available to a ministry and are often used as part of negotiations with donors for additional funds
- The sector strategy will include the actions of other stakeholders outside a ministry, either other ministries or the private sector, NGOs, communities etc.
- The ministries' budget estimates will have to fit within the available resources, and may be produced on a line item incremental basis for the recurrent budget and separate capital budget.

It is possible that the figures in the costed strategy and in the Budget estimates presented to the Ministry of Finance are very different, due to the lack of integration between these two processes.

The preparation of the plan needs to include the assessment of resources available for the implementation of the planned strategies. This would be the same process as that described later in this Handbook on macroeconomic forecasting.

It is likely that the cost of the actions outlined in the strategies would exceed the resources available, and a process of prioritisation of government expenditures needs to be undertaken and some lower priority activities would be reduced in scope, redesigned, handed over to other stakeholders to implement or dropped altogether from the strategy. Options are summarised in the table below.

It is important that this process takes account of donor funded programmes which may not be included in the Budget. Thus there may be some activities that are included in the strategies which are funded outside the government Budget.

Table 13. Options for Reducing Cost of Strategies

Specific Government Actions	Alternative Options for Reducing Costs
Provide extension support to farmers to increase production	Involve NGOs in the provision of extension support
Undertake web based research on the market for processed fruit and vegetables	Involve the private sector in market research
Develop training programmes for SMEs	Require SMEs to cover some of the training costs
Develop branding/marketing strategies for products	This is an activity that the SMEs will take responsibility for

Step 8: Linking the Plan to the Budget

Ideally a plan document would include a macroeconomic framework and a set of costed activities which are the same as those included in the budget. Thus the budget is the mechanism through which the plan is implemented. The activities and performance indicators would be monitored along with the financial implementation of the Budget, and the analysis of this performance would form the basis for the next round of budget preparation.

Step 9: Plan Implementation, Monitoring and Evaluation

The format in the table above provides a starting point for drawing up an action plan which can be used for implementation, monitoring and evaluation of the plan.

For the activities to be implemented by the government it is vitally important that these can be clearly linked to the responsible ministries' budgets. Without such a link it is likely that the activities will not be implemented as set out in the plan.

In addition it is important to establish mechanisms for regular monitoring and evaluation of the plan. This can be achieved through:

- Defining clear performance indicators against which progress can be measured
- Collecting data to monitor performance
- Holding regular meetings of the stakeholders in a sector to assess performance and identify actions required to improve performance.

Ideally these monitoring and evaluation indicators and processes would be linked to or be part of the same systems established within line ministries and agencies to monitor their own performance rather than establishing separate systems: see Chapter 11 for more information on monitoring and evaluation.

CHAPTER 5 POLICY ANALYSIS

Introduction

Overview of the Chapter

This Chapter sets out the processes and responsibilities for public policy analysis and review with the following sections:

- Defining a policy, summarising the varying scope of policies and policy documents
- The weaknesses that many MEFMI member states face in policy formulation and approval
- Common policy areas
- How policy affects budget requirements
- Practical suggestions for analysis and costing of policies
- The steps and responsibilities for policy appraisal and approval.

Summary of Key Issues

Policies define the way in which governments achieve their objectives. For example a government may have an objective to increase economic growth and can implement a range of policies that will determine how this objective is achieved, including increased emphasis on private sector growth.

Policies can be developed at various levels, e.g. macroeconomic policies, sector level and very specific level such as operational policies. There are a number of common policy areas that will determine the way in which governments provide goods and services to the population:

- The role of government in the sector
- Financing of services: cost sharing, user charging, free services
- Targeting of services to specific beneficiaries
- Collaboration and partnerships with other stakeholders

Each of these policy choices will have budget implications, e.g. if the role of the government is to provide services to the public the costs will be higher than if the government is only facilitating private sector provision of services.

However in many cases weak policy analysis and formulation means that new policies are introduced without sufficient assessment of their cost implications and whether the existing policies are the most effective means of achieving government objectives. Often new policies will be introduced for political reasons without ensuring that sufficient funds are available to implement the policy. Thus effective policy formulation and analysis is a key element of the Public Expenditure and Financial Management system.

In addition, development partners can take the lead in formulating new policies and line ministries may not be sufficiently involved in the process to ensure that the new policies are both affordable and within the capacity of the ministry to implement.

New policies can have additional funding requirements which may not have been included in the budget planning process and will therefore necessitate unforeseen expenditures.

What are Policies?

Box 21. Definition of a Policy

Policies describe the guidelines through which government objectives are to be achieved. "A policy is a deliberate plan of action to guide decisions and achieve rational outcome(s). The term may apply to government, private sector organisations, groups, and individuals. Presidential executive orders, corporate privacy policies, and Parliamentary rules of order are all examples of policy." Policies are therefore defined at various levels of authority and entail different scopes of information on any action-plan.

Government policies can be developed and defined at various levels:

- Macroeconomic: monetary, fiscal, etc.
- National: environmental protection
- Sector: trade policy, water policy, agricultural policy
- Ministry level: cost sharing policy
- Departmental: rural roads maintenance policy
- Procedural level: control over the use of government vehicles.

Links between Objectives and Policies

Policies will act as a guide to the way in which governments achieve their objectives. For example the government may have an objective to increase access to water and sanitation for the rural population.

However the government can have a range of policy options for the ways in which this objective can be achieved, for example:

- Privatisation of water and sanitation so that these services are provided by the private sector
- Involvement of communities and NGOs in the provision of these services
- Cost sharing with communities
- Free provision of services and expansion of water and sanitation infrastructure.

Table 14. Examples of Objectives and Policies

Objective	Policies
To increase access to education	Free primary education
To increase economic growth	Private sector led growth
To increase economic growth	Export promotion
To reduce poverty	Promotion of indigenous producers

Scope of Policies

The scope of policies can vary from being very broad to very specific, ranging from:

- Policy documents such as an environmental protection policy document
- Specific issue policies: free primary education
- Policies for broad issues or sector: for example a food security policy which affects several ministries
- Very specific relating to procedures to be followed, such as procurement policies.

Overview of Policy Formulation, Analysis and Implementation Processes

Policies, like plans, budgets and projects, go through a number of stages including:

- Formulation
- Analysis and appraisal
- Implementation
- Monitoring and evaluation.

Policy formulation involves assessing whether existing government and ministry objectives are being achieved through existing policies and defining either new policies or changes to existing policies. An example of policy analysis is provided in the Box below.

Policy analysis and appraisal: once a proposal is formulated for a new policy, ideally the line ministry planning unit and Ministry of Finance would undertake a detailed analysis and appraisal of the policy to assess whether the proposed policy is the most cost effective means of achieving government objectives.

Policy implementation: once the policy has been approved, any cost implications would need to be included in the relevant ministry budget so that the policy can be implemented. As explained above, some policies will lead to savings in a ministry's budget, for example where the services are handed over to another organisation, and some policies will have no impact on the budget.

Policy monitoring and evaluation: as in the case of a plan and budget, it is equally important to undertake regular monitoring and evaluation of the policy. This is a much neglected area in most developing countries. Suggestions for improving policy monitoring and evaluation are included in the final section of this Chapter.

Common Weaknesses of Policy Formulation, Analysis and Monitoring & Evaluation

In many governments policy formulation, analysis and monitoring and evaluation are limited because:

- New Policies and policy changes are not always based on sufficient analysis of issues, i.e. they can be in response to political initiatives rather than the need for policy change
- Not all line ministries have adequately staffed or skilled planning units
- Even where the staff exist, there are limited skills in policy formulation and analysis
- Donors tend to take the lead in policy formulation through sector reforms
- Ministry planning staff and relevant technical departments are not always involved in policy reforms
- There is insufficient information sharing within and between ministries
- There is little if any link between policy analysis and formulation and the budget process
- There is a lack of expertise and experience in collaboration with relevant partners in the private sector, NGOs etc.
- There are limited connections between sector policies and overall national policies.

The Box below presents a list of good practice criteria in public policy particularly focused on developing countries.

Box 22. Policy-Budget Link

The main criteria of good decision making (loosely related to the components of good governance) are the following:

Discipline. Policies should be consistent, without internal contradictions
Realism. Policies should be affordable and implementable
Stability. Frequent policy reversals should be avoided: a clear vision and sense of direction for the medium term are necessary for good policy making
Openness and clarity. Although the deliberations leading to budgetary policy decisions must usually be confidential, political accountability requires that the criteria and processes of decision making be explicit and public
Selectivity. In developing countries, the capacity to make good policy decisions is perhaps the scarcest of all. Because the focus ought to be on important issues, an appropriate administrative mechanism is needed to filter out minor matters and prevent wasting political leaders' time and attention
Communication. A badly understood policy cannot be implemented and is unlikely to be properly reflected in the Budget

Source: Salvatore Schiavo-Campo, The Budget and its Coverage, Budgeting and Budget institutions.

Common Policy Areas

There are a number of common policy areas on which governments will need to make decisions, each of which will have an impact on the budget:

- The role of government in the sector
- Financing of services: cost sharing, user charging, free services
- Targeting of services to specific beneficiaries
- Collaboration and partnerships with other stakeholders

The Role of Government and Funding Implications

The role of government in a programme will determine its funding requirements:

- If government is the main provider of services and/or infrastructure, such as education, roads, police, the funding requirements will be higher than if government is only supporting private sector provision of services
- If government is a facilitator of private sector development, such as in the development of market information and infrastructure, the funding requirements would be lower than if government is actually responsible for the marketing service
- If government's role is regulator of private sector activity, such as providing an appropriate legal framework, these would have the lowest funding requirements of the three options.

The above analysis needs to take account of situations where government is both a provider of services and also a facilitator of private sector activity. For example in primary education, government provides most of the primary education services, but is also facilitating the operation of community schools and regulating the operation of private schools.

Charging for Government Services

Decisions on whether government provides services to the population for free or charges for the services will have a significant impact on the Budget. For example, making primary education free in many MEFMI countries required significant increases in the budget allocations for the Ministry of Education in these countries.

The options for financing of government services include:

- Free provision of services in which government covers all of the costs
- Cost sharing where the recipient of the services pays a contribution but does not cover all costs of the service
- Cost recovery where all costs of the service are borne by the recipient of the services
- The government establishes infrastructure and then beneficiaries pay rental for use of the services, such as small business or factory shells.

In some MEFMI countries specific funds have been established to provide funds directly to beneficiaries such as the Constituency Development Fund in Kenya and Zambia, and revolving funds targeting women and youths. These experiences have not always led to the intended beneficiaries receiving the funds as planned, due to lack of transparency and regulations in the use of these funds.

Decisions on whether to charge for services need to balance two issues:

- The cost to government of providing the services and whether this is affordable with existing funding levels
- The impact on the beneficiaries in terms of affordability: would the charges for the services mean that a significant proportion of the population would not be able to afford the services?

This second issue can be addressed through charging different rates for different sections of the population based on their ability to pay. For example user charges may be introduced for health services, but the poorest section of the population may be exempted from paying either a part of or all of the fees.

It is important that the user charges are implemented using the following principles:

- There is clear legal authority for collection and retention of the user charges
- Consultation with users on the scope and level of the charges and the services to be delivered
- Estimation of the full cost of providing the service so that it is clear what percentage of the cost is being borne by the user and the percentage being paid for by the government. This estimation should be based on the same cost that would be faced by the private sector in delivering the service
- Equity issues: whether there should be specific categories of users who are exempt from paying the charge or who pay a lower charge for the service
- Efficiency in collection of the user charges
- The same principles of transparency and accountability should be applied in the allocation and use of these resources, i.e. the total funds to be collected from the user charges and the expenditures required to provide the services should be presented to the Ministry of Finance and Parliament rather than the net amount, (i.e. the total expenditure less the user charges collected).

Targeting of Services to Specific Beneficiaries

A similar issue is the targeting of services to specific groups within the population. This can be for several reasons:

- The services provided are only relevant to specific people, e.g. primary education, pregnant mothers
- While the services are required by the whole population they are targeted to the most vulnerable or those most in need of the services. For example the distribution of food to the most vulnerable in times of drought.

Collaboration and Partnerships with Other Stakeholders

Government objectives can be achieved through collaboration and partnerships with other stakeholders, i.e. government does not need to provide all the services by itself. Examples of this include collaboration with church organisations in the delivery of health services, working with NGOs in the delivery of extension services and private sector sponsorship of sports activities.

All of the above policy choices will have an impact on the level of funds required by a line ministry.

Public Goods

One of the key issues in the area of public policies is that of public goods, i.e. those goods which will usually only be provided by the public sector. Public goods are provided by a government or funded by a government and provided through third parties such as the private sector or NGOs. Usually government goods and services are provided for free or at a minimal charge.

Public goods are different from private goods in two ways:

Non Excludability

It is not possible to prevent some people from benefiting from the goods being provided, for example clean air. In this case people who have not paid for the service are also able to enjoy the benefits from their consumption.

Non Rivalry

The consumption of the public goods by one individual does not result in the reduced availability of the goods/service.

These two characteristics give rise to one key problem known as the "Free-Rider Effect." Because Public goods are provided at no charge or at minimum charge, consumers (even wealthy consumers) can enjoy their benefits without paying for their provision, as the cost of their provision is covered through government revenue.

Another issue associated with public goods, is that of externalities. Externalities occur when one person's actions affect another person's well-being and the relevant cost and benefits are not reflected in market prices. For example, a factory can create air pollution which affects the communities in the surrounding area. The prices charged by the factory for its products do not take account of the negative impact of the pollution.

This can create a situation where a government must intervene to correct what is known as market failure, which includes:

- Where, because the provision of goods and services creates non excludability or non rivalry, the private sector would not provide the services and government therefore needs to provide the services
- Where the provision of goods or services leads to negative externalities, such as the case of pollution: governments will intervene to regulate the way in which factories operate to reduce the pollution levels. Thus the factory owners will be required to undertake pollution control measures at their own cost.

How Does Policy Affect Expenditures?

Policies will determine how an objective is to be achieved and therefore the cost of achieving the objective.

For example
- free primary education involves higher costs
- shifting the emphasis to private sector growth should reduce some costs for government

However some policies do not have any public expenditure implications, e.g. liberalisation of agricultural prices can have a significant impact without any costs for government. At the same time a mixture of policies can involve a combination of both increases and savings in government expenditures:
- free primary education (+)
- community participation in school maintenance (-)

In many cases new policies are introduced without a full analysis of the expenditure implications of the policy and thus the policy is not fully implemented as it becomes unaffordable.

The issues to be considered when assessing the expenditure implications of policies include:
- what will be the implications of the new or revised policy:
- will it lead to new services?
- will it lead to an increase in services?
- providing services for free, which were previously charged
- increasing the cost of a particular expenditure item, such as wages
- changing the way in which services are provided, e.g. decentralisation
- what are the specific expenditure implications of the above:
  - some will result in the need for additional funds
  - some will result in savings
  - others will result in the transfer of funds from one organisation to another
- it is important that the medium to long term costs of these policy changes are estimated, for example changing salary structures is an ongoing change that will be implemented over the long term.
- these expenditure implications need to be given a cost in order to develop a comprehensive picture of the total cost of a policy change, and the costings used in the decision making process.

Therefore it is important that the expenditure implications of policies have a cost and the cost is taken into account when:
- reviewing existing policies to assess whether there are modifications to existing policy that could be introduced and lead to cost savings
- proposing changes to existing policies
- proposing new policies.

The steps involved in costing policies are described further below.

Policy Assessment, Analysis and Formulation

As we can see from the above, policies can have a significant effect on the way that government objectives will be achieved and the cost of achieving these objectives. Existing policies and proposals for new policies and policy changes need to be thoroughly assessed to ensure that they are the most cost effective means of achieving government objectives.

This section describes the issues to take into account when assessing policies.

Consistent Policy Framework

The first step in analysing policies is to have an overall picture of the existing policy framework. Within a ministry or a sector there will be a number of policies in place and in order to understand the expenditure implications of existing and any new policies there needs to be a sound understanding of:

- What are the policies being implemented in the sector? This would require a review of all existing plans and policy documents both within a specific ministry, and also from other related ministries, the Ministry of Finance and Cabinet.
- Are they consistent with achieving the objectives in the sector? More detailed suggestions on the questions to ask are provided below.
- Is there a need to change the policies to make them more consistent and/or effective?
- What are the expenditure implications of the existing policies and any proposed changes to policy?

Processes of Policy Analysis and Formulation

Policy analysis and formulation is similar to the planning process but with particular emphasis on the policy aspects. This process can be required for a whole sector such as the agricultural sector or for a specific issue, such as agricultural subsidies.

Policy analysis involves:

- Assessment of the existing sectoral issues, e.g. current government objectives for the sector, successes/weaknesses in achieving these objectives, identifying the underlying constraints to achieving the objectives, assessing whether key stakeholder needs are being met
- Assessing the existing policy framework including:
  - What are the services being provided by government? Are these effective?
  - Are these provided for free or is there some charge?
  - How effective is the existing regulatory/policy framework in contributing to the achievement of government objectives?
  - Is there scope for better collaboration with other stakeholders such as the private sector, NGOs, communities etc?
- Developing revised or alternative policies that would better enable government to achieve its objectives
- Costing these policy changes and developing detailed proposals for appraisal by the Ministry of Finance and Cabinet.

Box 23. An Example of Policy Analysis in the Industrial Sector

Analysis of the Existing Situation

The Ministry of Trade and Industry is responsible for the provision of support to the private sector in expanding industrial production.

Government objectives are to increase economic growth and reduce poverty.
However the industrial sector has only grown slightly in the past 15 years.

The underlying reasons are:

- Poor infrastructure
- Lack of skills
- Lack of marketable products
- Barriers to entry to foreign investors (high costs of doing business).

Government Services and Policies

Government provides training to small and medium enterprises in business skills and technical training. However there is no assistance provided to businesses in product development, access to markets and credit. Existing services are provided for free.

The existing policy/regulatory framework for the industrial sector is implemented through a number of different ministries and there is limited coordination between these ministries. This increases delays for the establishment of both local and international companies.
There is limited stakeholder consultation, particularly with the private sector.

Revised Policies

The Ministry of Trade and Industry will expand its services to include assisting business with product development and marketing, undertaking trade missions to generate interest in the products to be produced and other trade promotion activities.

The existing policies and procedures for establishing a business will be reviewed and harmonised, so that a “one stop shop” is established where potential businesses can use one office to complete all the necessary procedures.

Consultation with all stakeholders including existing and potential businesses will be increased and undertaken on a regular basis so as to ensure the services provided by the Ministry of Trade & Industry are relevant to the needs of the private sector.

Costing of Policies

Policy changes can have a significant impact on expenditure, either in the form of additional funds required or potential savings. Policy changes need to be linked to budget preparation and thus policy changes need to be fully cost as part of the policy formulation/revision process.

Costing policies involve:

- Identifying the specific services of the ministry that will be affected by the policy change
- Specifying whether this will lead to an increase or decrease in the level of services provided
- Identifying any new services to be provided, or existing ones to be dropped or handed over to another organisation
- Each of these areas would then be given a cost to arrive at the total cost of the proposed policy change, ideally over the medium term.

Table 15 below provides an example of change in cost as policy changes are introduced in the Industrial Policy.

Table 15. Example: Costing Change in Industrial Policy

Change in services	Impact on Cost +/-	Description of Budget Requirements	Year 1	Year 2	Year 3
Product development assistance to business	New activity	Training workshops for SMEs Consultancy support in product development	50,000 30,000	75,000 20,000	100,000 10,000
Increased stakeholder consultations	New activity	Workshops with stakeholders twice a year in various sectors	15,000	15,000	15,000
Trade promotion activities	Expansion	Additional funds for trade missions to Europe and Asia	20,000	30,000	40,000
Review of existing legislation	New activity	Workshops to review existing legislation/ procedures	20,000	0	0
Establishment of "one stop shop"	New activity	Consultancy support to establish "one stop shop" for establishing new businesses	20,000	15,000	0
Total additional costs			155,000	155,000	165,000
Transferring responsibilities to one stop shop	Savings	Existing ministries handling work permits, business permits etc to hand over staff to one stop shop, leading to reduction in cost	50,000	50,000	50,000
Total cost (additional less savings)			105,000	105,000	115,000

In the example discussed in the table above, the policy could be further complicated by:

- Changes in the trade policy which either increase or decrease incentives for exporters
- Changes in tax policies which change exporter incentives

- Changes in the services provided by NGOs which may either increase or decrease the demand for the Ministry of Trade and Industry services
- Changes in the international trade regime.

This highlights the complexity of policy issues. It is difficult to isolate individual policies and to assess their costs and benefits, impact and financial implications as there will be many interrelated policies within a ministry and in other organisations inside and outside government.

Appraising Policy Proposals

Policy proposals will need to go through a number of stages prior to final approval and implementation.

Assessing Policy Proposals

Appraising policy proposals would involve asking the following questions:

- Has the analysis of the existing situation and need for the policy change been undertaken?
- Is this analysis correct? Would the policy change lead to the envisaged improvements?
- Would the policy change involve a significant change in the role of the ministry? Is this an appropriate role in relation to the ministry's mandate?
- Is the proposed policy change in line with overall government policies?
- Does the ministry have the capacity to implement the proposed policy changes?
- Does the policy proposal include a detailed action plan on how the policy change would be implemented?
- Has the policy change been given a cost? Is the costing realistic and accurate?
- Would the policy change require significantly more funds than the ministry's existing budget?

Based on the answers to these questions it may be necessary to ask for further analysis to be undertaken, further information to be provided or even for the proposal to be reformulated.

Evidence Based Policy Research

Policy analysis can be undertaken on a significantly more in-depth basis through collecting information to analyse the impact of existing and proposed changes to policy.

This is known as evidence based policy research (EBP) which places the emphasis on having sufficient information on which to base policy decisions. EBP has been used extensively in the UK government and is beginning to be used in developing countries. For example, the Government of Tanzania has used the results of household disease surveys to inform health service reforms that helped reduce infant mortality by 40 per cent.

This approach implies that sufficient information needs to be available through:

- Reviewing existing research
- Commissioning new research
- Making use of external and internal experts to collect information
- Considering a wide range of properly cost and appraised options.

This information can include: research, analysis of stakeholder opinion, economic and statistical modelling, public perceptions and beliefs, anecdotal evidence, and cost/benefit analyses; as well as a judgement on the quality of the methods that are used to gather and synthesise the information.

Evidence for policy has three components. The first component is hard data (facts, trends, survey information), and the second component is the analytical reasoning that sets the hard data into context. Third, an evidence base comprises stakeholder opinion on an issue or set of issues. The reason for this triangulation approach is to confirm the validity of the information.

Processes and Responsibility for Policy Analysis and Appraisal

The ideal process would involve the following steps:

- A technical department in a line ministry would initiate a review of existing policies, either in response to a specific issue or as part of ongoing evaluation of its performance
- The technical department would be supported by the planning unit of the line ministry to undertake the review and develop the policy proposals
- The proposals would be submitted to senior management of the line ministry for review and approval, followed by submission to the Minister
- Once approved within the line ministry the proposal would be submitted to the Ministry of Finance for appraisal and analysis
- If necessary comments would be sent back to the line ministry with a request for further information and clarification
- If approved by the Ministry of Finance the policy proposal would be submitted to Cabinet for review and approval.

However in practice this approach is not always followed in many countries. Instead:

- Technical departments may not involve the planning units in the process
- Ministers may impose policy changes without sufficient technical and budgetary analysis
- Line ministries may not give a Ministry of Finance sufficient time to analyse the proposal before submitting the proposal for Cabinet approval
- New policies may be approved without sufficient analysis of the budgetary impact, making them difficult to implement.

The Role of Cabinet in Policy Approval

In a number of countries, the Cabinet Office, usually within the Prime Minister's Office, has responsibility for appraising policy proposal prior to their submission to Cabinet. However the capacity of these organisations is often weak and there is insufficient analysis of policies prior to submission.

The Role of Parliament and the Public in Policy Formulation

Ideally Parliament and the public will play an important role in the formulation of new policies, particularly where the policy will involve changes to existing legislation or is linked to additional expenditures.

There should also be a range of specific stakeholder consultation processes during the policy formulation and review stages through stakeholder workshops, through inviting public submissions and/or holding public meetings where new policy proposals are discussed.

Policy Implementation, Monitoring and Evaluation

The implementation of policies also needs to be monitored and evaluated, either as part of the planning and budget cycle or as a separate process to monitor and evaluate a specific policy.

Policy monitoring and evaluation through the budget process would take place:

- During the review of a ministry's performance in the preparation of a plan or document that presents a ministry's requirements and inputs into the setting of ministry expenditure ceilings
- In the preparation of the budget estimates
- As part of the end of year evaluation of a ministry's performance.

In addition the implementation of a policy can be monitored and evaluated on a regular basis particularly where the policy has a major impact on the operation of a ministry such as free primary education.

An example of the issues to be addressed and data to be collected in the monitoring and evaluation of free primary education policy are listed in the table below.

Table 16. Monitoring and Evaluation of Policy Issues

Issues	Policy Example: Free Primary Education	Monitoring and Evaluation Data
Is the policy being implemented as planned?	Are all children of primary school age receiving free education? Are there some aspects that parents still pay for such as school uniforms?	Data to be collected on number of children enrolled in primary education
Is the implementation of the policy efficient?	Has the Ministry of Education been able to recruit sufficient teachers to meet the increased demand for primary education?	Teacher: Pupil ratio Text book: Pupil ratio
Is the implementation of the policy effective, i.e. leading to the planned objectives and outcomes	Has the increase in enrolments led to improvements in transition rates and pass rates?	Enrolment figures Pass rates
Has the policy led to any unintended impact?	Has the increase in primary enrolment led to classroom overcrowding?	Classroom: Pupil ratio
Are there any unforeseen issues that are preventing the successful implementation of the policy?	Has the increase in number of child headed households due to HIV/AIDS meant some children are unable to attend school?	Data on child headed households

The detailed approaches and issues to be addressed for policy monitoring and evaluation are the same as those described in Chapter 11: Performance Monitoring and Evaluation.

CHAPTER 6 THE MEDIUM TERM EXPENDITURE FRAMEWORK

Introduction

Overview of the Chapter

This Chapter describes the Medium Term Expenditure Framework (MTEF) process. It starts with an overview of the process, the key objectives and approaches to achieving these objectives.

The next section describes the process of setting ministry ceilings including a description of the traditional approach to setting ministry ceilings.

Details of more recent approaches to the setting of ceilings as part of an MTEF are presented including the detailed steps of developing the fiscal framework, obtaining line ministry requirements, matching the requirements with the available funds, the role of the various stakeholders and country experiences in this process.

Specific issues are considered in the allocation of funds between items of expenditure, (wages, operating costs and capital) as well as between line ministries. Options for developing ceilings for both recurrent and capital budgets are presented and for ways in which off budget funds (i.e. donor funds which are not included in the budget) can be presented as part of the ceilings.

Key Issues

The Medium Term Expenditure Framework (MTEF) process was introduced to enable the achievement of the three objectives of:

- Improved fiscal discipline
- Allocation of resources in line with priorities
- Improved efficiency and effectiveness of expenditure.

Achieving these objectives involves a top down and bottom up approach of matching limited resources with unlimited needs. More specifically:

- Defining the availability of resources (both government and donor) over the medium term (usually three years) through the development of a macroeconomic and fiscal framework
- Dividing these resources between line ministries on the basis of government priorities, which involves line ministries providing an indication of their funding requirements as an input into the setting of ceilings
- Ministries prepare a three year performance based, integrated (recurrent and development) budget, focusing scarce resources on priority activities.

Most MEFMI member governments have introduced some form of the MTEF approach to planning and budgeting, with varying degrees of success. Some governments started with a focus on defining the fiscal framework and line ministry ceilings (i.e. the top down element), while others focused more on the three year performance based budget process (i.e. the bottom up process).

As the process has been in place for over ten years in some governments, both the top down and bottom up elements of the process are now being addressed by most governments in the MEFMI region.

The MTEF Approach

Overview of MTEF Approach

The Medium Term Expenditure Framework approach has been developed to address the weaknesses in developing country PEFM systems, as described in Chapter 3. These include:

- Lack of transparency and consultation in the way ministry ceilings are set
- An incremental approach to setting ceilings, i.e. a percentage increase in the previous year's budget allocation
- An annual focus in the planning and preparation of the Budget
- Separate processes for setting recurrent and development, and local and external resource ceilings
- External resources are usually excluded from the resource envelope when determining total resources.

The main focus of the MTEF approach is to introduce a more transparent approach to allocating resources in line with government priorities, moving away from the incremental approach to setting ministry ceilings. The allocation of resources is set within a medium term context, which is usually three years.

The process involves a top down (Ministry of Finance and Cabinet) and bottom up (line ministry) approach of matching limited resources with unlimited needs. More specifically:

- Defining the availability of resources (both government and external) over the medium term (usually three years) through the development of a macroeconomic and fiscal framework
- Dividing these resources between line ministries on the basis of government priorities, which involves line ministries providing an indication of their funding requirements as an input into the setting of ceilings
- Ministries prepare a three year performance based, integrated (recurrent and development) budget, focusing scarce resources on priority activities.

Three levels of development of the MTEF approach have been identified:

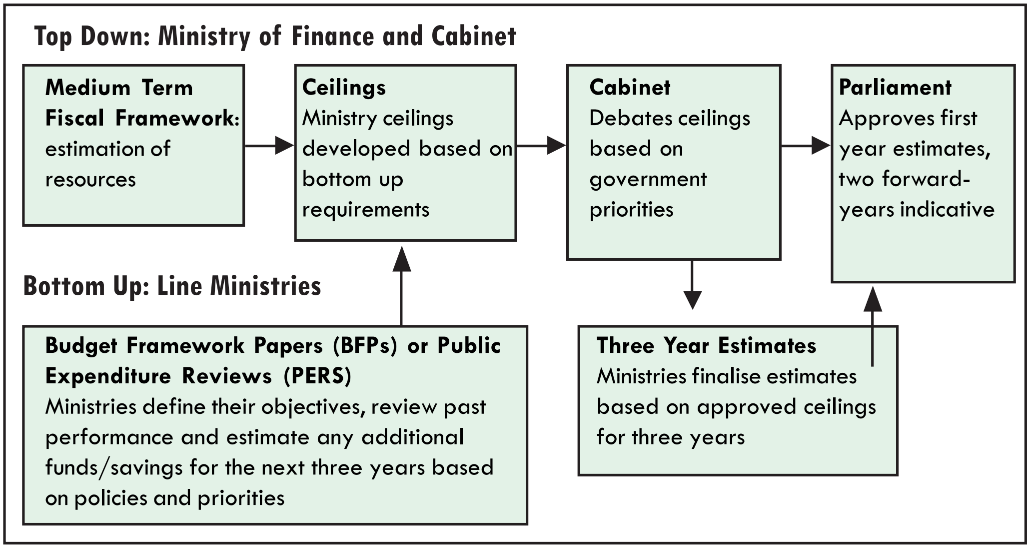
- A Medium Term Fiscal Framework (MTFF) which sets out the macroeconomic framework and fiscal targets

- A Medium Term Budget Framework (MTBF) which also includes the sectoral spending targets for each sector and spending agency for the three year period
- A Medium Term Expenditure Framework (MTEF) which also includes the introduction of performance based budgeting and management.

The MTEF Process

The MTEF comprises a process of estimating a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, finally the matching of costs with available resources in line with government policies and priorities.

Figure 4. Overview of MTEF Process



The detailed process for an MTEF based budget is shown in Figure 4 above. The process involves:

Development of Macroeconomic and Fiscal Framework: from the top down the Ministry of Finance estimates the total resources available through the updating of the macroeconomic and fiscal framework

Review of performance: Public Expenditure Reviews or Budget Framework Papers: line ministries prepare a document that summarises their past performance, identifies issues that need to be addressed and estimates any additional funds required for the next three year period.

Development of ceilings: the Ministry of Finance develops proposed ceilings by

- Taking the total resources available over the three years

- Deducting statutory and other non discretionary expenditures
- Allocating the discretionary expenditures between ministries based on government priorities.

Cabinet reviews the proposed ceilings and proposed fiscal framework: to assess whether the proposed allocations are in line with government priorities. The final ceilings are included in the budget call circular issued to the line ministries.

Ministries produce multi-year estimates for both recurrent and capital that fit within the ceilings: these estimates are reviewed by Ministry of Finance to ensure that they are in line with priorities and fit within the agreed ceilings.

The three year estimates are presented to Cabinet and Parliament: although the Budget documents may present three year estimates, it is only the first year which is formally approved by Parliament. The two forward years are presented as indicative figures to provide an indication to line ministries of the funds they are likely to receive over the three year period. These two forward year figures are updated and rolled over each year.

Key Elements of the MTEF Process

Allocating resources between ministries and priorities (setting sector ceilings)

- Unlike the current incremental approach, the MTEF involves dividing resources between ministries based on government priorities.
- Line ministries develop comprehensive plans focused on achieving agreed objectives, outputs and outcomes, including both government and donor resources, moving away from the incremental approach.
- Ministries can propose changes in policy or make a case for additional resources based on this analysis.
- The information is used at the centre to make reallocations between ministry ceilings based on achieving government objectives and government makes clear choices about how funds will be allocated between sectors based on clearly defined priorities.
- There is increased transparency in the way that resources are allocated between and within ministries both in terms of involving line ministries in allocating resources and through preparation and discussion of documents that set out ministry ceilings over the medium term

Basing the Budget on the achievement of targets (outputs) and objectives

From the bottom up, ministries move away from an incremental approach to budget preparation and start by defining their objectives and performance indicators, reviewing their performance and identifying issues that need to be addressed in order to improve their performance.

- In defining their objectives, outputs and activities, ministries define a set of performance indicators so that they can begin to measure whether their programmes achieve the planned objectives
- There is increased focus on improving service delivery and ministries develop performance indicators to assess
- Efficiency: whether the inputs will result in the outputs
- Effectiveness: whether the outputs will result in the outcomes

Three year comprehensive Budget

- The Budget is set within a three year framework including all resources, both domestic and foreign, so that ministries can plan their activities over the medium term
- The three year estimates provide line ministries with predictability in planning their activities: estimates are reviewed and rolled over each year rather than from scratch
- The budget process becomes comprehensive: all resources are planned and budgeted for together: donor and government, recurrent and capital

Increased stakeholder consultation

- The MTEF process involves increased participation of and consultation with line ministries in the setting of ceilings. This ensures that the ceilings are based on their requirements.
- Ideally the MTEF process involves greater discussion of government priorities and how these are reflected in the budget ceilings and estimates

Various country approaches to this stage in the MTEF process are summarised in the Box below.

Box 24. Country Approaches to the Sectoral Allocations Process

In Uganda Sector Working Groups prepare Budget Framework Papers that are aggregated into a national Budget Framework Paper discussed by Cabinet and Parliament prior to detailed annual budget preparation. This approach is also followed in South Africa with their Medium Term Budget Statement.

In Tanzania a sector Public Expenditure Review process is undertaken that identifies issues to be included in setting of ceilings. The call circular includes three year ceilings, but these are not approved by Parliament.

In Ghana, ministries go through a "Policy Review" process in which sectors review expenditure and policy issues as input into development of ceilings.
In Zambia the ceilings are incorporated into a Green Paper which is published and subject to debate in Parliament. Feedback is invited from other stakeholders.

In Kenya the budget process starts with a Budget Outlook Paper that sets out nine sector ceilings, and the ministries in each sector produce a Ministerial Public Expenditure Review Report which is discussed within the sector to arrive at the ministry ceilings within the sector. The Treasury uses the information from the Ministry PERs to produce a Budget Strategy Paper and ministry ceilings to guide the preparation of the detailed estimates by line ministries.

In Lesotho ministries prepare Budget Framework Papers which review their performance and identify issues that need to be addressed to improve performance. These issues are used to identify possible savings and new areas that require funding. This information is discussed with Ministry of Finance at sector hearings.

The next section describes the process of setting the ministry ceilings, the first stage in the MTEF process. Details of how the budget preparation process is changed under the MTEF are described in Chapter 7: Budget Preparation, Principles and Processes

Detailed Process of Setting Ministry Ceilings

This section describes a generic approach to setting of sectoral or ministry ceilings based on the process followed by a number of governments in the MEFMI region. The setting of ceilings is the first stage in the budget preparation process, and should provide the link between the national and sectoral priorities as defined in a planning document and the allocation of funds in the Budget.

In the MTEF process the setting of ceilings is a key stage as shown in the Figure above. It involves:

Step 1: development of a macroeconomic and fiscal framework
Step 2: ministries defining their requirements
Step 3: Ministry of Finance discussing requirements with each ministry
Step 4: the Ministry of Finance developing proposed ministry ceilings
Step 5: the presentation of proposed ceilings to Cabinet for discussion and approval
Step 6: the inclusion of ceilings in the Budget Call Circular to guide the line ministries in budget preparation.

In some countries the document produced under Step 5 is printed and discussed in Parliament and with wider civil society, for example in the Medium Term Budget Statement in South Africa.

Each of these steps are described in detail in the sections below.

Development of the Macroeconomic and Fiscal Framework

The process starts with the development of a macroeconomic framework, which is described in detail in Chapter 3. The macroeconomic framework is used to develop the fiscal framework which sets out:

- Revenues: domestic and foreign grants
- Expenditures: recurrent and capital
- Deficit (i.e. the gap between revenues and expenditures)
- Financing: how the deficit will be financed

The fiscal framework provides an indication of additional resources available and it is important that this includes all external resources (donor funding) so that total resource availability can be considered. Chapter 13 on External Resource Mobilisation and Management describes the processes for improving the inclusion of aid funds into the fiscal framework, i.e. bringing aid on budget.

In some cases the ceilings are set within the 3 year rolling framework and the Ministry of Finance uses the ceilings from the previous years as the starting point for the baseline in future years.

Definition of Ministry Requirements

As noted above, in some countries ministry ceilings are developed with no input from the line ministries themselves. However as part of improvement to PEFM systems, governments have introduced processes through which ministries identify their expenditure requirements.

The exact process for defining ministry requirements varies between countries. Some governments require the preparation of a Budget Framework Paper and others a Ministry Public Expenditure Review as described in Box 24 above. Rather than ministries simply requesting additional funds, these requests need to be set in the context of the following information:

- Defining the ministry's mission statement and objectives: this sets out why the Ministry exists and the objectives it aims to achieve over the medium term
- Reviewing the ministry's performance: reviewing ministry performance in terms of the efficiency and effectiveness of its programmes. This can be linked to a review of the outcomes and outputs for each programme.
- An analysis of planned policy changes and their likely impact on the need for additional resources.
- Priority areas for the ministry over the forthcoming three years.
- Details of specific requirements for additional funds as well as identifying possible savings.

This analysis usually involves the preparation of some form of document which is submitted to the Ministry of Finance and used as an input in setting ceilings.

The preparation of these types of documents needs to be seen not only as a binding document, but also as an opportunity for a ministry to review issues of policy change or increase/ decrease in the provision of certain services before focusing on the detailed budget preparation.

Discussion of Requirements with MOF

Once the documents have been prepared by the line ministries, there needs to be a forum for discussion of the funds required by each ministry with the Ministry of Finance. These discussions would focus on:

- Issues of performance: why were performance levels not as envisaged? Has the ministry identified remedial actions to be implemented in subsequent years?
- Priority areas identified by the ministry: are these in line with government priorities?
- Proposed policy changes: are these appropriate and in line with overall government policies?
- Estimates of additional expenditures: are these realistic? Have they been fully budgeted, does the ministry have the capacity to spend the proposed funds within the period of the budget?

Determining Ministry Ceilings

The resource envelope (i.e. total resources available over the medium term) need to be divided into:

- Statutory Expenditure (i.e. that expenditure which government is required by law to honour): pensions, public debt.
- Discretionary expenditures: that expenditure which government has freedom to allocate.

The discretionary category of expenditure can be allocated in at least three ways:

- By type of expenditure: wages, goods and services, capital etc.
- By sector and line ministry: broad sectors and specific ministries and organisations within the sector.
- By level of government: central government, regional or provincial government, district or local government.

By Type of Expenditure

The total budget is made up of four types of expenditure:

- Wages and salaries
- Goods and services that fund the running cost of an organisation as well as the services provided by the organisation such as teaching, training farmers etc
- Transfers and subsidies provided to other organisations
- Capital expenditure: these are usually grouped into capital projects in the capital or development budget.

The issues to consider in relation to these broad types of expenditure include:

- **Wages:** there needs to be an assessment of current and future staffing levels, are there plans to either increase or decrease the size of the civil service? What are current wage policies, are there plans to increase wages?
- **Goods and Services:** is the share of goods and services within the overall budget appropriate? For example if wages constitute 90% of the recurrent budget and therefore only 10% is available for goods and services are there any policies that are being put in place to increase funds to be spent on goods and services?
- **Subsidies and Transfers:** are these in line with government priorities and policies? Are they affordable in the medium to long term? Does the use of the funds contribute to government objectives?
- **Capital:** is the size of the existing capital or development budget sustainable, are ministries currently under-spending or over-spending on the capital budget, are there large projects in the pipeline, is there a move to support budget so that in future, donor funds will be spent in the recurrent budget?
- **Recurrent/Capital Mix:** is there an appropriate share of recurrent and capital expenditure in the budget, i.e. sufficient funds to cover the cost of providing services compared to funds being spent on new infrastructure and to fund the recurrent cost arising from completed projects? This involves consideration of both budget allocations, i.e. a move to a more

integrated planning and budget preparation of the two budgets, as described in more detail in Chapter 7: Budget Preparation, Principles and Processes.

Allocations Between Ministries

The total of all ministry requests as outlined above would most likely exceed the total resources available to government. In the incremental approach to setting ceilings, the Ministry of Finance simply adds a percentage to the previous year's budget. Under the MTEF approach the Ministry of Finance will need to analyse the requests from each ministry and use this information to propose ministry ceilings to Cabinet.

The process of allocating funds between ministries can be based on:

- Taking the current year's budget allocation as the baseline, i.e. as given, and only focusing on the allocation of the additional resources that will be available in the next three to five years (this sometimes is referred to as the fiscal space)
- Consideration of the total ceilings between ministries so that ministries have to justify their total budget requirements, not only any additional funds they are requesting

Ministries will have prepared a document that sets out their requests for the next three to five years. As the requests from all ministries are likely to exceed the total funds available the Ministry of Finance will need to consider the following issues:

- Whether the ministry has been performing with the existing budget levels
- Whether any proposed change in services or policies is appropriate in relation to overall government objectives and priorities
- Whether there are any changes to legislation or activities of other stakeholders that are required before a ministry can implement agreed changes to its services
- Whether increases in the implementation of services or a large capital project can be more realistically phased in over the medium term rather than "frontloading" the expenditure
- Whether a ministry has the capacity to implement any changes or increases in services
- Whether some of the proposed activities are already being funded by donor funded projects or programmes
- Whether some existing services and activities will be scaled down in scope, i.e. will there be any savings?
- An analysis of the trends in approved budget and actual expenditure in the previous years, (ideally 3 years) to have an expenditure trend to show:
  - the variation between approved budget figures and actual expenditures. This provides an indication of a ministry's performance in spending approved budget amounts in previous years
  - the percentage share of the total budget allocated to each ministry in previous years.

At the same time even if all ministry requests for additional funds could be justified on the basis of the above criteria, it is likely that the total request will exceed the total resources.

Therefore choices between ministries will need to be made on the basis of:

Government Priorities: those ministries which directly contribute to the achievement of government objectives would receive higher priority. Government priorities are usually stated quite broadly such as economic growth which would make a number of ministries a priority. However it is the more detailed strategies for achieving the objectives that will also need to be taken into account. For example, if economic growth is to be achieved through a focus on education and training, it would be the Ministry of Education that would be a priority ministry.

Role of Government: priorities alone cannot be the only factor. Although a sector may be a priority to Government it is the role of government in the sector that will determine the funds required to achieve government objectives.

If government is a **provider of services**, e.g. provision of extension services, the funds will be greater than if government is a **facilitator of private sector development**, e.g. providing market information to increase access to market; or is the government a **regulator of private sector activity**, e.g. defining the legal framework for agricultural marketing.

Level of and Cost of Services to be Provided: it is also the level of services to be delivered by a ministry that will determine the funds provided to that ministry. Therefore if the Ministry of Trade is mainly a facilitator of private sector development, but has decided it will construct factory shells for the private sector, this will require a higher level of funds than if the main function of the ministry was simply to provide an enabling environment through review of legislation etc.

Political Choices: political involvement in the process can be seen as "interference". However it is the appropriate role for Cabinet - as choices on how to allocate funds are really political in nature. While politicians may "interfere" in the budget process by parachuting projects or policies without explicit links to national priorities and resource constraints, an improved process for setting ceilings should enable politicians to make better informed decisions.

Cabinet needs to be provided with detailed information on the cost of new policies and projects and encouraged to make trade-offs between new and existing policies and programmes. Thus if politicians want to introduce a new policy, a lower priority programme needs to be identified which would be reduced in scope so as to generate the necessary savings to cover the cost of the new policy/programme.

Specific Issues in Developing Ceilings

Developing Models for Setting Ceilings

There is a misconception that setting ceilings can be achieved through the development of a mathematical model, which would build a link between the contribution of a particular sector to economic growth and the share of government expenditure that this sector/ministry should receive.

However this practice is not feasible because:

- There is no direct link between the contribution of a sector to economic growth and its expenditure requirements. As explained above, it is the role of government in the sector that will determine its funding requirements. Thus if the government is facilitating private sector activity, then expenditure requirements will be lower than if government is the main provider of services
- In addition, recent analysis of the determinants of growth indicate that it is not simply investment that will lead to economic growth. Other factors such as an appropriate policy environment, governance, cost of doing business etc will have a greater impact on growth
- Finally decisions on allocation of funds between ministries are ultimately political rather than technical in nature. While all governments may strive for economic growth and reduction of poverty, the political party in power may have different ways of achieving these objectives. For example one party may focus on private sector led growth, in a free market environment, while another may facilitate private sector growth but within a set of regulations that protect the interests of the poor.

Integrated Ceilings for Recurrent and Development Budgets

As part of focusing on a more integrated approach to expenditure planning and management, there is a need for ministries of finance and line ministries to consider all resources together. Thus decisions on allocating funds to a ministry should take account of all funds available to the ministry, recurrent, development, government and donor.

By considering each part of the budget separately it is possible that:

- A ministry may be allocated an increased recurrent budget when some of the activities are already being funded in the development budget
- There is no link between a planned increase in development spending which will lead to increased needs in the recurrent budget in future years
- Government funds may be allocated to a ministry which is already receiving significant external resources to fund government priorities.

Ideally ministries would be allocated one ceiling for all funds (recurrent and development, government and external) and the implication of this would be that the line ministries could make decisions on how to allocate the total ceiling between the two budgets. These decisions would be based on a ministry's own priorities in terms of recurrent and capital expenditures. This requires that funds are "fungible", i.e. they can be moved from the recurrent budget to the development budget.

However in practice this approach has some difficulties:

- The development budget consists of ongoing projects and it is not sensible to bring these projects to a stop or to postpone implementation in order to switch funds to the recurrent budget
- The development budget is also funded by development partners and their funds are not "fungible", i.e. the funds cannot be used for other purposes

Thus it is not always possible to provide line ministries with one integrated budget ceiling. Separate ceilings need to be developed for the recurrent and development budgets. However, it is important that these two ceilings are presented to Cabinet, also showing the total ceiling. Thus Cabinet will have a view of the total resources including donor funds to be allocated to each ministry.

Including Off Budget Donor Funds

Some governments still have significant levels of donor funds which are off budget, i.e. not included in the Budget Estimates and do not pass through government accounting systems. If these funds are not included in the ministry ceilings the percentage shares for each ministry will not be a true representation of the actual allocations.

However the ministry ceilings are used to indicate the funds that will be approved for each ministry, i.e. those funds over which the government has control, and it would therefore not be appropriate to include the off budget funds in the formal ministerial ceilings.

As explained in Chapter 13: External Resource Mobilisation and Management, development partners are being encouraged to provide full information on the funds they provide, including those that are not passed through the government budget. Some governments require development partners to submit information on planned disbursements and actual expenditure on a regular basis. Line ministries will also have information on the external resources they receive which are not included in government budgets and accounts.

This information on off budget funds needs to be included with the funds that are included in the Budget to indicate the total funds being provided to a ministry.

One option would be to present the ceilings in three parts as shown in Table 17:

- Government funds: recurrent and capital
- Donor funds on budget
- Total funds which pass through the Budget
- Off budget funds
- Total funds (i.e. on and off budget).

Table 17. Including Off Budget Funds in the Presentation of the Ceilings

Government		Donor (on Budget)	Total Ceiling	Off Budget Funds	Total funds available
Recurrent	Development				

Providing Ministries with Ceilings Prior to Budget Preparation

Where ministries are not provided with ceilings prior to the start of budget preparation or where ceilings are provided very late in the process, this encourages ministries to submit budgets that are well in excess of likely available resources. This often results in ministries being unwilling to reduce their estimates to fit within the ceiling and the Ministry of Finance typically making arbitrary cuts in the ministries' estimates. These cuts are not linked to ministries' priorities and usually ministries do not revisit the Budget estimates and adjust the figures to reflect their priorities.

This approach tends to focus on the finalisation of budget estimates on line item details rather than ensuring that budgets are based on achieving government objectives and addressing larger policy issues.

In an ideal situation, where line ministries submit budget estimates which exceed their ceilings, they would be required to:

- Review their estimates to reduce them to the ceilings
- Prepare and submit a justification for the additional funds.

Detailed suggestions for improving the submission of budget estimates by line ministries are included in Chapter 7: Budget Preparation, Principles and Processes.

Allocating Funds by Level of Government

In countries where local government exists, this complicates the expenditure allocation process significantly. The decisions on resource allocation between levels of government will be determined by the responsibilities of each level of government and by the resource allocation mechanisms between the levels of government. Often these inter governmental fiscal arrangements are enshrined in law.

One option is for line ministries to define overall government objectives and policies, with local government being responsible for actual implementation of these objectives at the local level. Thus funds would be provided to local government for the delivery of these services.

Linking Expenditure Ceilings and Ministry Performance

In some resource allocation systems poorly performing organisations are "punished" by being allocated a lower level of funds than they may have requested. A danger of this approach is that the beneficiaries of a ministry's services will also be punished if reduced levels of funding are allocated to a ministry because of mis-management of the ministry.

In linking performance and expenditure allocations the following issues need to be addressed:

- the reasons why a ministry is not able to spend the approved budget and implement the agreed activities needs to be identified. Remedial actions need to be taken to address these problems, some of which may require additional resources
- it is important that the appropriate performance indicators are being measured

Documentation and Consultation on Ministry Ceilings

One of the objectives of improving the process of setting ceilings is to make these decisions more transparent and to also increase participation in the process. Therefore the way in which this information is presented is very important.

Documentation

In some countries the information is brought together in one document which is presented to Parliament and the public to allow for wider debate of government priorities and plans prior to the detailed budget being developed.

These documents would contain the following information:

- The macroeconomic policy framework over the medium term and the macroeconomic fiscal framework including projections of revenue, expenditure and borrowing
- National objectives and priorities for the medium term
- The translation of these priorities into ministry ceilings (for recurrent and capital, including donor funds where possible)
- An overview of the performance and priorities of each ministry.

The production and dissemination of this document enables Parliament and civil society to review government's plans and priorities and to comment on these before work on the detailed budget starts. This means that the larger issues of priorities and policies can be discussed before the detailed budget is presented, when it is more likely that Parliament and other stakeholders will focus on these details.

Stakeholder Consultation

The preparation of this macroeconomic framework document enables the government to present its proposals for the medium term not only to Parliament but also to the wider civil society. In order for this consultation process to be effective the following issues need to be considered:

- The documentation needs to be user friendly so that all stakeholders can fully understand the issues being presented (a separate simplified version of the document may be required for this purpose)
- There needs to be sufficient time for all stakeholders to discuss and give their comments back to government (however this process should not lead to delays in the actual budget preparation process)
- Mechanisms need to be in place for stakeholder feedback
- While it is not necessary to include all stakeholder views in the medium term plans and priorities of the government there needs to be a transparent process of responding to stakeholder views so that there is a continued incentive for participation in the consultation process.

Once the ceilings are approved, the Ministry of Finance will issue the call circular and ministries will commence budget preparation as described in Chapter 7: Budget Preparation, Principles and Processes.

OECD Approaches to Setting Ceilings

In some OECD countries the process of setting ceilings involves agreeing on a baseline level of the budget (i.e. current salaries, levels of service etc) and then negotiating with line ministries on the additional funds required to implement new policies.

This approach means that only the additional funds are negotiated with the Ministry of Finance and Cabinet. Ongoing services and capital projects are seen as being already approved. However there are some services for which expenditure requirements would increase over the medium term, for example primary school enrolments would be increasing due to population growth.

The assumption of this approach is that the baseline programmes and activities and their budgets are "appropriate" in terms of being the most efficient and effective means of achieving government objectives.

In some OECD countries, ministries are required to achieve "efficiency dividends", i.e. each ministry has to make savings equalling a percentage of the total recurrent budget every year. Therefore ministries' budgets will be reduced by this percentage (1.5% annually in Australia and Sweden) each year and the ministry will decide where the savings can be made. The intention is for organisations to respond to these cuts by improving the efficiency of their services rather than reducing the level of services to their beneficiaries.

However these two approaches may not be appropriate in MEFMI countries:

- Only focusing on the additional funds to be provided assumes that the baseline is already in line with government priorities and existing services are fully funded, which is often not the case
- As expenditure is not yet in line with the requirements of priority services, i.e. some services are under funded, the issue for developing countries is to reallocate the limited resources to a few adequately funded services, rather than attempting to generate efficiency savings in all services.

Chapter 7 Budget Preparation Principles and Processes

Introduction

Summary of the Chapter

This Chapter sets out the process of budget preparation and the various approaches that can be used including the issues to be considered in budgeting for specific items such as:

- Statutory expenditure
- Salaries and wages
- Recurrent expenditure
- Capital expenditure
- Non tax revenue

The next section presents common weaknesses in budget preparation and is followed by an overview of recent reforms to budget preparation including:

- Improvement to the initiation of the budget process
- Strengthening the medium term focus of the budget
- Integration of the recurrent and development budget processes
- Introduction of a performance based budget.

Overview of Key Issues

Until recently budget preparation processes have tended to focus on a detailed line item approach to the recurrent budget and a separate development or capital budget. This meant that budget preparation focused mainly on inputs rather than outputs or the goods and services to be produced with approved funds.

Many MEFMI member countries have introduced a range of reforms to the budget preparation process through the introduction of the Medium Term Expenditure Framework (MTEF) process.

These reforms have included:

- A three year time frame for the Budget estimates: the first year being approved by Parliament and the second and third years presenting indicative estimates
- Introducing a stage in the budget preparation process which enables line ministries to provide an input in the setting of ministry ceilings
- Introducing a performance focus in the budget process by linking budget estimates to the levels of performance to be delivered.

While these new approaches to budget preparation have been implemented for a number of years, ensuring that these reforms provide the full benefits requires:

- Ongoing assessment of the reforms to identify strengths and weaknesses
- Requiring ministries to continuously assess their programmes, outputs and activities rather than the new processes becoming incremental
- Linking improvements to budget preparation to budget implementation, performance monitoring and evaluation.

Overview of the Budget Preparation Process

The broad functions of budget preparation are:

- Planning for the activities and funds required to implement government programmes
- Allocating funds in line with government policies and priorities
- Estimating the revenues to be collected to fund government services
- Providing budget limits so that line ministries and government as a whole keep expenditure within approved levels and targets for the collection of revenue
- Providing the basis for managing the implementation of government activities and management of the funds required.

In addition a Budget is a major macroeconomic management tool for a government, i.e. the levels of taxation, expenditure and the size of the government deficit will have a significant impact on an economy particularly where the private sector is relatively small.

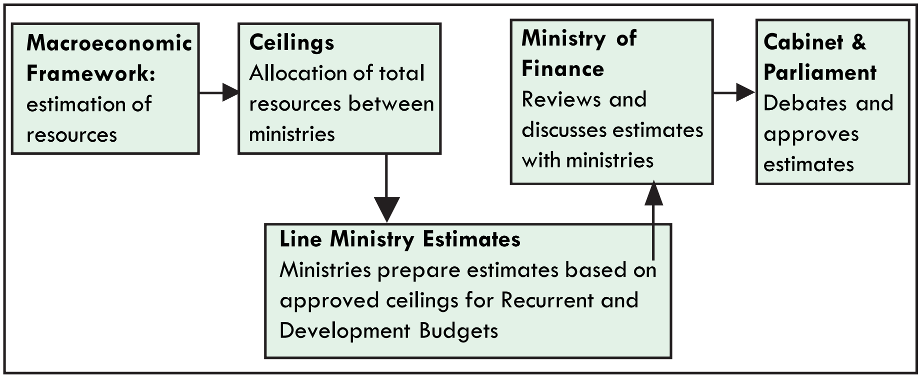
- Taxation is used to provide incentives to the private sector and also to distribute the benefits of economic growth from the more wealthy in society to the poor
- Government spending can have a major impact on the economy, particularly through the implementation of large capital projects
- The size of the deficit and need to borrow from the private sector can have a significant macroeconomic impact through changes in the interest rate and monetary policies.

In recent years budget preparation has focused increasingly on providing a mechanism for governments to be held accountable to Parliament and the public for the use of public funds through improving the transparency and user friendliness of the budget documentation. This is explained in more detail in Chapter 8: Budget Coverage, Classification and Presentation.

Figure 5 illustrates the budget preparation process:

- Updating the macroeconomic framework to estimate the total funds available from both domestic tax revenues and external resources (donor funds)
- Ministry ceilings developed by deciding on how these funds should be allocated between statutory and discretionary expenditure, and between ministries
- Line ministries prepare their estimates of the funds they will require for the budget period for the recurrent and capital (development) budgets
- Ministry of Finance negotiates with line ministries to agree on the total budget estimates
- Cabinet discussion and approval of the Budget Estimates
- The approved estimates go to Parliament for debate and approval.

Figure 5. Overview of the Budget Preparation Process



Particular Issues for Elements of Budget Estimates

This section considers particular issues in the specific elements of Budget Estimates:

- Statutory expenditure
- Salaries and wages
- Recurrent expenditure
- Development expenditure
- Non tax revenue

Statutory Expenditure

Statutory expenditure includes debt payments, pensions and other expenditure which is legally binding. Estimating debt payment is usually the responsibility of debt management units and accountant general's departments and is dependent on having an effective debt recording system. Similarly, estimating reliable pension payments is the responsibility of the accountant general's departments and is dependent on having reliable information.

Contingent Liabilities

Contingent liabilities reflect existing commitments, the ultimate fiscal consequences of which are dependent on future events that may or may not materialise. Examples include loan guarantees, exchange rate guarantees, deposit insurance, and indemnities (covering, for instance, commitments by government to private companies in the context of privately financed infrastructure projects or recently privatised enterprises). Future obligations under public pension programs are not contingent liabilities. Implicit guarantees, such as the possibility that a government may in the future bail out a public enterprise or a private sector bank, are also excluded, because of the potential moral hazard to which being transparent about such provisions could give rise.

Contingent liabilities can be quite large, and they should be taken into account in fiscal decision making. However, such liabilities are typically only covered in cash based financial reporting systems if and when the covered event occurs, and a financial obligation must first be met.

Budgeting for Salaries and Wages

Budgeting for salaries and wages involves a number of issues and challenges including:

- Ensuring that the establishments list or records of the number, grades, salaries etc of an organisation is up to date and is a true reflection of the actual numbers
- Ensuring that the information is correct and up to date for the following year's estimates such as staff promotion, retirements, transfers, leave of absence etc
- Including the annual salary increment provided to civil servants

These issues are particularly difficult in large ministries which employ a significant number of staff such as ministries of education and health. There are various types of computerised systems that exist for managing such information, including simple payroll systems, and more complex human resource management systems. Governments will often have to undertake an evaluation or audit of the number of civil servants to "clean" the civil service data so as to ensure that the information is correct and to delete "ghost workers" from the system.

Recurrent Budget Preparation

The recurrent budget is used to fund the services delivered by a ministry such as education of pupils, running of hospitals, operation of prisons, as well as the administration of the organisation itself.

Recurrent budgets are usually prepared on line item incremental basis and are often the responsibility of accounting staff rather than heads of department responsible for the implementation of activities funded through the recurrent budget. This means that the recurrent budget is not linked to the level of services to be provided by the organisation. See the discussion below on performance budgeting to improve this process.

Capital (Development) Budget Preparation

The capital budget is made up of a number of capital or development projects, each of which is aimed at achieving a specific objective, such as the construction of a road, within a defined timeframe.

Some of the particular issues/problems in relation to the capital (development) budget include:

- Some governments have a large number of projects, many of which are not fully implemented due to lack of funds. This makes it difficult to manage the capital budget.
- There is often a lack of prioritisation of the capital budget also resulting in a large number of projects.
- Many of these projects are "parachuted" into the capital budget for political reasons, rather than because of a genuine requirement for the activities within the project.
- Not all projects can be clearly linked to national objectives, and some projects may have been in existence for many years

- Some projects are really recurrent in nature but are included in the capital budget because they are funded by a donor organisation
- Not all donor funded projects are in line with government objectives and priorities
- Not all donor funded projects are included in a government's budget
- The capital budget tends to be prepared quite separately from the recurrent budget, with the result that there can be duplication of activities in the two budgets and the recurrent costs that will arise from the completion of a capital project are budgeted for in the recurrent budget.

Budgeting for Non Tax Revenue

Non tax revenues are those fees and charges collected by line ministries for their services, such as for work permits, passports, hospital services, etc. In most cases the preparation of the revenue estimates by line ministries is also an incremental approach, i.e. adding a percentage to the previous year's level of collection.

This approach means that ministries are not basing their estimates on the level of services to be provided and are not reviewing the level of charges for their services. As a result line ministries may be collecting significantly less than the potential levels.

The introduction of a performance based budget allows for ministries to link the collection of non-tax revenue to the level of services and activities to be implemented. The estimates of non-tax revenue would be based on the number of activities which involve the collection of fees etc multiplied by the level of the fee to be charged. This provides the Ministry of Finance with more useful information with which to question line ministries on their estimates of non tax revenue.

Contingencies

Most budgets will include a contingency provision of which, there are two types. Firstly, there can be a technical contingency that would provide for changes such as changes in inflation, exchange rate etc. Secondly, there could be a contingency for policy changes during the year. Some governments have rules about the size of the contingency which would normally be specified in the financial legislation or appropriation law.

Types of Budgeting

There are a number of different approaches to budget preparation, most of which have been used in MEFMI countries. The type of budget process will reflect the main objectives and focus of the budget system. They include:

- Line item, incremental budget processes: input and control focus
- Dual budget systems: recurrent and development budgets, mainly control focus
- Zero based budgets: efficiency and effectiveness of expenditure
- Programme budgets: effective resource allocation

- Performance based budget processes: efficiency and effectiveness of expenditure
- Medium term budgeting.

In each of the types of budget preparation processes, it will be important to have an appropriate and common budget classification system and chart of accounts as explained in Chapter 8: Budget Coverage, Presentation and Approval.

Line Item, Incremental Budget Processes

Line item budgeting focuses on the inputs required to deliver government services, e.g. salaries and wages, goods and services, capital. It is aimed mainly at control of expenditure, rather than on improving the allocation of funds and efficiency and effectiveness of expenditure. Line item budgets can be very detailed, and yet provide limited information on what government resources will be spent on.

Line item budgeting does not have to be incremental, i.e. adding a percentage to the previous year's allocation. It is possible to prepare line item budgets by estimating the levels of funding required based on the level of service to be provided. However, in practice line item budgets tend to be incremental, so that spending ministries do not have to plan and justify the activities and results they are responsible for.

Line item budgets are prepared only for the recurrent budget and are usually left to accounting staff to prepare, largely as an administrative process. Technical departments will often have limited input into the preparation of their budgets and are therefore often not aware of the funds approved for their use. This can undermine ownership of the Budget and is more likely to result in waste of funds.

Separate Recurrent and Development (Capital) Budgets

In most developing countries, governments operate two separate budgets: one for the recurrent or operating costs of government services and administration and the other for capital or development projects, usually donor funded projects. These two budgets are usually prepared, approved and implemented quite separately by different officers in line ministries and in the Ministry of Finance.

The reason for having two separate budgets is to enable the use of different procedures for the approval and implementation of the two types of activities funded within each budget:

- Recurrent budget: It is assumed that this funds operational costs of government and it therefore does not require a high level of analysis and scrutiny. The implementation of the recurrent budget is seen as a routine exercise.
- Development or capital budget: projects require in-depth analysis and approval processes, particularly those funded by donor organisations. The release of funds to projects needs to be linked to the implementation of the projects within the capital budget.

However in practice the recurrent budget is funding significantly more than the administrative functions of government. It also funds the basic services that ministries provide to the public.

Therefore recent reforms to budget preparation processes have focused on greater analysis of the services provided through the recurrent budget and the need to realistically estimate the actual short term and medium term costs of these services.

In addition, the separation of the two budgets can lead to problems such as duplication of activities in the two budgets, difficulties of having a comprehensive picture of total funds provided to a programme or service, and failure to plan for the recurrent costs arising from completed projects.

Zero Based Budgets

Zero based budgeting was introduced in the 1970s in the USA. It involves evaluating and costing all activities every year and a fundamental questioning of whether an organisation should exist and perform all of its functions. The process involved organisations defining their objectives, and assessing different means of achieving these objectives and funding levels.

Programme Budgeting

Programme Budgeting was introduced in the United States in the 1940s and evolved over time into the planning-programming-budgeting system (PPBS) in the 1970s. The approach focused on planning and budgeting along programmes which could cut across organisations. It was used as a mechanism for making trade-offs between programmes across government.

In its pure form PPBS was not successful and was abandoned in the 1970s due to:

- Insufficient attention to the political dimensions of resource allocation
- Difficulties of comparing the benefits of various programmes based on a common index
- It generated too much information
- It led to centralisation of control
- Alienation of spending agencies.

Programme budgeting has been used in developing countries, however with a different focus and emphasis. The US approach focused on using government wide programmes for deciding on priorities and allocating resources in line with these priorities. In developing countries, programmes are seen as broad functions or priority areas of an organisation and are used to allocate resources and present information on the purpose of expenditure within an organisation.

Although programmes define ministry functions, they may cut across several organisational units within a ministry. Therefore it is important for managerial control that a department or division responsibility within a programme be clearly defined so that each department can be held accountable for their contribution to programme performance.

Performance Based Budgeting

Performance based budgeting is the process of linking the allocation of funds to the performance to be delivered by an organisation. Performance refers to the levels of services to be provided and/or infrastructure to be developed by the organisation, usually referred to as outputs.

In many MEFMI member countries the Medium Term Expenditure Framework (MTEF) process has involved the introduction of some form of performance based or activity based budgeting. This section provides an overview of:

- The objectives of performance based budgeting
- A summary of ways in which it is implemented in OECD countries

Annex 3 provides detailed guidelines on how to prepare a performance based budget, including detailed steps on the various costing approaches that can be used.

Performance budgeting can have a number of objectives:

- To use the delivery of specific levels of performance e.g. pupils educated, as the basis for planning the budget
- To hold organisations and individuals responsible for the delivery of agreed levels of performance
- To use this information for achieving "optimum" allocation of funds between organisations
- To provide incentives or sanctions for achieving agreed levels of performance
- To measure an individual's performance as the basis for salary increases and promotions through performance contracts.

The main objectives for the introduction of performance based budgets in developing countries have been to:

- Introduce a process which enables line ministries to plan and cost the delivery of agreed levels of service and performance
- Improve the basis for discussion of budget priorities within a ministry and between line ministries and the Ministry of Finance
- Improve the presentation of budget information so that Parliament and the public can see the planned levels of service and performance to be delivered with the approved funds
- Provide the basis for monitoring the physical implementation of the budget.

In OECD countries the introduction of performance budgeting has focused on using performance information for making decisions on the level of funds to be allocated to each organisation as described in Box 25 below.

Box 25. Performance Budgeting Approaches in OECD Countries

In some OECD governments, the setting of outcome or output targets is linked to the level of funding provided. An example is the UK Public Service Agreement system, which was established to ensure that increases in expenditure would be linked to improved outcomes

Some countries use formal contracts where performance is linked to funding levels. For example output based supplementary funding arrangements, i.e. additional funds have to be justified by increases in levels of outputs. Another example is an outcome/quality based performance bonus funding system, where an explicit part of funding an organisation receives, is linked to achieving outcomes or quality outputs.

In the health sector in particular, an output-purchase budgeting approach is used in which hospitals are paid for the services actually delivered. For example, hospitals are funded on the basis of the level of services they deliver with a different price set for different types of services. Hospitals can make a “loss” if the actual cost of the service exceeds the price they receive. The hospital is only paid for the services it delivers and the idea is that this creates an incentive for efficiency. This approach was developed in New Zealand in the 1990s.

Ministries of Finance or other central agencies may also undertake a performance rating or programme evaluations on a regular basis to assess an organisation’s performance in detail. In the US this takes the form of a Program Assessment Rating Tool (PART) under which the Office of Management and Budget (OMB) assess the performance of 20% of government programmes (see Chapter 11: Performance Monitoring and Evaluation).

Adapted from: Does Performance Budgeting Work?

Medium Term Budgets

Many governments are moving to the preparation of a medium term budget, either as part of a Medium Term Expenditure Framework (MTEF) or to put the annual budget in the context of medium term projections.

The reasons for introducing a medium term perspective in the budget process is that the annual focus:

- tends to encourage ministries to plan for implementation of activities within one year
- does not enable the forecasting of future commitments such as pensions, primary school enrolments, etc
- does not facilitate reallocation of expenditure between and within organisations
- tends to focus organisations on the details of the budget with less emphasis on a strategic direction for revenue and expenditure.

While the estimates are produced for a three year period, in most cases Parliament will only approve the first year of the estimates and the second and third year estimates are presented as indicative figures, i.e. an indication of the likely funds to be allocated to each ministry over the following two years.

The three year estimates also tend to be prepared on a rolling basis, i.e. at the start of each year the first year of the Budget is dropped and a new year added, by updating the macroeconomic framework and the three year estimates as illustrated below.

Figure 6. Three Year Rolling Estimates

Cycle 1	Year 1	Year 2	Year 3			
Cycle 2		Year 1	Year 2	Year 3		
Cycle 3			Year 1	Year 2	Year 3	

Common Budget Preparation Problems in MEFMI Countries

There are a number of common problems faced by MEFMI institutions in the budget preparation process as outlined below:

- **Incremental approach to budget preparation:** the recurrent budget is prepared by adding a percentage to the previous year's budget, rather than estimating the funds required to implement specific activities.
- **Input focused budget:** the Budget is focused on the inputs (e.g. fuel) rather than the activities to be implemented (the reason why the fuel is required) and the targets and objectives to be achieved (output focus).
- **Only an annual focus in budget preparation:** many activities are implemented over more than one year, and it is important to plan over the medium term so that ministries can plan and phase activities over a number of years.
- **Lack of involvement of line ministries in setting ceilings:** Budget ceilings are set by allocating a percentage increase on previous years' expenditure, without ministries providing an input into the setting of ceilings nor providing for consultation with stakeholders. This means that the ceilings are not based on the needs of line ministries.
- **Lack of ownership of ceilings** which results in ministries not adhering to ceilings in the budget preparation process and final budget cuts are made by the Ministry of Finance rather than the line ministries themselves. As a result the Budget does not reflect the needs of the line ministries which is likely to lead to virements and over and under-spending during budget implementation.
- **There is no link between activities defined in plan documents and those funded in the Budget.** Therefore the programmes and activities set out in plan documents such as the Poverty Reduction Strategy (PRS) are not implemented in practice.

- **Recurrent and capital budgets prepared and managed separately**. Thus the activities funded in the two budgets are not aimed at achieving common objectives, and the recurrent budget costs that will arise from completed capital projects are not budgeted for.
- Often the way **budget information is classified and presented does not provide a clear link between the Budget and the plans for achieving government objectives**
- **Delays in the issue of the call circular** from the Ministry of Finance and submission of estimates from line ministries leads to insufficient time for the preparation and analysis of the budget estimates.
- The **legal framework** does not support effective budget preparation.

Reforms to Budget Preparation and Management

As noted in Chapter 1 Overview of PEFM systems, current reforms to PEFM systems emphasise a move away from due process, i.e. correct application of detailed budget processes and controls, to devolving responsibility for budget allocation and management to sector ministries.

Recent reforms to the budget preparation processes in OECD and developing countries have focused on:

- Sector ministries producing more useful information for central agencies to make the big decisions about sectoral allocations as described in Chapter 6: MTEF
- Central agencies giving more freedom to sector ministries to make detailed decisions on use of resources
- Sector ministries being held accountable for achieving agreed performance levels.

In the MEFMI region, the introduction of the Medium Term Expenditure Framework (MTEF) approach involves improving the following aspects of the budget preparation process:

- Improving the initiation of the budget preparation process
- Strengthening the medium term focus in budget preparation
- Introducing a performance based budget
- Integrating the preparation of the recurrent and development budgets
- Improving the prioritisation and finalisation of estimates within line ministries
- Improving the submission of line ministry estimates to the Ministry of Finance.

Improvements to the Initiation of the Budget Preparation Process

Improvements to the budget preparation process can start with the early stages in the process, e.g. through enabling ministries to have an input into the setting of the ceilings, providing clear guidance to ministries through a Call Circular and encouraging ministries to establish budget committees to manage the budget preparation process.

Ministry Input into the Setting of Ministry Ceilings

As explained in detail in Chapter 6: The MTEF, the first stage in the MTEF process is to provide an opportunity for line ministries to have an input into the setting of the ministry ceilings.

Providing ministries with ceilings prior to the preparation of the detailed budget enables them to prioritise their budgets rather than the Ministry of Finance imposing arbitrary cuts in the budget in the final discussion and negotiations. However this requires that the Ministry of Finance enforces the principle that any cuts to a ministry's budget should be made to specific programmes by the line ministry itself, as in some cases ministries may be able to put pressure on the Ministry of Finance, sometimes through Cabinet, to increase the budget beyond the ceiling.

Initiating the Budget Preparation Process

The budget preparation process is initiated with the issuing of a call circular or budget circular, which should set out the:

- Budget preparation timetable with clearly defined deadlines
- Budget ceilings which should provide ministries with a limit on the budget estimates they should submit to the Ministry of Finance
- Guidance on national priorities and policy issues that need to be taken into account in preparing the Budget Estimates
- Detailed guidance on the specific processes and formats to be used in preparation and presentation of the Budget Estimates to the Ministry of Finance.
- Key economic assumptions such as inflation rates, salary increases etc.

Some governments will hold a workshop with all line ministries to launch the budget preparation process and outline key government priorities and policies.

Involving Managers in Budget Preparation

Budget reforms have involved introducing a performance focus into the budget process and moving away from the culture of budget preparation being seen as an administrative function. This means that departmental managers need to be involved in preparing their own budgets and having a forum in which budget decisions are made by the senior management of the ministry.

This can be achieved by establishing budget committees in each ministry with the following responsibilities:

- Developing internal budget ceilings through dividing the total ministry ceiling between the various departments based on the priorities set out in the budget guidelines
- Overseeing the preparation of the ministry inputs into the budget ceilings and the ministry budget estimates in line with the procedural guidelines, on time and within ceilings
- Developing and managing a budget preparation training programme to ensure all stakeholders in the ministry are trained, including district officers where appropriate
- Coordinate the preparation of annual work plans and cash flow forecasts and requests for funding from departments for submission to the Ministry of Finance
- Manage the monitoring and evaluation of programmes and activities and report to the Ministry of Finance as required.

Introducing and Strengthening Medium Term Budgeting

As explained above, medium term budgets have been introduced to:

- encourage ministries to plan for implementation of activities over the medium term
- to enable the better forecasting of future commitments such as pensions, primary school enrolments, policy changes, etc
- facilitate reallocations of expenditure between and within organisations
- provide a more strategic focus for trends in revenue and expenditure requirements and away from detailed line items of expenditure.

However experience of medium term budgeting has shown that there are several areas where the process needs to be improved, including:

- ensuring that the medium term estimates are used as the basis for the start of the next budget year rather than starting each year's process from scratch
- ministries still tend to focus the budget on the next financial year and not the full three year period
- the presentation of the three year estimates still tends to focus on presenting detailed estimates rather than a more summarised programme level which shows the strategic decision making.

These issues are described in more detail below.

Using the Estimates as the Baseline for Future Years

One of the objectives of preparing rolling medium term estimates is to develop a medium term plan of government priorities and for these to be reflected in the allocation of funds over the medium term.

For example, if the priorities of government are to allocate additional resources to health and education this would be reflected in a higher percentage share of the total budget being allocated to these ministries over the medium term (see Chapter 8: Coverage, Analysis and Approval). While lower priority ministries may not receive a decline in the absolute level of their budgets, their percentage shares of the budget may decline to reflect government priorities.

Therefore the intention of preparing a rolling medium term budget is to use the three year estimates as the base line figures for the preparation of subsequent years' estimates, rather than starting the process of setting ceilings and preparation of budgets from scratch. Thus in the second year, the budget for the next three years would be based on the figures presented in the medium term estimates and any change to these figures would be the result of:

- changes in the macroeconomic situation which would require an increase or decrease in government spending
- changes in government policies or priorities.

However in practice many governments do start the process of preparing both the budget ceilings provided to line ministries from scratch without making use of the three year estimates as the starting point. Some of the reasons for this practice include:

- insufficient attention and commitment to the two forward years during budget preparation: there is a rush to complete the annual budget figures and the forward estimates are included without sufficient attention
- unreliable projections of revenue and expenditure over the medium term so that the macroeconomic basis of the budget has to be changed each year
- insufficient forward planning and analysis of government policies and priorities so that major policy initiatives are not factored into the projections and have to be included on an annual basis. For example a government may have approved a policy of fiscal decentralisation which would have significant budgetary impact over the medium term. However these costs may not be factored into the medium term estimates either by the Ministry of Finance or other relevant ministries such as local government.

In some situations multi-year budgets are prepared but then not linked to the annual budget process, so that the figures in the three-year estimates are different from those presented to Parliament as the annual Budget. For example Public Investment Programmes are prepared for three years but are not always linked to the annual capital or development budget estimates.

Encouraging Forward Planning

The main purpose of preparing three year estimates is to provide line ministries with an indication of the likely funds they will receive, enabling them to plan ahead and encourage the forward planning of activities and expenditure. However in practice, ministries tend to focus on the first year of the estimates, which usually exceeds the ceilings provided by the Ministry of Finance, while the second and third years' estimates can often be lower than the ceilings provided by Finance.

The introduction of a performance focus and activity based budget provides a tool for encouraging ministries to plan over the medium term, i.e. planning the number of outputs and activities over a three year period should provide a more meaningful basis for medium term budgeting than simply adding a percentage increase to a line-item budget for an additional two years as would be the case under a line item budget approach.

Presentation of Three Year Estimates

The way in which three year estimates are presented varies between countries. In some cases the three year estimates are presented at the same level of detail as the annual budget and in the same format, i.e. the detailed line item is shown for three years rather than one.

The major reason for presenting three year estimates is to have a strategic view of the direction of government expenditure and this is not possible to see if the estimates are shown at this level of detail. Instead it is more useful to show the three year estimates at a higher level, for example by ministry, or by ministry and department or programme for both the recurrent and capital budgets together. See Chapter 8: Budget Coverage, Presentation and Approval for issues on budget presentation.

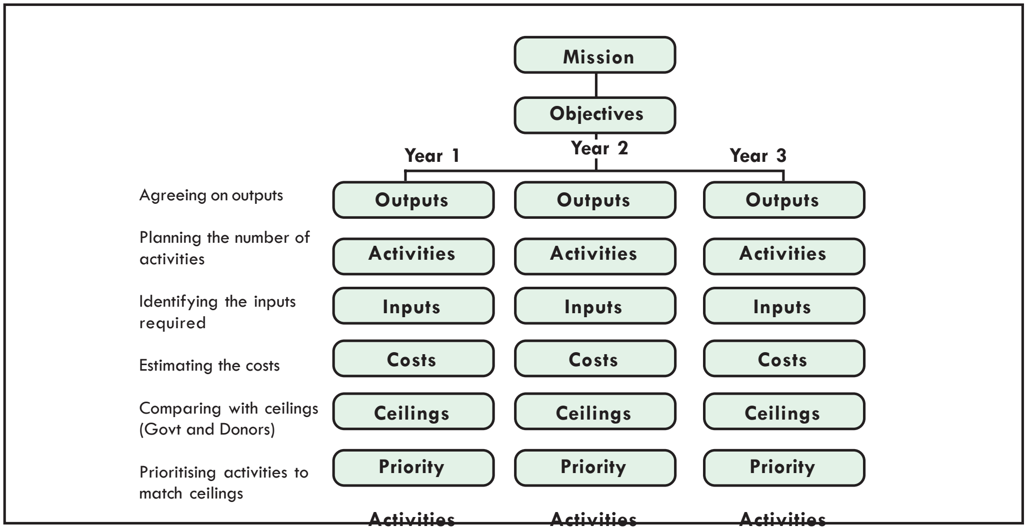
Preparing a Performance Based Budget

Overview of the Process

The process of preparing a performance based budget is illustrated in Figure 7 below and involves:

- Defining the ministry mission statement: the reason for the ministry's existence
- Defining the ministry objectives: the improvements the ministry is aiming to achieve to contribute to the achievement of the sector and national objectives
- The outputs to be produced in each of the three years in order to achieve the objectives, i.e. the goods and services which are defined specifically and are measurable
- The activities to be implemented to produce the outputs which are also defined and quantified for each of the three years
- Identifying the inputs required to implement the activities, using the government chart of accounts
- Costing the activities for each of the three years, which are aggregated to estimate the total cost of implementing the activities, producing the outputs and achieving the objectives
- Comparing the total cost of the activities with the available resources
- Prioritising activities to fit within the available resources.

Figure 7. Overview of Three Year Performance Budget



More details are provided in Annex 3: Preparing a Performance Based Budget on the definition of objectives, outputs and activities. The approaches to activity costing are summarised below and described in detail in Annex 3.

Costing Activities

There are several approaches to the estimation of costs and budget estimates within a performance based budget:

- Defining performance targets without undertaking a detailed activity based budget, (instead preparing a line item budget and presenting this alongside performance indicators)
- Preparing an activity based budget
- Defining performance indicators and only costing new activities to be implemented
- Defining the performance indicators and using alternative costing approaches such as costing models
- Undertaking an analysis of the cost of delivering planned levels of performance using actual expenditure: Activity Based Cost Management.

These various approaches are described in detail in Annex 3.

Problems of Performance Budgeting

The introduction of performance based budgeting does present a number of difficulties. These include:

- There are some difficulties associated with defining appropriate performance indicators, particularly in the public sector (see Box 26 below)
- If the rationale for introducing performance budgeting is not clear, the intended benefits will not be defined and the system will not be designed and implemented to achieve specific objectives. As noted above, performance budgeting can be introduced for a number of reasons, it is important to be clear about the reasons for introducing performance budgeting
- Defining the outputs and activities at the correct level of detail. There is a tendency to define outputs and activities at a very low level of detail, making it difficult to analyse and monitor the outputs and activities
- Defining performance indicators in the budget but not collecting information to measure progress and not linking physical to financial performance, and as a result, not using the results of performance monitoring to plan for subsequent years.

Box 26. Defining Performance Indicators in the Public Sector

For some ministries defining performance indicators is relatively easy:

- the Ministry of Works can measure the number of kilometres of roads constructed
- the Ministry of Health can measure the number of patients treated

For more administrative ministries defining indicators can be more difficult, e.g.

- measuring the performance of the Ministry of Public Service in promoting effective service delivery in the public sector
- the Ministry of Finance in improving financial management
- The Ministry of Foreign Affairs in improving a country's relations with the international community

However output indicators can be developed to measure performance in these ministries:

- Ministry of Public Service: Number of ministries assisted to prepare strategic plans, number of ministries trained in performance management system.
- Ministry of Finance: number of ministries trained in MTEF, or financial management, number of ministries where IFMIS is implemented.
- Ministry of Foreign Affairs: number of international agreements signed.

The introduction of a performance based budget needs to take account of the above issues and it is important to recognise that it is likely to take two to three years at least to develop appropriate performance indicators that reflect the key performance areas in an organisation and that are at the appropriate level of detail.

Linking the Preparation of Recurrent and Capital Budgets

A common issue being addressed by a number of MEFMI countries is the integration of the recurrent and capital (development) budgets. This can be achieved through a number of stages:

- Planning the two budgets together
- Presenting the two budgets together
- Integrating the two classification systems

Step 1: Planning the two budgets together on the basis of the strategic plan

In most countries the recurrent and development budgets are planned separately. Most projects have been developed without links to the ministry's strategic plan and priorities.

The first step is to assess existing projects on the basis of whether they are consistent with the ministry's priorities, as shown in the example below. This can be achieved by defining the outputs for both recurrent and development budgets and comparing the two sets of outputs to assess whether:

- The outputs are consistent with overall priorities of the ministry
- The two sets of outputs are consistent with each other
- There is an overlap or duplication of outputs being produced between the two budgets
- The recurrent budget will cater for the recurrent costs arising from the completed project
- There are project outputs which are not included in the budget or plan.

An example from the health sector is shown in Table 18 below.

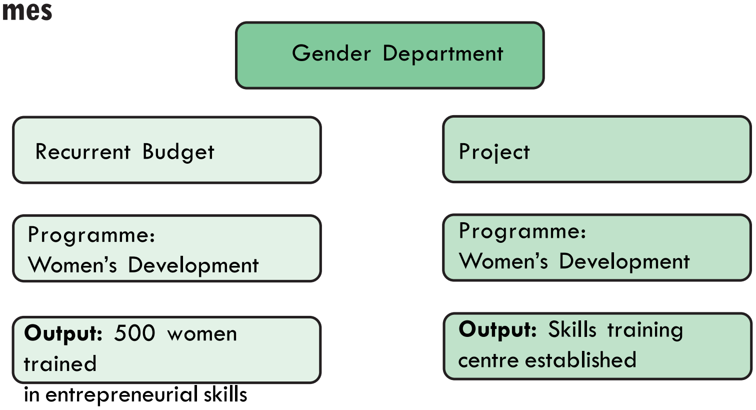
Table 18. Assessing Project and Plan/Budget Outputs

Projects	Project Outputs	Plan and Recurrent Budget Outputs	Comments
Health Reform Project	Trained health planning staff Revised legislation	Revised legislation	Training not included in plan. Plan to be revised
Support to HIV/ AIDS	ARVs provided by donors to 50% of HIV population	Recurrent costs of ARV provision not included	Budget to include government contribution to cost of ARVs
Health Infrastructure Project	20 clinics constructed100 clinics upgraded	20 clinics constructed100 clinics upgraded	All outputs consistent

Step 2: Presenting the two budgets as one budget

The next step in improving the integration of the two budgets is to present the information on Recurrent and Development expenditure together so that it is possible to see the total funds approved for a ministry. Where a performance based budget is prepared, it would also be useful to present the outputs or performance indicators for both budgets together so that it is possible to see the links between the performance planned using the two budgets, as illustrated in Figure 8.

Figure 8. Linking Recurrent and Development Budgets to Common Programmes



Step 3: Integrating the two budgets

The final step in the integration of recurrent and development budgets would be to integrate the two budgets, i.e. instead of having two separate budgets, there would be one budget and the budget classification system would be used to differentiate between recurrent and capital expenditure as explained in Chapter 8: Budget Coverage, Presentation and Approval.

Finalisation of Ministry Estimates

The final two stages in the budget preparation process within a line ministry are:

- To compare the total departmental estimates and the resources available, i.e. the ministry ceilings to identify the gap
- To prioritise activities and funds to fit within the available resources

Comparing Costs with Resources

Once all the activity and overhead costs have been estimated, the next step is to compare the total cost with the funds available to the ministry. Ideally the budget ceilings will have been provided to the line ministry by the Ministry of Finance by this stage in the budget cycle and ministries will develop their own internal ceilings once they receive the ministry ceiling from the Ministry of Finance.

Table 19. Comparison of Total Funding Requirements and Total Funds Available

	Funding Requirements		Funding available
	Recurrent budget		Government funds Donor budget support
	Development projects		Government funds Donor project support (included in the ceilings)
A	Total requirements	C	Total ceilings
	Projects outside the budget		Donor funds outside the Budget
	Other programmes such as Global Fund, MCC etc		Other donor funding outside the budget
B	Total requirements for other programmes	D	Total funds outside the budget
A+B	Total requirements	C+D	Total Funds Available

Table 19. presents a summary of the funding requirements compared to the funding available emphasising:

- Ministries will have activities in the recurrent budget that are funded by government funds and donor funds through General Budget Support, i.e. not tied to specific activities (see Chapter 13: External Resource Mobilisation and Management)
- The funding for projects is tied to the specific projects and cannot be used for other activities
- Adding the total requirements (recurrent and capital) and comparing them with total funds would show the funding gap.

Although development partners are making efforts to increase the coverage of their funds in the MTEF, i.e. in the budget ceilings, there are still significant funds that are not included in the fiscal framework and therefore in the three year ceilings. However line ministries which receive these funds do have information on the funds that they are likely to receive outside the government budget and it is important that these funds are included in a ministry's analysis of the funding gap, i.e. the difference between the funds required and the funds available.

Thus the total funding gap should take account of funds both inside the government systems and those that are off budget. Because external resources are provided in different ways, and some are not “fungible” (i.e. funds approved for a Global Fund cannot be spent on other programmes and activities), the analysis of the funding gap has to take account of the ways in which funds are linked to specific programmes or activities as shown above.

Prioritisation of Programmes and Activities

It is likely that the cost of the programmes and activities will exceed the ceilings provided to line ministries by the Ministry of Finance. It will therefore be important for ministries to prioritise programmes and activities in order to fit within the ceilings.

Within each department, programmes and activities will need to be assessed in terms of their prioritisation. Lower priority programmes and related activities need to be reviewed so as to identify those that can be:

- Dropped altogether
- Scaled back by reducing the scope of the programme or activity, e.g. reducing the outputs to be produced or coverage of the service to be provided
- Options for reducing the costs of programmes and activities to produce the same outputs at a lower cost need to be considered.

Factors for prioritising programmes and activities include:

- Ministry priorities: the priority given to activities should be linked to the overall priorities of the department, ministry and government.
- Level of funding required for the activity: it is not only the priority given to acivities that will determine the level of funds to be allocated to an activity, it is also the level of funding required by the activity. A high priority activity may be to revise the legislation but this may not require significant resources. A lower priority activity may be to rehabilitate the ministry headquarters building, but this will require a higher level of funds than the regulatory activities.
- Changes in policies: changes in policies can affect the level of funds required for an activity. For example if a policy change requires that the levels of existing services be expanded additional funds will be required.
- The impact of the programme/activity: Those that enable the ministry to achieve the agreed outcomes should be given higher priority.
- The least cost approach to achieving the objectives/outcomes.
- The least time or most direct means of achieving the objectives/outcomes.

Where there are insufficient funds for all departments and activities within a ministry to receive all their requirements:

- High priority departments and activities should receive a higher proportion of their requirements even if this is a lower percentage of the total level of funds
- For example if the drafting of new legislation is the highest priority for the ministry, the department responsible for this output should receive 100% of the funds required
- Lower priority sub cost centres would receive a lower percentage of their requirement, even if this translates into a higher level of funding.
- This involves making decisions or trade-offs between new and existing policies and programmes.

- Thus if a department is to introduce new activities or policies and therefore receive a higher percentage of the total ceiling, a lower priority department needs to be identified to be reduced in scope so as to generate the necessary savings to cover the costs of the new policy/programme

This is the last stage in the performance budget process.

Improving Budget Submissions to Ministry of Finance

The detailed budget submission will usually include detailed tables of estimates for the recurrent budget and summaries of capital budget estimates. Often these detailed estimates focus more on the explanation of the detailed line item costs than on the wider policy issues and priorities of the submitting ministry. Ministries will also be required to submit information to be included in the Minister of Finance's Budget Speech. However these often focus on a description of past performance of the ministry.

In situations where ministries prepare submissions as an input into the setting of the ceilings which analyses their performance and priorities, the documentation that accompanies the detailed budget can be significantly less meaningful at the policy and priority level.

These documents need to justify a ministry's budget and would include:

- A summary of the ministry's mission and objectives
- The priorities of the ministry either shown as programmes or specific activities
- Where a performance based budget is produced, the performance to be delivered with the funds requested
- A presentation of the recurrent and capital budgets for the three year period, including an explanation of the linkages between the two budgets (see above)
- The detailed annual estimates for the recurrent and capital budget along with an explanation of the basis of the budget estimates and comparison with the previous two years' approved budgets
- Detailed information on staffing, proposed increases/reductions in staff positions
- For capital projects, additional information should be provided on the total estimated cost of the project, expenditure to date, unspent balances for the remainder of the project life, and any recurrent costs arising from the completion of the project
- Estimates of non tax revenues, any proposed changes in fee rates and increases/reductions in revenue collections
- Information on subsidies, the number of beneficiaries, subsidy per beneficiary, and whether these will increase or decrease in the forthcoming year.

Thus the information provided with the detailed estimates should place the information in the context of the plans and priorities of the ministry.

The next Chapter 8: Budget Coverage, Presentation and Approval focuses on ways in which the information included in budgets can be improved to increase transparency and make the documents more user friendly to Parliamentarians and the public.

Annex 3 Preparing a Performance Based Budget

The preparation of a performance based budget is summarised in Chapter 7 and this Annex describes the process in more detail. The process described involves:

- Defining the ministry mission statement
- Defining the ministry objectives
- Defining and quantifying the outputs or targets to be achieved to attain the objective
- Defining and quantifying the activities to be implemented to achieve the targets
- Costing activities
- Comparing the costs with resources
- Prioritising the activities to fit within the ceilings.

Defining a Ministry Mission Statement

This is a broad definition of why the ministry exists or, sets out its overall mandate. The mission statement should set out:

- why the ministry exists
- the core business of the ministry
- who are its customers or target beneficiaries
- its core values.

The mission statement is usually constant, changing very little over time.

Defining Ministry Objectives

There are a number of tools that can be used for developing organisational objectives, different ways of presenting objectives and different levels of organisational objectives.

- Problem tree
- SWOT analysis as explained above
- Identification of key issues

Objectives can also be defined and presented in various ways, for example:

- time frame: the objectives can focus on achieving a specific aim in the short, medium or long term.
- inclusion of targets in objective, e.g. to increase access to primary health care by 20% by 2015.
- levels of objectives: objectives can be defined at various levels, e.g. sector, ministry, department.

There is no wrong or right way of defining objectives. The important issue to bear in mind is that the approach needs to be used consistently across an organisation or government if the process is being implemented across government.

Ideally ministry objectives should be focused on those areas that the ministry is able to achieve. Thus ministry objectives should reflect the issues that the ministry needs to address in order to contribute to the sector objective, such as improving the quality of health services.

Using the tools listed above a ministry will identify the key issues in the sector, from which the causes of these issues are identified and the final step is to turn the causes of the key issues into positive objective statements that the ministry will be responsible for implementing, i.e. the objectives should be focused on addressing the key issues and their causes in the sector.

Table 20 below presents examples of the key sector issues, causes and ministry objectives.

Table 20. Examples of Key Issues, Causes and Ministry Objectives

Sector	Key Issue	Cause	Ministry Objective
Education	Low pass rates	Low quality of education	To increase the quality of education
Health	High infant mortality rates, high HIV/AIDS rates	Low access to primary health	To increase access to primary and preventive health care services
Agriculture	Unfavourable weather conditions	Lack of research and extension in appropriate crops and methods	To develop and provide research and extension services in appropriate crop production

Defining Outputs or Targets

Outputs are the goods and services produced by a ministry to contribute to the achievement of the objectives. Examples of outputs include:

- Curriculum reviewed and updated
- Child immunisation campaigns conducted
- Farmers trained in appropriate technology.

A ministry can be held directly responsible for the delivery of these services or outputs as compared to achieving outcomes for which several stakeholders will be responsible.

Links between Outputs, Outcomes and Impact

- Outputs: goods and services delivered by an organisation
- Outcomes: the results of the delivery of these services to which a number of different organisations contribute
- Impact: the effect on the outcome on longer term results, i.e. similar to an outcome but with a longer term horizon

This has the following logic:

- If an organisation produces an output
- It will have an outcome or result
- The result will have a longer term impact.

This logic can therefore be used to work backwards from a desired impact to the outputs that an organisation should be producing as shown in the example below.

Box 27. Education: Example of Performance Indictors

Objective: to increase the quality of education

Performance measurement: how will we know this has been achieved? What measures quality education?

Outputs:
- quality can be affected by the curriculum, thus an updated curriculum could be one of the outputs associated with this objective
- quality can also be improved through better trained teachers, therefore increased number of teachers receiving in-service training can be an output

Outcomes: if there is an improvement in the quality of education this will result in the following:
- improved pass rates
- improved retention rates

Impact: what will improved pass rates result in?
- improved transition rates to secondary and higher education
- increased skilled workforce
- increased employment and economic growth

Types of Output and Outcome Indicators

Outputs can measure:
- The level of services provided by an organisation, for example the number of people trained
- A tangible product such as a policy document, reports etc or a building constructed
- The result of a work process such as a virement application processed.

Outcome indicators are the intermediary indicators and can measure:
- The change in beneficiary status, e.g. number of people attending health clinics, education pass rates, women involved in the political process

Impact indicators can measure:
- The change in beneficiary status, e.g. health status, education pass rates, women involved in the political process
- Economic indicators: economic growth, agricultural production, tourists visiting a country, poverty indicators, employment rate
- Changes in factors such as environmental status; crime rate; levels of corruption; investor confidence.

Outputs and outcomes can be measured in a number of ways:

- Quantity: how many children were educated?
- Quality: how well were they educated, i.e. did they pass?
- Timeliness: were the services delivered on time?
- Cost: was the output produced at the least cost?

Deriving Activities from Outputs

Activities are the actions a ministry performs to produce its outputs.

- Activities should be determined on the basis of using the most cost effective approach to producing the output and achieving the objective
- Activities should include both those in the capital and recurrent budgets
- Activities should include both those funded by government and those funded by donors
- Activities should be assigned to specific departments/divisions/units in the ministry

Different types of activities

Service activities: these are the activities involved in providing the service such as teaching pupils, treating patients and reviewing policies. The number of activities to be implemented need to be linked to the agreed outputs to be produced. Services can be provided to external beneficiaries such as farmers, and also internally within the ministry, e.g. financial management services

Capacity building activities: those activities involved in developing the capacity of the ministry in order to improve its ability to deliver the services.

Capital investment activities: these include the construction or rehabilitation of buildings, roads, etc. and the purchase of new equipment and should be linked to the agreed number of outputs. These capital investment activities are usually grouped together into a project.

New activities arising from projects: it is important to plan for the new activities that will arise from the completion of projects, such as additional teachers required for new schools, training of staff when new computer systems are installed.

Administrative activities: these activities are involved in the running of an organisation and will include the cost of electricity, water, vehicle maintenance, etc.

Planning Outputs and Activities

Planning outputs and activities involves two steps:

- Specifying which outputs are to be produced to achieve the objectives, and the activities to be implemented to produce the outputs
- Quantifying how many outputs are to be produced in the three year period and how often the activities will be implemented to produce the agreed number of outputs each year.

In deciding on the outputs and activities to be included in the planning and budget process it is important to take into account the following issues:

- What are the outputs that are required to achieve the objective?
- What are the activities that need to be implemented to produce the outputs and lead to the achievement of the objective, i.e. are they effective?
- Different least cost options for producing outputs and implementing the activities should be considered.
- Options for involving communities, NGOs and the private sector should be considered so as to reduce cost for the ministry.
- Policy changes within the ministry which may determine the way in which the objective is to be achieved, e.g. introduction of a free service may increase demand for the service
- Other factors such as changes in demand and population growth may result in the need to change the way in which the objectives are achieved.
- Linkages between outputs and activities should be taken into account. Are there options for coordinating activities so as to reduce costs? Are there activities that other cost centres will need to implement in order for your cost centre to implement its activities?

The example in the table below illustrates the process of assessing different options for the outputs to be produced and activities to be implemented in achieving a ministry objective.

Table 21. Example: Assessing Options for Agriculture Outputs

Objective: to strengthen research and extension services for commercial agricultural production		
Most effective outputs	What will lead to objective being achieved?	New research results on commercial crops Farmers trained in commercial crop production
Most effective activities	What will lead to output being produced?	Undertake new trials New farmer training materials developed Training of extension staff
Least cost options	Are there least-cost ways of implementing these activities?	Collaborate with regional research organisations to reduce costs
Involvement of NGOs	Could other stakeholders be involved?	Some of the training could be undertaken in collaboration with NGOs
Policy changes	Are there policy changes that could affect the way the outputs are produced and activities implemented?	Farmers may have previously been charged for training and now training would be provided free, increasing the costs

Changes in external issues	Are there external factors that would affect outputs and activities?	Global warming will lead to the need for more drought resistant crops
Linkages	Are there possible linkages within and/or between departments to reduce costs?	The extension department could incorporate commercial crop production training with existing training programmes rather than running specific ones on this subject

Quantifying Outputs and Activities for Three Years

In order to plan the outputs and activities to be implemented for the three year period, they need to be made SMART.

SMART Outputs and Activities

- **Specific and measurable** (i.e. can be clearly seen and measured). For example, improved coordination as an output cannot be measured. Instead the output could be seen as a new coordination mechanism put in place, which can be measured in terms of whether this has been achieved.
- **Achievable**: the outputs should be realistic in that it would be possible to produce the outputs within the planned timeframe
- **Results oriented:** focused on achieving the agreed results
- **Time-bound for the three year period** (i.e. the quantity of outputs needs to be specified for each of the three years)

In addition when defining outputs and activities it is important that they:

- include both ongoing (e.g. existing agricultural demonstrations) and new (e.g. demonstrations on crop diversification) services and infrastructure
- include both recurrent and capital funded services and investment
- include those generated by both domestic and donor resources, i.e. include outputs to be produced from donor funded projects
- be within the control of the department/division to produce.

Planning output and activities should also take account of the following:

Relevance:

- The level of outputs (goods and services) needs to be linked to the level of demand for these services. For example the number of students educated needs to be based on the increase in enrolments, changes in pupil/teacher ratios etc. Changes in the world economy may necessitate changes in the services provided by government to the private sector
- The number of outputs that needs to be produced to achieve the objective

- Whether the way in which the activities are to be implemented will lead to the outputs and objectives being achieved
- How often the activities need to be implemented to lead to the production of the outputs and achievement of objectives.

Phasing
- The outputs and activities should be phased realistically over the three year period, i.e. not lumped together in the first year
- The programming of activities should take account of uncompleted activities from the previous year.

Capacity
- The phasing of outputs and activities should take account of the financial and human resource constraints in the ministry
- The programming of outputs and activities should be based on current implementation experience.

Recurrent and Capital Issues:
- Recurrent activities that will arise from new capital activities need to be planned
- The programming of outputs and activities should provide for all stages in implementation, i.e. tendering, design, construction, equipping and running costs
- It is important to limit the number of outputs to a few key outputs, as data will need to be collected and performance reported on against these outputs (see Chapter 11: Performance Monitoring and Evaluation). Thus, it is important that the output indicators are measurable and ideally that there is a system already in place for collecting data to measure performance.

Activity Costing

Once the outputs and activities have been defined the next step is to cost the activities, ideally in both the recurrent and development (capital) budgets. While each activity needs to be costed, there are overhead costs, such as some salaries and administration costs that are not linked to specific activities, and these also need to be costed and added to the activity costs in order to produce the total budget estimates.

There are several approaches to the estimation of costs and budget estimates within a performance based budget:
- Defining performance targets without undertaking a detailed activity based budget, (instead preparing a line-item budget and presenting this alongside performance indicators)
- Preparing an activity based budget
- Defining performance indicators and only costing new activities to be implemented
- Defining the performance indicators and using alternative costing approaches such as costing models

- Undertaking an analysis of the cost of delivering planned levels of performance using actual expenditure: Activity Based Cost Management.

These various approaches are described below.

Presenting Performance Targets and Budget Estimates

The most simple approach to a performance based budget is to indicate the levels of performance, i.e. services to be provided within the approved funding level but the budget is prepared on a line item basis, as shown in Table 22.

Table 22. Presenting Performance Targets and Budget Information

Primary Education Programme	Year 1	Year 2	Year 3
Targets (outputs)	2 million primary school children enrolled	2.4 million primary school children enrolled	2.6 million primary school children enrolled
	200 new classrooms constructed	200 new classrooms constructed	200 new classrooms constructed
Recurrent Budget	2,000,000	2,400,000	2,600,000
Development Budget	1,000,000	1,000,000	1,000,000
Total Budget	3,000,000	3,400,000	3,600,000

Thus the line ministry is not estimating the budget on the basis of achieving the performance but is indicating to the Ministry of Finance, Parliament and the public the service levels it plans to deliver.

Over time the ministry will be able to assess whether it is able to deliver the performance with the approved funds and make adjustments to the estimates. However there is no link between the two.

Full Activity Costing

This approach involves costing all the activities to be implemented by a ministry in the forthcoming year and possibly the next three years in the case where there is an MTEF. The example below shows how the targets or outputs are linked to activities and then each activity is costed.

Table 23. Example of Activity Costing

Primary Education Programme										
Objective	To increase access to primary education									
		Year 1			**Year 2**			**Year 3**		
Targets		2 million primary school children enrolled			2.4 million primary school children enrolled			2.6 million primary school children enrolled		
		200 classrooms constructed			200 classrooms constructed			200 classrooms constructed		
Activities	**Inputs**	**Qty**	**Unit Cost**	**Total**	**Qty**	**Unit Cost**	**Total**	**Qty**	**Unit Cost**	**Total**
Procure and distribute text books and teaching supplies	Text books	2 m	2	4 m	2.4 m	2	4.8m	2.6 m	2	5.2m
	Teaching supplies per school	5000	500	2.5 m	5000	500	2.5 m	5000	500	2.5m
	Distribution costs to each school	5000	100	0.5 m	5000	100	0.5 m	5000	100	0.5 m
Total Recurrent Budget				7m			7.8m			8.2m
600 new classrooms designed	Design costs	1	3,000	3,000	0	0	0	0	0	0
600 classrooms constructed	Construction costs	200	100,000	20m	200	100,000	20m	200	100,000	20m
Total Capital Budget				**20.003m**			**20m**			**20m**
Total Programme Budget				**27.003 m**			**27.8m**			**28.2m**

Only Costing New Activities

A hybrid of the two approaches above is to assume that the existing budget is the baseline budget and only new activities are costed.

Primary Education Programme	Year 1	Year 2	Year 3
Outcomes/Targets	2 million primary school children enrolled	2.4 million primary school children enrolled	2.6 million primary school children enrolled
	200 new classrooms constructed	200 new classrooms constructed	200 new classrooms constructed
New Activities	Recruit 75 additional teachers	Recruit 50 additional teachers	Recruit 45 additional teachers
	200 new classrooms constructed	200 new classrooms constructed	200 new classrooms constructed
Cost of new activities	20,050,000	20,040, 000	20, 035,000
Baseline Recurrent Budget	200,000,000	220,000,000	240,000,000
Baseline Capital Budget	40,000,000	45,000,000	50,000,000
Total Budget	**260,050,000**	**285,040,000**	**310,035,000**

Using Costing Models

An alternative to costing each activity is to use a costing model as demonstrated in Table 24 below. This approach involves:

- Defining the targets to be achieved or outputs to be produced, e.g. number of primary children to be taught
- Estimating the cost per child
- Multiplying the cost per child by the number of children to be taught to arrive at the total cost.

Table 24. Unit Costing: Example of Educating One Child

Assumptions: Based on the cost of running one school, with four classes, 30 children per class, a total of 120 children				
Unit	**Assumption**	**Qty**	**Cost**	**Total**
Teachers	1 teacher per class	4	20,000	80,000
Text books	3 text books per child	360	1,000	360,000
Paper, pens etc	1 set per child	120	1,000	120,000
Running costs	Quarterly utility bills etc	4	2,000	8,000
School maintenance	Maintained twice per year	2	5,000	10,000
Total				578,000
Divided by total pupils				120
Cost per pupil				4,816

This approach requires making assumptions about the way in which the service is delivered such as the number of text books per child, the pupil: teacher ratios etc. The above example is based on a number of underlying assumptions:

- Policies on the pupil/teacher ratios, pupil/textbook ratios
- The projected growth in pupil enrolments.

The use of a costing model enables further analysis by changing these assumptions (i.e. policy changes) and estimating the impact on budget requirements. However a costing model can only be used for costing those services where the same service is provided to a number of beneficiaries, such as primary pupils, patients treated, kilometres of road maintained etc.

CHAPTER 8 BUDGET COVERAGE, PRESENTATION AND APPROVAL

Introduction

Summary of Chapter

This Chapter focuses on ways in which government budget documents and public accounts can be improved in terms of increased transparency, comprehensiveness and usefulness for the various stakeholders in the Public Expenditure and Financial Management (PEFM) system.

It also focuses on ways in which public expenditures can be analysed and scrutinised by the Ministry of Finance, Parliament and even the public. The chapter covers issues of:

- Budget coverage: ensuring all resources are included in the budget and accounting processes and documents
- Budget classification: ways in which revenue and expenditure are classified to ensure maximum transparency and usefulness in the presentation of information in both the budget and public accounts
- Budget presentation: improvements in the presentation of budget information
- Budget analysis: ways in which budget information can be analysed to assess whether expenditure has been used in line with government priorities
- Budget scrutiny and approval: weaknesses in the way in which ministry budgets are reviewed within the Ministry of Finance, Cabinet and Parliament, and suggestions for how these processes can be improved.

Annex 4 presents detailed formats and analysis to be used in analysing government expenditure and revenue.

Key Issues

Budget information and documents in many developing countries tend to focus on detailed estimates of revenue and expenditure, and on the inputs required to implement the budget. As explained in Chapter 1: Overview of PEFM, this has been due to the main emphasis of budget preparation and management being in control of inputs, rather than on funding and performance of priority programmes.

Reforms to budget classification and preparation processes enable improved budget presentation, analysis, scrutiny and approval focusing on:

- The medium term and providing a strategic overview of revenue and expenditure
- The performance to be delivered with the approved funds
- Ministry programmes showing the broad functions of the expenditure
- Meeting international accounting and fiscal transparency standards
- Ensuring that the budget information and presentation is comprehensive, i.e. all government and donor funds are included

- Making Budget documents more user friendly taking into account the needs of the various stakeholders

The improvements in budget information should also enable a more thorough analysis and approval of the budget based on whether government funds are being allocated in line with priorities over the medium term.

Budget Coverage

One component of an effective Public Expenditure and Financial Management (PEFM) system is that it is comprehensive, i.e. all revenue and expenditure is included in the budget. If all resources are not included in the budget it is not possible to ensure that funds are allocated to priority areas.

Although not all funds may be included in the formal processes for budget allocation and management, there are some minimum requirements to ensure comprehensiveness in budget documentation and management.

The requirements are that:
- all revenue and expenditure should be included in the budget document
- estimates should be shown in “gross” terms, i.e. the total revenue and total expenditure should be shown separately and not “netted out”, where only the difference between the revenue and expenditure is shown
- all revenue and expenditure should use the same standard classification system
- accounts of autonomous bodies should be subject to external audits on a regular basis
- the government’s financial statements should also include the operations of autonomous funds and agencies.

Extra Budgetary Funds

In some countries a large proportion of the budget can be managed through special funds such as revolving funds, trading funds for business activities, emergency funds, special funds for specific purposes such as road funds, expenditure financed by donor funds, counterpart funds etc. In some cases these funds are not shown in the budget and are managed through Extra Budgetary Funds (EBFs). The reasons for setting up these funds include protecting certain expenditure from budget cuts, bypassing regulations for use of funds, political pressures and donor requirements to protect their funds.

While some EBFs are a legitimate requirement, they reduce the scope for a comprehensive picture of total resources and thus resource allocation decisions do not take account of these resources.

These funds are often not subject to the same procedures and rules as on budget expenditure. Sometimes this is due to lack of fiscal discipline, i.e. there are interests in keeping the management of these funds lacking in transparency. The transfer of funds to autonomous agencies is often shown as a line item transfer and the breakdown of how the funds have been spent, is often not presented to Parliament.

However there are some cases where special arrangements are appropriate. For example the use of Revolving Funds to manage the purchase of goods that may not be delivered immediately or where government enterprises are operating on a commercial basis. Even where EBFs exist it is important that the budget and accounts for the use of these funds are also presented to Parliament for their scrutiny.

Tax Earmarking

Extra budgetary funds are often financed from earmarked revenue, i.e. revenue collected from a specific activity or source and only spent on one type of service or investment. An example of this is a road fund through which revenue is collected from fuel or other transport related activity, and the revenue is used for the construction or maintenance of roads.

There are a number of types of earmarking (McCleary, 1991):

- A specific tax or fee matched to a corresponding end use, e.g. social security taxes, fuel taxes for road construction
- A specific tax or fee for broad use, e.g. lottery proceeds that finance specific types of activities, such as NGOs, arts and cultural organisations etc.
- General taxes earmarked for specific use, e.g. a fixed percentage of income tax used for development projects at the local government level.

The problems associated with earmarking of taxes include:

- Reduced flexibility in resource allocation: the fund earmarked for the specific purpose cannot be used for other purposes.
- Reduced scope for reprioritisation of expenditures as the funds allocated to the specific purposes are tied specifically to those activities
- Expenditure beyond actual requirements of the activities if additional funds are raised through the revenue raising measures, or under expenditure on these activities if insufficient revenue is raised
- Decisions about how the funds should be spent can be more open to influences that are not based on achieving government objectives and efficient and effective use of resources.

However where there is strong benefit-revenue link and the service is provided to easily identified users, earmarking may be desirable to encourage ministries or agencies to improve performance and facilitate cost recovery.

Quasi Fiscal Activities

These are activities that are undertaken by the central bank or state-owned banks to achieve government policy goals. These include interest rate subsidies, support to loss making organisations, payment of government debt and financing of exchange rate losses made by government.

In the interest of transparency it is often better to use clear measures that can be shown in the budget than these quasi fiscal operations that do not clearly show how government funds are being spent. Even if the expenditure is not clearly shown as part of the main budget document, there should be an annex that presents this information.

Government Liabilities and Contingent Liabilities

Governments have commitments that involve an immediate or future payment. These can be explicit or implicit and be certain or uncertain (i.e. difficult to predict). These include:

- Explicit liabilities and commitments which are legally mandatory and predictable. For example existing budgeted activities that will continue in future, multi-year projects, civil service salaries, pensions and debt obligations
- Explicit and contingent liabilities that result from a specific event that may or may not happen. This includes state guarantees for local government, parastatals and state insurance schemes for floods etc. As these are guarantees or insurance schemes, government will have to pay the loan for the organisations or pay out in case of floods etc, and will therefore incur expenditure on behalf of these organisations
- Implicit liabilities are a call on government expenditures which are the result of public expectations that government will continue to provide services or create new infrastructure.

Implicit and contingent liabilities are the most unpredictable type of liabilities as these are not backed by a legal requirement and are based on events that are less likely to occur. For example the expectation is that the government would intervene and provide support to the population in the event of a natural disaster such as drought or floods.

In most countries there is little attention paid to these liabilities other than debt servicing, pensions, salaries etc. This means that governments are not taking these potential risks and future obligations into account when preparing the budget. For example there is insufficient analysis of the future needs of the population in terms of health care, the recurrent cost arising from completed projects and the liabilities created through government guarantees of loans for organisations for which there is a high probability of the organisation defaulting on the loan.

These risks need to be incorporated into the medium to longer term planning of revenue and expenditure, so as to ensure that these liabilities are provided for and avoid the need to meet unforeseen expenditure.

Managing Fiscal Risks

Managing fiscal risks involves the following issues:

- Identify and estimate the potential cost of all existing liabilities – both implicit and contingent as described above
- Review whether these risks represent the best use of government resources, i.e. whether government guarantees for risky organisations is the best use of scarce resources
- Identify possible measures that could be implemented to reduce the risk, e.g. better management and oversight of parastatals to reduce risk of default on government guaranteed loans
- Information on the potential costs should be included in the budget documentation
- When the event occurs that requires that government funds are used compare the actual cost against the estimated cost and identify possible lessons for reducing the risk in future.

Using a medium term approach to budget preparation makes it easier to plan ahead for these types of risks and enables an assessment of the fiscal sustainability of revenue and expenditure plans. Therefore in a medium term fiscal framework that estimates revenue and expenditure, ideally an assessment of these fiscal risks should also be included.

Identifying and costing these potential risks is particularly difficult for those that are contingent, i.e. not certain. For example it is difficult to predict and estimate the cost of natural disasters and to assess the likelihood that an organisation which has received a government guarantee will default on the loan.

For government guarantees, a detailed assessment of the risks of the guarantee needs to be undertaken before the guarantee is provided. The budget documentation should include a list of all new government guarantees provided to other organisations and the performance of the organisations receiving the guarantees should be monitored to assess the likelihood of the organisation defaulting on the loan.

Governments can also provide lending support to organisations that meet government objectives, i.e. government lends funds to an organization such as a parastatal where the organization is unable to borrow at reasonable commercial terms or to supplement commercial borrowing. These loans also need to be part of a transparent budget preparation process, be subject to the same detailed analysis as on budget expenditures and the details of government lending should be included in the budget documentation.

In some cases the lending will involve an interest subsidy to the borrowing organisation if the level of interest rates is lower than the commercial rates. This subsidy also needs to be shown explicitly in the budget documentation.

Budget Classification and Chart of Accounts

A key component of PEFM reform is to improve the presentation and analysis of budget information. One of the ways in which this can be achieved is through reforms to budget classification and chart of accounts.

What is a Budget Classification?

Budget classification is the presentation of information on public funds in a number of ways so that they can be analysed and reported on according to specific requirements. Budget classification systems enable users of budget information to present and analyse budget data to answer the following questions:

- On what? i.e. by type of input, e.g. fuel
- By whom? The organisational unit or cost centre which is responsible for the expenditures and revenues
- Why? The reason for the expenditure, or broad area of activities
- Where? In which region, district or local government area
- Funded by whom? The funding source for the activities, projects etc.

These questions are answered through the use of a number of different ways of classifying public funds.

Line Item Classification: Line Item Classification is used to classify revenue and expenditure according to the nature of the revenue or expenditure. Line-item classification will usually have at least three or four levels of detail:

- Broad classification: such as revenue, expenditure
- Detailed level: revenue types, expenditure types, current and capital, wages, debt payments, goods and services, etc.
- Additional detail: within each category a further breakdown, e.g. into travel and transport costs under good and services
- Further breakdown: this can be divided further into detail such as fuel under travel and transport costs.

Economic Classification of Expense (expenditure): The Economic Classification of expense is part of the International Monetary Fund (IMF) classification system. It applies only to expense as defined in the GFS Manual 2001, i.e. a decrease in net worth resulting from transactions. It is cast at a higher level than line item. However, many countries design their line item classification structure to be consistent with the IMF's Economic Classification structure. The IMF also uses the COFOG system to classify outlays (i.e. expense and acquisition of non financial assets) according to the function or purpose for which the expense is incurred. COFOG is discussed further below.

IMF Revenue Classification System: The International Monetary Fund (IMF) has its own classification system for revenue. It categorises revenue at three levels, under the major headings of Taxes, Social Contributions, Grants and Other Revenue. The IMF Revenue Classification system is published in the GFS Manual 2001 (see the Manual Appendix 4). However, most countries would classify their revenue at a great level of detail than the IMF Revenue Classification system, whilst at the same time, remaining consistent with the IMF's system.

Organisational or administrative classification: this classification groups funds according to the organisations within government which are responsible for revenue collection and spending. The organisational classification would include:

- Ministry (sometimes referred to as vote or head)
- Department
- Division or unit

Organisational classification usually indicates the level of authority for revenue and expenditure within an organization, i.e. the cost centre or vote holder. The organizational classification does not always match the organisational structure, i.e. the budget classification may only include Departments although departments may be divided into divisions. This would mean that the department is the level at which the budget is prepared and controlled.

In some cases the introduction of budget reforms will involve devolving greater autonomy to lower levels within an organisation, so that the divisional level would also be included in the organisational classification and the budget would be prepared at the divisional level.

The organisational classification can also be used to indicate expenditure that takes place in a regional or district office of the ministry. Alternatively, the budget classification system may include a separate field to identify the geographic or spatial location of the spending. Therefore the classification may include additional levels to provide for regional or district budgets. These are the district offices of the central government ministry, rather than district offices of local authorities which are separate from central government.

Development (Capital) Projects: these can be classified in a number of ways:
- As part of the capital budget, individual projects can be shown separately
- As part of the organisational classification: projects can be classified as a type of administrative unit.

Programme Classification: which groups expenditure according to the broad function of government or set of activities with a common objective to which funds are allocated. Programmes can be sub divided into sub programmes which would indicate the sub-function within a programme. For example, a Primary Education programme can be sub-divided into "Classroom Construction" and "Maintenance" sub programmes.

The benefit of introducing a programme classification is that it is possible to link government expenditure to the broad functions of government, which is not possible when only using the line item and organisational classifications. Programme classification forms part of the programme budget preparation as described in Chapter 7: Budget Preparation, Principles and Processes.

Some issues to consider in defining programmes include:
- The programmes and sub-programmes answer the question "how will the objectives be achieved?"
- The definition of programmes and sub-programmes should be clearly distinct from the organisational structure, i.e. a training college is a cost centre not a programme. The relevant programme could be "Health Training", with sub-programmes for the different types of training. All cost centres that have training activities would include a training sub programme in their budget. For example the Extension Department in the Ministry of Agriculture could include a sub programme for Farmer Training as one of the sub programmes they will be implementing
- The phrasing of the programme and sub programme definition should describe the function of the programme to people who are not familiar with the services of the ministry, e.g. Field Services does not explain the kind of services that are provided under this programme
- All functions should be included in the programme classification including those organisations that receive a subvention or grant from their parent ministry. For example, a university may receive a grant from the Ministry of Education rather than being a department. In these circumstances tertiary education needs to be identified as a function of the Ministry of Education.

Performance Focused Classification: the introduction of a performance budget involves classifying expenditure according to outputs and activities and in some cases objectives. Thus it is possible to indicate the budgeted cost of producing an output and implementing the related activities. This is described in more detail in Chapter 7: Budget Preparation, principles and processes.

Functional Classification: this classification groups expenditure by sector and sub-sector and is usually linked to the use of the United Nations Classification of the Functions of Government (COFOG) described below. Functional and programme classifications can be similar in that sectors and sub sectors are broadly the functions of government. However as noted below, the COFOG classification is an international classification system, and will not fully match the functional or programme structure of all governments. Therefore, rather than restructuring government programme and functional classification to match the COFOG classification, mapping or cross walk tables can be used to reclassify government revenue and expenditure in order to meet government reporting requirements. Mapping tables and reports are easily handled by modern IFMIS applications.

Fund Classification: this identifies the source of finance to fund expenditure, e.g. domestic, loan, grant. It can also include details of donor funded agreements. A coding structure for donor funding would identify the donor organisation, such as the European Union and the funding agreement, such as the EU Rural Roads Programme Agreement. This would provide for situations where there are several donors funding a group of activities such as rural roads rehabilitation.

International Classification Systems

There are several international classifications of public resources. Two of these are:

1. The IMF Government Financial Statistics (GFS) (2001), which provides guidelines on classification for reporting government statistics for economic and functional reporting and for defining the fiscal position of government

2. The United Nations Classification of the Functions of Government (COFOG) which classifies expenditures according to the purpose or sector such as education, housing etc. The purpose of the COFOG is to allow for comparisons between governments

However these two international classification systems are only to be used for reporting to international organisations and should not substitute the budget classification developed to provide for all types of budget classifications according to the needs of country specific structures and uses.

The IMF GFS Classification was changed in 2001 with the main emphasis on changing the basis of accounting from a cash basis to an accrual basis, as described in detail in Chapter 12: Accounting and Reporting.

Chart of Accounts

The chart of accounts is the coding structure applied and used in accounting for expenditure, revenue, assets and liabilities. The structure should be compatible with the budget classification structure to ensure that expenditure and revenue included in the budget can be monitored and reported in the same format.

The budget classification system can be more detailed than the chart of accounts. For example, the Budget may be estimated at the level of paper and pens, while the chart of accounts may include a category for stationery.

The main focus of the budget classification system is the preparation and presentation of the budget documents, showing the expenditure and revenue, while the chart of accounts needs to ensure that revenue and expenditure are classified in such a way that the government is able to produce regular financial reports and the annual public accounts, as described in Chapter 12: Accounting and Reporting.

Reforming Budget Classifications and Chart of Accounts

Government budget classification structures will usually have been introduced as part of establishing government systems during the colonial period and will have been modified over a long period of time. Many of these changes will have been introduced on an ad hoc basis, so that the consistency within the classification structure may have deteriorated, with new items being introduced to respond to specific issues rather than as part of an overall review of the classification structure.

The budget classification and chart of accounts will often be reviewed and updated as part of introducing a budget and/or accounting reform, particularly the Medium Term Expenditure Framework (MTEF) or Integrated Financial Management Information System (IFMIS).

The following issues need to be taken into account in reviewing and updating the budget classification structure and chart of accounts:

- There should be a common structure across the whole of government
- There should be a common structure across both recurrent and development budgets
- Any ambiguities in the meaning and use of the classification structure should be avoided
- Existing inconsistencies in the classification should be removed
- The structure should meet international standards so that governments can meet their international reporting requirements to the International Monetary Fund and can achieve best practice in terms of presentation and reporting the use of government funds
- The classification should enable effective analysis of where government funds are allocated and spent
- The classification structure should provide different information and analysis to all the users of budget information.

Budget reforms will often lead to the introduction of more complex classifications, such as programme and performance focus. Thus an existing classification structure might include only:

- Line item classification
- Organisational classification

The introduction of budget reforms could lead to the additional classification of:

- Programmes and sub programmes

- Outputs and activities
- Fund, i.e. the source of funding for an activity, e.g. donor organisation and funding agreement as described above

Thus a budget classification structure could be expanded from a two dimensional structure to a five dimensional structure. This would be difficult to manage in a situation where budgets are prepared and managed with a manual system and the introduction of more complex structures is only possible where such systems are being computerised.

Computerised accounting systems are usually based on a relational database which will allow for the coding of revenue and expenditure according to the various classification categories therefore providing for the multiple dimensions of the classification structure.

As noted in Chapter 4: Planning Approaches, many donor funded projects have elements of recurrent expenditure which are then misclassified as capital expenditure. Thus it is important to have a common classification for recurrent and capital budgets which would enable the classification of expenditure into the "correct" categories of expenditure. All expenditure could then be analysed to present total recurrent and total capital expenditure.

As indicated in the example below, the budget would be divided into recurrent and capital budgets but would use a common budget classification structure which would reflect the true nature of the expenditures, i.e. into recurrent (recurring expenditure) and capital expenditure, (that result in a capital asset). Thus it would be possible to show the budget by either recurrent or capital budget and also by type of expenditure.

Table 25. Integrated Budget Classification

Project: Support to Agricultural Extension	Recurrent in Nature	Capital in Nature
Recurrent Budget	Purchase of extension materials	Purchase of computerised information system and equipment
Capital Budget	Training of extension staff	Construction of extension offices

Budget Presentation

Presentation of the budget can significantly improve transparency of budget processes and allocation decisions. In developing countries budget documents fulfil three roles:

- Format for presentation to and approval by Parliament
- Information to civil society on governments budget performance and plans
- Implementation and control mechanism for use by the Ministry of Finance (or Accountant General's Department) and spending ministries

As noted in the Box below, the International Monetary Fund has a number of guidelines on the reporting and presentation of budget information.

In developing countries, budget presentation formats tend to have the following characteristics which do not meet these IMF guidelines:

- The Budget Speech or Statement tends to be descriptive with limited presentation and analysis of budget data and performance
- Budget estimate documents are very detailed, intended for use as control tools rather than as a presentation of larger sectoral allocations and policy issues
- Limited analysis and presentation of meaningful information
- Some governments also present an economic and fiscal report which is not widely distributed or is distributed after the main budget documents have been circulated.

In some countries additional information is presented as Annexes to the budget including information on donor funded projects, grant aided organisations etc.

Box 28. Budget Presentation Principles

IMF Guidelines

The IMF Manual on Fiscal Transparency (page 41) sets out standards for fiscal data and budget presentation:

"Appropriate standards for fiscal data and information make crucial contribution to fiscal transparency. Principles and practices in this regard relate to the contents of budget documentation, the classification and presentation of budget estimates, budget implementation and monitoring, and fiscal reporting.

Budget Documentation

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

The Code proposes good practices in connection with budget documentation relating to: (1) fiscal policy objectives and sustainability; (2) fiscal rules; (3) the macroeconomic framework; (4) separating existing commitments from new policies; and (5) major fiscal risks."

In addition to these principles, there are four dimensions of transparency in budget documentation:

- The number of separate documents in which information is presented should be limited
- The budget documents should enable outsiders to independently verify the data and assumptions in the budget
- The presentation of the information should avoid opaque and arbitrary language and to apply generally accepted accounting standards
- The documents should include explicit justification of the data and assumptions.

Alt and Dreyer-Lassen quoted in Budgeting Institutions for Better Fiscal Performance: Jurgen von Hagen, Budgeting and Budgetary Institutions

Different Users of Budget Information

There are a number of different types of budget information and different budget users. Their needs will differ depending on how they use the information. This section identifies the types of budget information, the various users of budget information and their needs. The following section presents suggested improvements to budget presentation.

Types of Budget Information

- Estimates of revenue and expenditure at various levels of detail using line item classification
- Total sector and ministry allocations, ideally showing recurrent and capital budgets
- Expenditure by source of funding, e.g. government or donor, and specific donors and funding agreements
- Macroeconomic and fiscal data including projected total revenue, expenditure, debt and deficit/surplus levels as well as data to assess performance in these areas
- Comparison of approved budget estimates with actual expenditure to analyse budget performance
- Fiscal data in a form which enables governments to report to international organisations such as the IMF on government economic and financial performance.

Table 26 below presents the various users of budget information, the way in which they use this information and the kind of information required to meet these needs. In reviewing both budget classification and budget presentation options it is important to identify these various users and their needs and to ensure that budget information is presented in ways that will best meet these needs.

Table 26. Users and Levels of Budget Information

Budget User	Role	Level of detail required
Parliament	Review and approval of estimates	Estimates of revenue and expenditure, previous approved budget and actual expenditure. The level of detail depends on the level at which the budget is approved by Parliament Macroeconomic policies and projections Overview of national priorities and issues and ministries' budget allocations
Cabinet	Review and approval of estimates, to assess policy issues and priorities	Broad macroeconomic and sector allocations, ministry allocations linked to national priorities and policy, major expenditure items and related issues such as macroeconomic and fiscal policies, wage policy and levels of donor funds (both within and outside the budget)
Ministry of Finance	Detailed scrutiny and approval of estimates	Detailed estimates from ministries with justification of revenue and expenditure, for both recurrent and capital, and for government and donor funds, (ideally even those donor funds outside the budget) Senior management will require information on macroeconomic policies and projections and an overview of national priorities and issues and ministries' budget allocations
Line Ministries	Detailed preparation of estimates	More detail on department budget estimates, justification of estimates, priorities and policies within ministry Managers within the government need budget and financial information to manage and report on budget implementation
Civil Society	Review of estimates to asses consistency with government priorities	Broad macroeconomic and sector allocations, ministry allocations linked to national priorities and policy, major expenditure items and related issues such as wage policy, donor funds (both within and outside the budget)
Donors	Review of estimates to asses consistency with government priorities	Broad macroeconomic and sector allocations, ministry allocations linked to national priorities and policy, major expenditure items and related issues such as wage policy, donor funds (both within and outside the budget)

Suggested Improvements to Budget Presentation

As described above, it is important to assess the various needs of budget information and ensure that the content and presentation of budget information meets their needs. In addition, the introduction of budget reforms also provides for additional information that can be presented to the various stakeholders. These include:

- The three year focus in the MTEF
- Performance based budget showing performance levels to be achieved
- Integration of recurrent and capital budgets
- Inclusion of donor funds in the budget

Three Year Estimates: under an MTEF process the budget documents have a multi-year focus (usually three years), with the first year being approved by Parliament and two forward years being indicative. Therefore it is not necessary to show the three year budget at the detailed line item level – the three year estimates could be shown at the ministry or departmental level or at the programme level if a programme budget has been introduced.

The three year estimates can include:

- One table for each ministry over three years, including at least two previous years, with an explanation of how this represents government policies and priorities, and includes the additional costs of new policies and/or service levels
- For each ministry the allocations by programme or cost centre for the three years, with an explanation of how these reflect the priorities of the ministries, and additional cost of new policies and/or service levels.

Programme and/or performance based budget: if a performance based budget has been introduced it would be useful to include a description of each programme and its objectives, along with high level performance indicators or results to be achieved with the funds being approved by Parliament.

Integration of recurrent and development (capital) budgets: the integration of the two budgets involves planning the two budgets together as described above and also presenting the two budgets together. This could be achieved by linking the recurrent and capital budgets to the common programmes in each ministry and presenting the estimates for the two budgets together.

Inclusion of donor funded activities within the Budget documents: ideally donor funds should be included within the programmes and/or projects/activities in the main budget document. The distinction between government funded activities and donor funded activities can be provided for in the use of the fund classification that would ideally be shown as one comprehensive programme. Where it is not possible to show all donor funds in the main part of the budget estimates, it would be possible to produce an annex to the budget that shows the funds being provided to the government which do not pass through the government's Consolidated Fund.

Budget Scrutiny and Approval

Budget scrutiny and approval involves the review of budget proposals and formal approval of the estimates and passing of the Appropriation Act so as to enable the spending of the approved budget and collection of revenues. The detailed steps include:

- Finalisation and submission of the line ministry budget to the Ministry of Finance
- Analysis and scrutiny of the budget estimates by desk/budget officers in the Ministry of Finance
- Submission of reports and recommendations to the senior management of the Ministry of Finance
- Budget hearings with line ministries to discuss the budget estimates
- In some countries there may be ministerial level hearings to discuss the estimates
- The proposed budget allocations are compared and integrated into an updated fiscal framework to ensure that the budget fits within the overall macroeconomic framework and fiscal policies
- The proposed fiscal framework and ministry budget allocations are submitted to Cabinet for discussion, amendment and approval
- The final estimates are submitted to Parliament by the Minister of Finance with the Budget Speech
- Parliament will debate and approve the estimates and an Appropriation Bill will be passed.

The exact scope of these steps varies between governments, with some stages being more involved in some countries than in others. For example the scope of Parliamentary debate can vary. In some countries the full house will debate the budget estimates while in other countries separate committees will debate specific ministry budget estimates.

In the past the line item, input focused recurrent budget and separate development budget preparation processes meant that budget scrutiny and approval had a number of weaknesses in line ministries, Ministry of Finance, Cabinet and Parliament as outlined below.

Weaknesses of Budget Scrutiny and Approval in Developing Countries

Budget Scrutiny within Ministry of Finance

- The line item budget approach does not provide very meaningful information for linking the budget to priorities and policies
- The processes for preparation, scrutiny and approval for recurrent and development budgets are quite separate
- The information being analysed during budget scrutiny will not always be comprehensive: donor funds may not be included, special funds may be excluded from the budget and a build up of arrears may not be adequately reflected in budget estimates
- Often the budget finalisation may be rushed due to delays in starting the process, leading to late submissions from line ministries which does not provide sufficient time for detailed discussion of budget estimates
- Where ministries are not given ceilings in advance of budget preparation, the decisions on the level of funds approved are not transparent and can appear arbitrary

- Even when ceilings are provided in advance there may be last minute decisions on additional funds to be provided to particular ministries which will undermine the credibility of the setting of the ceilings
- Line ministries may submit estimates which are over their ceiling, knowing that the Ministry of Finance will cut the budget, and the budget finalisation becomes a “game” between line ministries and the Ministry of Finance
- Also line ministries may under-budget for high priority areas knowing that during budget implementation the Ministry of Finance will have to provide additional funds. This can also apply to projects where ministries will submit low cost estimates to get the project into the budget knowing that once the project is in the capital budget the Ministry of Finance will be required to increase the budget allocations for future years.

Budget Scrutiny by Cabinet

- Cabinet may not be provided with sufficient information to make informed decisions
- This may be the result of budget classification and budget presentation issues
- Ministries of Finance may feel that it is not the role of Cabinet to discuss resource allocations
- Civil servants tend to see politicians as “interfering” in budget allocation decisions
- Powerful Cabinet ministers may make a case for their own ministry or concerns even if these are not in line with overall government and national priorities.

Budget Scrutiny by Parliament

Processes for budget scrutiny by Parliament vary from country to country. In some countries there may not be detailed scrutiny, while in others specific Parliamentary sub committees have been established to scrutinise the estimates of spending ministries. As explained in Chapter 2 the degree to which Parliament can recommend changes to the detail of the budget also varies between countries. Parliamentary debate and approval can be constrained by various weaknesses:

- The information may be presented in a way that does not enable meaningful analysis
- Parliamentarians may not have sufficient understanding of the budgetary process and presentations
- Budget debates can focus on constituency requirements – there is not a culture of budget debate focused on national issues and priorities.

Involvement of Civil Society in Budget Discussions

Similarly civil society debate and involvement in budget scrutiny can be constrained by lack of sufficient and meaningful information on the policy issues and expenditure choices, partly due to the way in which budget information is presented. As noted in Chapter 2, in recent years a number of civil society groups are facilitating greater budget debate through production of more user friendly information on budget issues and encouraging greater debate.

Improvements to Budget Scrutiny

Public Expenditure and Financial Management (PEFM) reforms involve changes to the roles of stakeholders and information presented as part of the budget approval process. The aim is for the Ministry of Finance, Cabinet and Parliament to focus on larger policy issues and move away from discussion of detailed line item estimates. This means there needs to be:

- Effective institutional mechanisms for discussion and approval of estimates within line ministries so that budgets are focused on achieving government objectives
- Clear roles and responsibilities for scrutiny and approval processes, i.e. line ministries focus on details and strategic issues, while Ministry of Finance and Cabinet focus on strategic policy issues
- Sufficient information for scrutiny of the estimates which show levels of performance and associated costs
- Presentation of estimates in a manner that enables effective analysis of revenue and expenditure over the medium term
- All resources considered together: all government resources (recurrent and development) and all donor resources
- Sufficient debate and consideration of whether resources are being allocated in line with agreed national priorities
- Adherence to the agreed overall fiscal targets and individual ministry ceilings. If there is agreement that a ministry is to receive an increase beyond its allocation, cuts in other ministry ceilings need to be identified, so as to maintain fiscal discipline.

Within Line Ministries

The scrutiny of the budget should start in the line ministry itself. Line ministries need institutional mechanisms, such as an internal budget committee, for ensuring that the ministry's budget is allocated and spent in line with the agreed priorities of the ministry.

Budget processes that focus on recurrent estimates being prepared mainly by accounting staff on a line item incremental basis and a separate process for preparing the capital budget do not lend themselves to prioritisation and critical analysis of allocations within a ministry.

Thus it is important that the senior management of a ministry is involved in:

- Setting departmental ceilings, i.e. dividing the ceilings provided by the Ministry of Finance between the ministry departments based on the priorities of the ministry
- Introducing improvements to the budget process itself, through integrating the preparation of the recurrent and capital budgets, linking the budget to performance indicators, requiring departments to justify their budgets in relation to the ministry objectives
- Reviewing and agreeing on the final budget estimates to ensure that these reflect the priorities of the ministry, prior to their submission to the Ministry of Finance.

These discussions would focus on re-prioritising activities and expenditures so that the ministry budget fits within the ceiling rather than relying on the Ministry of Finance to make the budget cuts.

Within Ministry of Finance

Within the Ministry of Finance the process of reviewing and scrutinising line ministry submissions can also be a disjointed process, with some budget officers reviewing the recurrent budget estimates and planning review of capital estimates.

Thus the overall picture of the line ministry's priorities and how these are reflected in their budget estimates is difficult to assess. Improved budget scrutiny processes are linked to:

- The improvements in the budget preparation process itself, i.e. an integrated process that considers all expenditure together which are linked to a ministry's priorities and to the delivery of agreed levels of performance
- Encouraging joint analysis and review of budget submissions by those officers responsible for the recurrent and capital budgets
- Preparing detailed briefs for senior management of the Ministry of Finance on the budget estimates. These briefs would summarise the answers to the questions below, to be used in assessment of a ministry's budget submission.

Box 29. Questions for Reviewing Budget Submissions

- Are the three year estimates within the ceiling for each of the three years?
- Is there sufficient explanation of the estimates?
- Do the allocations within the ministry (by department) reflect the priorities of the ministry?
- Are there any recent policy changes or events (e.g. drought) that would require either an increase or decrease in the budget of the ministry that were not included in the setting of the ministry ceilings?
- Have the estimates for non tax revenue been submitted? Do these seem realistic? Is there a need to review existing levels of fees and charges?
- How do the figures by programme/cost centre compare with previous years' expenditure?
- Does the ministry have the capacity to implement the proposed level of expenditure?
- Is all the information required for capital projects provided? Have the recurrent costs arising from completed projects been included in the estimates?
- Are there donor funded activities that are already funding activities for which funds are being requested?
- If the ceilings provided additional funds for the ministry for specific purposes have the additional funds been allocated to this purpose?
- Technical level: do the figures add up/ make sense? Have all issues been covered, i.e. salary adjustments, inflation?
- Has all the information been provided to justify detailed expenditure, e.g. assumptions?
- Has detailed justification been provided where required?

Within Cabinet and Parliament

The process of reviewing and scrutinising budget submissions by Cabinet and Parliament would also be significantly improved through:

- the improvements in the budget preparation process itself, i.e. an integrated process that considers all expenditure which is linked to a ministry's priorities
- presentation of budget information which links expenditure allocations to the delivery of agreed levels of performance
- Sensitisation of Cabinet and Members of Parliament on the objectives, rationale and content of new budget processes and documentation to ensure that the discussion and scrutiny of budget submissions is improved.

Within Civil Society

Although civil society groups play an important role in educating the public about budget issues, governments can also contribute to improving public understanding of budget issues. They can do this by:

- Developing a Ministry of Finance website on which information and data is presented for the public to access such as budget documents, speeches, information on funds released to ministries etc
- Publishing this kind of information in the press. A number of countries publish information in newspapers on the budget and on the funds released to ministries
- Producing user friendly documents such as a citizen's guide to the budget.

Analysis and Restructuring of Expenditures

The Need for Regular Analysis

An important part of improving the quality of public expenditure is the regular analysis of those expenditures, ideally by planning and budget staff in ministries of finance and line ministries. This involves an assessment of public expenditure data, both historical and the budget submissions from departments and ministries.

This analysis is necessary at various stages throughout the budget cycle including:

- At the stage when the ceilings are set
- During the process of budget finalisation, review and approval
- During budget implementation as part of the monitoring process
- During evaluations of budget performance.

The analysis of expenditures at the stage of setting ceilings is most important as this is the stage at which strategic or big picture decisions need to be made on the future allocation of funds between and within sectors. These decisions are based on:

- An assessment of previous expenditure trends, i.e. were they in line with government priorities and policies?
- Future trends, i.e. ensuring that ongoing policies are implemented and reflect changes in policies and priorities

The World Bank undertakes a systematic analysis of government expenditure through its Public Expenditure Reviews as described in Chapter 1. In addition a number of governments in Africa including Tanzania and Ghana undertake regular Public Expenditure Reviews.

Government expenditure can be analysed at several levels:

- Fiscal – aggregate revenue, expenditure and financing
- Sectors, i.e. allocation of expenditure between broad sectors such as administration, social sector, economic & infrastructure and public safety
- Ministry level
- Programmes and departments

- Expenditure types: statutory, wages and salaries, goods and services, capital
- Source of funds: government and donors.

Data on previous expenditure needs to be collected, usually from budget documents and the government's financial management system. Other sources of information particularly for external resources, the breakdown of local government budgets, etc. will need to be collected from the appropriate organisations. Suggested processes for analysing government expenditure are presented in Annex 4 including formats for presentation of the data and the issues to be considered.

Significant Restructuring of Expenditure

The analysis of government expenditure by line ministry may reveal that existing expenditure patterns do not match government priorities. For example a government may have given priority to providing health and education services and the highest proportion of the budget may be allocated to lower priority areas such as public administration.

Significant changes or reallocations of expenditure are not possible through small changes in allocations over the medium term. Instead, they require:

- A review of government policies and implementation of major policy initiatives such as handing over some government services to the private sector
- The restructuring of government to downsize ministries and the civil service as described in Chapter 2: Institutional and Legal Framework. Restructuring programmes normally takes several years to complete

The next Chapter sets out the processes and systems involved in budget Implementation, including common weaknesses faced by MEFMI member states and suggestions for improving these processes.

Annex 4 Detailed Analysis of Government Expenditure

Government expenditure can be analysed at several levels:
- Fiscal: aggregate revenues, expenditure and financing
- Sectors, i.e. allocation of expenditure between broad sectors such as administration, social sector, economic & infrastructure and public safety
- Ministry level
- Programmes and departments
- Expenditure types: statutory, wages and salaries, goods and services, capital
- Source of funds: government and donors.

Data on previous expenditure needs to be collected, usually from budget documents and the government's financial management information systems. Other sources of information particularly for donor funds, the breakdown of local government budgets, etc. will need to be collected from the appropriate organisations.

Suggested formats for presentation of the data and the issues to be considered are described below.

Fiscal Analysis

The analysis of fiscal data would focus mostly on those issues that have an impact on budget implementation such as economic growth, revenue collections, the overall figures for revenues, expenditure, the deficit, etc. The types of issues to be assessed include:
- Whether economic targets were achieved as planned, e.g. growth rates, revenues, the size of the deficit etc and an analysis for good or poor performance
- The difference between planned shares of economic growth, revenue, inflows of donor funds etc and actual performance, with analysis of reasons for changes in actual performance.

Sector, Ministry and Departmental Level

Table 27 below presents a suggested format for analysis of sector and ministry shares of total expenditure.

Table 27. Sector and Ministry Shares of Total expenditure

	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Sector/ Ministry	Data	Data	Data	% share	% share	% share
Public Administration Sector						
Ministry of Finance						
Ministry of Local Government						
Total						

In reviewing the data showing the percentage shares of sectors and ministries, the following issues need to be considered:

- do expenditure allocations reflect government priorities, i.e. what percentage is allocated between the sectors and ministries? However as noted above the role of government needs to be taken into account when assessing the link between priorities and expenditure allocations
- is there some expenditure which is included in a ministry which is spent by other ministries, e.g. contingencies, provision for wage increases in the Ministry of Finance budget?
- funds spent at the local government level may be shown under the ministry of local government. A true allocation between sectors would require that these figures are divided into sector spending.

Table 28 below shows a similar format for analysis of departmental and programme expenditure within a ministry.

Table 28. Share of Ministry Expenditure

Ministry	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Departments	Data	Data	Data	% share	% share	% share

This analysis would focus on the same issues as those at the total sector and ministry levels as described above, as well as:

- departmental allocations may need to be regrouped to provide more meaningful analysis. For example, if there are several departments providing the same services, such as rural water services, these can be grouped together to improve the analysis of expenditure
- within a department. The funds provided to an organisation receiving a government subvention are usually shown within the administration department, although the services provided by the department are technical rather than administrative in nature. This needs to be taken into account in the analysis of departmental expenditure.

Types of Expenditure

In addition to an analysis of expenditures between and within ministries, an analysis of expenditure between types of expenditure can provide useful information on the quality of expenditure as explained below.

Table 29. Types of Expenditure

	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Expenditure Type	**Data**	**Data**	**Data**	**% share**	**% share**	**% share**
Wages and Salaries						
Goods and Services						
Capital						

- What is the share of wages, goods and services and capital in the total budget? Is there an appropriate balance, i.e. the size of government in terms of the number of civil servants and the level of services provided by government, and the level of infrastructure needs to be in balance. For example, a government budget could allocate a large proportion of the budget to salaries and wages, with insufficient funds for the provision of services, and at the same time spend a high proportion of the budget on capital projects, without sufficient funds allocated to provide for the recurrent costs that will arise once the projects are completed

- **Wages and salaries**. Funds spent on wages are linked to salary scales and the size of the civil service etc. These issues can be analysed in terms of:
  - Is the size of the civil service appropriate to the levels of services provided?
  - Is the structure appropriate in terms of levels of staffing, i.e. are there sufficient staff in senior, middle and junior levels, technical and administrative staff in relation to the types of services provided?
  - Is the salary grading structure appropriate, i.e the differences between levels of salaries in relation to the levels of responsibility that are linked to the grading structures?
  - How do the salary levels compare with salaries in the region?

- **Goods and Services.** Is this sufficient to provide for the services provided by the ministry and to cover the recurrent costs that will arise from completed projects? In some sectors a significant proportion of certain types of services may be funded by donors outside the budget. For example, ARVs may be funded through the World Bank's Global Fund, which do not appear in the government budget. These funds need to be included in the analysis

- **Capital Budget.** How many capital projects are there in the development budget? Does this seem like a manageable number of projects? Could they be grouped together? Do the projects fund recurrent services, and how do these link to the services funded in the recurrent budget and donor funds off budget, i.e. is there a duplication of funding between the various funding sources?

Sources of Funds

An analysis of the sources of funding of the budget would enable the following issues to be addressed:

- What percentage of total donor funds is included in the budget and the percentage of funds outside the budget?
- What percentage of the budget is funded by donors, is this sustainable?
- What is the balance of types of donor funding? Have these been changing over time? Is this balance in line with government policy?

Table 30. Source of Funds

Expenditure Type	Year 1 Data	Year 2 Data	Year 3 Data	Year 1 % share	Year 2 % share	Year 3 % share
Government						
Donor Total						
Loans						
Grants						
Budget Support						
Total						

Expenditure Trends

Table 31 below illustrates the analysis of expenditure trends, i.e. rates of increase or decrease in expenditure over a period. This analysis should be undertaken for sector and ministry allocations, as well as expenditure types, and could be undertaken in both current (i.e. with inflation) and constant (without inflation) prices.

Table 31. Expenditure Trends

Sector/ Ministry/ Expenditure Type	Year 1 Data	Year 2 Data	Year 3 Data	Year 1 %	Year 2 %	Year 3 %
Sector						
Ministry						
Ministry						
Total						
Wages and Salaries						
Goods and Services						
Capital						
Total						

The data can be used to analyse:

- What have been the trends in expenditure over time? Has the expenditure been in line with changing priorities?
- Is it possible to identify reasons for trends in expenditure, e.g. a major event such as elections, or drought, or introduction of new policy such as free primary education?

Budget Variances

Table 32. Budget Variances

	Year 1			Year 2			Year 3		
	Budget	Actual	Var.	Budget	Actual	Var.	Budget	Actual	Var.
Sector									
Ministry									
Ministry									
Total									
Wages and Salaries									
Goods and Services									
Capital									
Total									

Table 32 above illustrates the analysis of budget variances, i.e. the difference between planned and actual expenditures and revenues. This analysis should be undertaken for sector and ministry allocations, as well as expenditure types, for which the following issues can be analysed:

- What are the variations between planned and actual expenditure?
- How do these variations differ between and within ministries and between recurrent and capital expenditure?
- Is it possible to identify the reasons for either over and under expenditure?

Efficiency and Effectiveness of Expenditure

Efficiency of expenditure means that the least inputs (e.g. teaching materials) are translated into the most outputs (pupils educated) at the least cost. This means that the lowest possible amount of teaching materials is provided for teaching the highest number of pupils, possibly through the sharing of materials by pupils.

Effectiveness of expenditure means the least inputs will have the highest impact, e.g. the fewest number of teaching materials to result in the highest level of pupils passing primary school examinations. Thus, ensuring effectiveness may require a different approach as sharing of materials may have a negative impact on pupils' understanding of the curriculum and therefore on the pass rate. Achieving improved effectiveness may require higher levels of expenditure than simply focusing on efficiency.

Measuring the efficiency and effectiveness of expenditure involves consideration of the cost of providing a particular service per beneficiary, such as provision of teaching materials. Where a government is implementing an activity based budget and is also accounting by activity, this expenditure should be available from the government budgeting and accounting system, (as described in Chapters 10: Accounting and Financial Reporting, and 11: Performance Monitoring and Evaluation).

Table 33. Example of Efficiency of Expenditure

Service	Total number of pupils	Year 1 Total Cost	Year 2 Total Cost	Year 3 Total Cost	Cost per Pupil	Cost Per Pupil	Cost Per Pupil
Provision of teaching materials	10,000	100,000	120,000	130,000	10	12	13

Table 33 above illustrates how the total cost of providing teaching materials can be analysed in terms of the number of pupils taught. The example shows the number of pupils remaining constant but the cost per pupil increasing (assuming that these are in constant prices). This information can be used to highlight that the service is becoming less efficient and an analysis of the underlying reasons can be undertaken.

In cases where it is not possible to link the budget to particular services or activities, a similar approach can be used by comparing total expenditure and the expenditure per beneficiary as shown in the example below.

Table 34. Example: Analysis of Primary Education Expenditure

Primary Education Programme	Year 1	Year 2	Year 3	Year 4
Recurrent Budget				
Government expenditure				
Capital budget				
Government expenditure				
Donor expenditure				
Total Capital				
Total Expenditure				
Number of Primary School Pupils				
Expenditure per pupil				
Recurrent expenditure per pupil				
Capital expenditure per pupil				
Other country spending per primary school pupil				

The above table can be used to analyse the expenditure per student on primary education in various ways:

- Changes in expenditure per pupil over time
- To compare spending across districts within a country
- To compare with other countries in the region.

Presenting Expenditure Analysis

The above analysis needs to be presented in a report which shows:

- the analysis of each expenditure type with the data and conclusions
- an overall assessment of the trends and conclusions drawn
- any recommendations for changes in expenditure allocations that can be made from the analysis of previous trends.

Chapter 9 Budget Implementation

Introduction

Introduction to the Chapter

This Chapter describes the processes involved in the implementation of the budget, a key stage in the financial management cycle.

Its starts with an overview of the steps in the budget implementation process, followed by a description of the control environment, i.e. the financial regulations that determine the way the budget is implemented.

The next sections describe the responsibilities for budget implementation and common problems faced by developing countries in budget implementation. More detailed sections are included on cash management and the implementation of cash budgets, procurement processes, as well as personnel, asset and debt management.

The following section explains the efforts donor organisations and civil society organisations are making to identify whether funds are used in line with the priorities in the budget through Public Expenditure Tracking Studies (PETS).

The last section sets out the attributes of an effective budget implementation system.

Key Issues

Budget implementation is a crucial stage in the PEFM cycle, but often not given sufficient attention in PEFM reforms, which have tended to focus on improving budget planning (MTEF) and improved accounting and reporting (IFMIS).

Existing budget implementation systems in many MEFMI institutions are still focused on line item controls, which are very cumbersome and do not give managers the freedom to manage their funds effectively. At the same time existing rules and sanctions are not always applied when funds are misused.

For example, budget implementation processes have not been reformed to introduce a performance focus in the way that the budget is implemented and managers are not being held responsible for delivering improved levels of performance.

Strengthening budget implementation involves:

- Linking the implementation of the budget (cash planning, release of funds and use of funds) to a well developed plan of activities and outputs
- Reviewing existing financial regulations and use of sanctions and incentives to reward good performance and ensure use of sanctions for misuse of public funds

- Streamlining of budget implementation procedures to provide more managerial freedom and speed up service delivery
- Requiring the regular reporting on both financial and physical implementation.

In addition to these technical reforms it is even more important to encourage the creation of a new culture of budget implementation – one that encourages managers to manage scarce resources so as to deliver effective services to the public, rather than simply focusing on expenditure control.

Overview of the Budget Implementation Process

Budget implementation follows on from the budget preparation and approval phase when government ministries and agencies spend funds in order to implement activities and achieve government objectives and collect government revenues as set out and approved in the budget.

There are three key elements of budget implementation:

- Ensuring that funds are spent and revenues collected in line with defined rules and regulations as explained in Chapter 2: Institutional and Legal Framework, so that agreed fiscal objectives and targets are met
- Ensuring that the way in which funds are used and managed leads to the planned levels of performance, i.e. improved service delivery
- Monitoring budget implementation to take account of financial and physical performance and allowing for some adjustments to the budget to take account of these changes.

This involves:

- ensuring that ministries follow the financial rules and regulations in budget implementation and that these rules are up to date and in line with any reforms to PEFM systems
- having effective cash management systems in place to manage the inflows(revenue), outflows (expenditure) and government borrowing
- having effective monitoring and reporting systems in place to monitor the financial and physical implementation of the budget
- having sufficient flexibility in budget implementation systems that allows for changes to approved budget allocations where necessary.

Recent reforms to PEFM systems particularly in OECD countries has focused on increasing the levels of flexibility and freedom of managers to use funds in line with their requirements, while also increasing the degree of accountability or responsibility for delivering agreed levels of performance.

Budget implementation has the following stages:

- Preparation of cash flow plans by line ministries and Ministry of Finance to project the levels of expenditure, revenue and debt, including donor inflows

- Release of funds to line ministries by the Ministry of Finance through warrants etc.
- Procurement of goods by ministries
- Commitment of funds, i.e. an indication that funds will be spent on particular goods and services and are no longer available for other purposes
- Delivery of goods and verification that they meet the terms of the order or contract
- Payment for the goods and services, either by the line ministry or Ministry of Finance.

These stages are implemented within the rules and regulations as defined in the Financial Legislation described in Chapter 2: Institutional and Legal Framework, and are described in more detail in the following sections of this Chapter.

Stages of the Budget Implementation Process

Once the Budget is adopted by the Legislature and the Appropriation Act passed, there are key stages in the budget implementation process.

Cash Planning

Cash planning enables the Ministry of Finance to forecast on a regular basis, (weekly, monthly or quarterly), its inflows and outflows to ensure that release of funds to line ministries and agencies is carried out in an optimum manner.

The preparation of the annual cash plan will involve:

- Estimating projections of tax and customs revenue from revenue agencies
- Estimating inflows of non tax revenue from line ministries and agencies
- Verifying these projections by comparing them with past collection patterns
- Estimating projections of donor inflows, interest and debt payments from the office responsible for debt management
- Obtaining itemised cash outflow forecasts from line ministries and agencies (ideally produced on the basis of work plans).

Authorisation and Release of Funds

Once a Budget is approved by Parliament, ministries, departments, agencies and other vote holders are authorised to spend money, consistent with the legal appropriations for each line item as contained in the Appropriation Act, and collect the revenue as indicated in the Budget documents.

The exact nature of these authorisation processes differ from country to country. Most governments will issue a warrant at the start of the budget year. Warrants may be issued for the entire year's budget in the case of the recurrent budget or on a monthly or quarterly basis. In some countries the level of funding approved through the warrant is based on the cash plan submitted by the line ministries. In other countries the warrants for the recurrent budget are based on an equal quarter of the annual budget with the assumption that the recurrent budget is implemented on an equal basis each month.

In addition to the issue of warrants authority, to spend funds can also include through notification of cash limits particularly in a cash budget environment (see section below), and/or the issue of specific authorisation to spend through the transfer of funds to bank accounts or imprest accounts.

The level of authority to spend will also differ between countries: in some cases the warrant or authority to spend is provided by the Ministry of Finance to the line ministries and the line ministries will then allocate or allot the funds to specified spending units within the line ministry. In other situations the Ministry of Finance authorisation will specify how the funds should be allocated within the line ministry or district accounts.

There are often different procedures for the release of funds for the recurrent and capital budgets. The recurrent budget warrant may be issued on a monthly or quarterly basis, while spending agencies may be required to make requests for specific amounts for the capital budget.

In the case of a cash budget, while the Ministry of Finance may authorise expenditure through the issue of a warrant, the actual authority to spend will be determined either:

- By the provision of additional authority in the form of cash limits, or
- The availability of cash in the consolidated fund or in a ministry's account

One of the key weaknesses experienced in many MEFMI countries in the release of funds to line ministries has been the delays and lack of transparency in the rationale for funds allocated to each ministry, as described below in the section on cash budgets.

Procurement Stage

This stage involves the processes of procuring goods and services by line ministries which need to follow specific guidelines on procurement. In some countries there will be a central tender board that is responsible for managing the procurement of large contracts while in other countries the entire procurement process has been decentralised to line ministries.

The Commitment Stage

This is the point where a future obligation (liability) to pay is made. The precise definition of commitment varies from one budget system to another, but broadly arises when a purchase order is placed or a contract is awarded for delivery of specified goods or services. This means that the ministry will have an obligation to pay the funds at a later date when the goods or services are delivered.

The Delivery and Verification Stage

At this stage goods are delivered and/or the service rendered and the ministry checks that they are consistent with the order or the contract. The line ministry or spending agency making the purchase usually has the financial and administrative responsibility to verify that the delivery is in full compliance with the terms or conditions of the contract.

Payment Authorisation or Payment Order Stage

This stage differs from one country to another and depends on the size and importance of the purchase. In some systems where payment orders are centralized, the line ministry or the spending unit hands over the bill for processing and payment to the Ministry of Finance. In other countries the line ministry or the spending unit is responsible for making the payment to the supplier and a payment authorisation process will be followed in the line ministry.

Payment Stage

At this stage, payments are made through various instruments such as cash, cheque, or electronic transfer. In some systems, the payment is made through a single Ministry of Finance account in the central bank or with a designated commercial bank. In others, the payment is undertaken through the banking system through bank accounts held in the names of individual line ministries with the central bank or with designated commercial banks.

Within these various stages there are a number of specific management systems including asset management, aid and debt management, and personnel and pay management.

The budget implementation process operates within a set of control procedures as described in the next section.

Control Environment for Budget Implementation

Budget implementation is controlled through a number of mechanisms:

- The use of internal controls and regulations as defined in the Financial Legislation and Regulations (described in Chapter 2: Institutional and Legal Framework)
- Internal audit procedures
- The rules governing change of use of funds during budget implementation, e.g. virement and supplementary estimates
- Specific controls such as commitment controls

The purpose of these controls is to minimise risks which include:

- The risk that procedures are not followed which can lead to build up of arrears, lack of transparency etc. although the funds are not actually mis-spent
- The risk of errors in recording of revenue and expenditure leading to inaccurate financial reports
- The risk of delays in the implementation procedures leading to delays in payment of suppliers, service delivery and financial reporting
- The risk of waste and misuse of resources
- The risks of fraud and corruption
- The risks that the use of the resources does not lead to the most efficient and effective service delivery.

In many MEFMI countries the control environment focuses on the control of detailed inputs with the Ministry of Finance being actively involved in the approval of some aspects of the control procedures. For example a department in a ministry will have a budget for an item such as stationery, and if the annual allocation in the departmental budget is exceeded, the ministry will be required to seek approval from the Ministry of Finance to move funds from another item of expenditure. In addition, line ministries will be required to follow a set of detailed procedures when purchasing goods and services, some of which involve the Ministry of Finance as described below.

While these procedures provide for a level of checks or controls to ensure that funds are spent in line with the approved budget, they can also lead to delays in the implementation of activities and encourage line ministries to find ways of avoiding these control procedures. This can then have a negative impact on budget implementation as described below on the common problems in budget implementation.

Internal Control Procedures During Implementation

During the process of ordering and payment for goods and services line ministries will need to follow a series of checks (compliance procedures) to ensure that the funds are spent as intended:

- At the commitment stage (financial control), when the goods and services are ordered, the line ministry accounting unit will be required to check: that the purchase order has been approved by an authorised person (e.g. head of a section); that funds will be used in line with the budget allocations; that there are sufficient funds still available in the appropriate category of expenditure; and that the expenditure is classified in the correct way in the purchase order
- When goods and services are delivered (verification), there needs to be documentary evidence that the goods have been received or that the service was carried out as required
- Before payment is made, it is necessary to confirm that: the expenditure has been properly committed; a competent person has signified that the goods have been received or that the service has been carried out as expected; the invoice and other documents requesting payment are complete, correct and suitable for payment; and the supplier is correctly identified
- After final payment is made, it is necessary to examine and scrutinise the expenditure concerned and report any irregularity.

Virements

During budget implementation, it may be necessary to change the use of funds as indicated by the line item appropriations approved by Parliament. Such changes are termed virement and there are specific rules on who can authorise virement and the circumstances under which virement is permitted.

Virements are necessary and appropriate in some circumstances as it is not possible to accurately plan for the detailed implementation of the budget and adjustments to budget allocations will be required during the year to take account of changing circumstances. An example might be the delay in the purchase of an item or equipment because the staff who will use the equipment have not been trained and the need to speed up the refurbishment of the office.

In most cases authority to change the line item allocations is at several levels:

- Within a line ministry there is usually authority to switch funds between the lowest level of detail, for example from stationery to consumables
- Ministry of Finance will need to approve virements from one expenditure category to another, e.g. from Operating Costs to Special Expenditure
- Virements between major expenditure categories is usually not permitted, e.g. between salaries and capital expenditure.

Supplementary Estimates

Supplementary Estimates are used to seek Parliamentary approval for the increase and decrease in expenditure as approved by Parliament in the annual budget estimates. For example, if the expenditure on a project is expected to exceed the amount provided for in the budget, then Supplementary Estimates may be proposed to Parliament to seek approval for additional funds.

Internal Audit

The Institute of Internal Auditors (IIA) defines internal audit as "Internal auditing is an independent, objective, assurance and consulting activity designed to add value and improve an organisation's operations."
(See The Institute of Internal Auditors website: www.theiia.org)

Internal audit staff are responsible for ensuring that ministries comply with the financial rules and regulations during the budget implementation process and that funds have been spent as approved by Parliament. Internal auditors will usually develop a plan or programme of specific issues to audit over a financial year and can cover issues such as reviewing the efficiency and effectiveness of operations, the reliability of financial reporting, deterring and investigating fraud, safeguarding assets, and compliance with regulations and financial procedures.

Internal auditors can either be centrally located in the Ministry of Finance with the responsibility for internal audit programmes within line ministries, or recent practice is to decentralise the internal audit function to line ministries.

Internal audit staff should report to the head of the relevant ministry and it is important that they are able to provide independent conclusions and advice. This means that internal auditors should remain separate from the management and service delivery functions of the ministry or organisation.

While internal audit staff are an independent source of advice to the management of a ministry, they are still part of the organisation, and therefore not as independent as the external audit organization as described in Chapter 12: External Audit.

In addition reforms to internal audit are focusing both on expanding the scope of internal audit and on providing support service to a ministry in the management of risks. Implementing this new approach to internal audit will require new skills and professionalism of the internal audit role. The Institute of Internal Auditors (IIA) has developed a globally recognised certification for internal auditors as well as a number of standards and guidelines. These guidelines are mandatory for IIA members and internal audit organisations claiming to complete audits to IIA standards around the world.

Responsibilities for Budget Implementation

Budget implementation covers a number of key issues including management of the macroeconomic implications of revenue collection and expenditures, monitoring the implementation of the budget, and ensuring that ministries comply with financial regulations.

Ministry of Finance

The responsibilities of the Ministry of Finance for budget implementation are divided between a number of departments and divisions.

The **Budget Department** is usually responsible for monitoring budget implementation, including receiving cash flow plans and progress reports, participation in the approval for the release of funds, approval for virements, and preparation of Supplementary Estimates.

The **Accountant General's Department** is usually responsible for the control of budget execution, administering the system of release of funds, monitoring expenditure flows, preparing in-year budget revisions, managing the payment system, supervising government bank accounts, administering the central payroll system and preparing accounts and financial reports.

The **Macroeconomic Department or Division** will be responsible for monitoring budget implementation from a macroeconomic perspective with particular focus on the impact of the levels of government expenditure, revenue and debt on the economy.

In addition these three departments along with the senior management of the Ministry of Finance are responsible for overall monitoring of budget implementation, including reviewing progress independently or jointly with spending agencies, identifying policy revisions where appropriate, and recommending to government reallocations of appropriations within the framework authorised by Parliament.

Line Ministries

The responsibilities of line ministries for budget implementation include the following:

Senior Management of the Ministry is responsible for overall monitoring and management of budget implementation, ensuring that the implementation is on track, receiving reports from accounting and planning staff on progress, authorising any changes to budget allocations where appropriate.

Accounting Staff of the ministry are responsible for budget administration, allocating funds to departments and divisions, making commitments, purchasing and procuring goods and services, verifying the goods and services acquired, preparing requests for payment and/or making payments, preparing progress reports, monitoring performance indicators, and keeping accounts and financial records. Some governments have introduced specific procurement units with the responsibility for managing the procurement process.

Planning Units are responsible for periodically reviewing the implementation of the relevant programmes and projects through the monitoring of performance indicators, identifying problems and proposing appropriate solutions, and requesting the release of funds and reallocation of funds for capital projects.

Technical Departments are responsible for the implementation of the programmes and for producing regular reports on implementation progress.

Development Partners

Development partners are usually interested in reviewing the implementation of the budget and assessing its impact on fiscal aggregates and on the economy, the use of donor funds and provision of goods and services and how it impacts on the standard of living. As development partners move to the provision of General Budget Support, they need to rely on government systems for reporting on the implementation of the budget as described in Chapter 13: External Resource Mobilisation and Management.

Civil Society

Civil society groups also have an interest in the implementation of the budget as this is the stage in the budget cycle where funds may be used on lower priority programmes and activities particularly if the systems to control expenditure are not fully implemented. As described in the section on expenditure tracking, some civil society groups have played an active role in tracking poverty related expenditure through the budget implementation processes.

Coordinating the Implementation Process

When several departments in the Ministry of Finance and other agencies are involved in the supervision of budget implementation, close co-ordination of their activities is required and their respective functions should be clearly delineated.

In particular, in a number of countries, coordination between the budget department of the Ministry of Finance, which is responsible for budget preparation, and the accountant general or treasury which is primarily responsible for budget execution, is often insufficient. The division of responsibilities for budget execution varies between countries, however the important consideration is to ensure effective coordination between the key departments and organisations. This is described in more detail in the section on cash management.

Common Problems with Budget Implementation

Budget implementation is the stage of the public financial management cycle where resources are used to implement government priority programmes and policies. Successful budget implementation depends on the ability to maintain fiscal discipline, transparency and accountability while also making the necessary adjustments to the budget to respond to external and internal factors such the changes in the macroeconomic environment, implementation capacities of ministries, donor inflows etc.

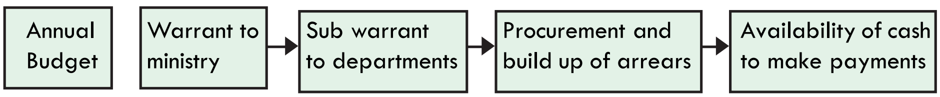
Thus several problems and constraints encountered in the budget implementation process in developing countries are described below.

Funds Not Used as Approved

Ideally the implementation of the budget would result in the use of funds in line with the priorities agreed in the budget preparation process. However, in practice the various stages in the budget implementation process create situations where funds are not allocated or used in line with these priorities.

Figure 9 below sets out the stages in the budget implementation process. The ways in which funds can be misallocated at each of these stages is described below.

Figure 9. Overview of Budget Implementation



Warrants and sub warrants: Where warrants are provided as one lump sum for the whole ministry, the line ministry will then sub warrant the funds and provide authorisation to specific departments. However, the actual allocation may not be in line with priorities set out in the budget. For example a lower priority department may get first priority in the sub warranting of funds, which will enable them to proceed with payments, while higher priority departments may suffer delays in sub warranting of their funds.

Where a cash budget is implemented **cash limits** for each ministry are agreed each month by the Ministry of Finance. However, these limits may not be in line with priorities in the approved budget, both from the cash limits approved by the Ministry of Finance and those authorised within line ministries (see section below on cash budgets).

Procurement: ministries may procure goods and services without appropriate authorisation, leading to a build up of arrears, with the result that funds may be required to pay for lower priority activities. This is possible where some suppliers are willing to accept verbal or informal orders from government officials, because there are insufficient funds available to support a properly authorised purchase order. The supplier realises this will result in delayed payment of his invoice, but in most cases the price of the goods or services is inflated to compensate for this.

Availability of cash to make payments: the actual payment for goods and services is based on the availability of cash in government bank accounts, either central bank account operated by Ministry of Finance or line ministries. The process of making payments will also involve a decision about which goods and services to make payments for, and this will involve decisions on priorities.

These steps also provide opportunities for “leakages” from the system, which is the main reason for the Public Expenditure Tracking Studies (PETS), see below.

Use of financial procedures that bypass expenditure controls

This arises when line ministries bypass the normal procedures and use “exceptional procedures,” to speed up the process for procurement of “urgent” goods and services. For example, a line ministry may use exceptional procedures to procure a service when the financial year is nearing an end. Sometimes suppliers are prevailed upon to make additional supplies available on credit. In such situations it is unclear whether the appropriation limit has been respected, or whether there will be cash available to pay for the expenditure.

Sometimes these exceptional procedures are used because the existing control procedures are cumbersome and lead to delays in the delivery of goods and services. While it is important that control procedures are in place to prevent corruption and ensure that the budget implementation process is open and transparent, there is also a need to review existing implementation procedures and identify ways in which they can be streamlined to allow for effective service delivery.

It is important that this review takes place as part of the design of an Integrated Financial Management System (IFMS) as described in Chapter 10: Accounting and Financial Reporting.

Inefficient and Ineffective Release of funds to Line Ministries

Systems and procedures for the release of funds to line ministries can often be cumbersome and lacking in clarity and transparency. This has serious impact on the provision of goods and services by line ministries in that: they do not have predictability in the flow of funds; they cannot make the best use of limited resources; funds may not be released in line with priorities set in the budget; there may be limited, if any transparency in the release of funds; and the credibility of the budget process is undermined.

Accumulation of Arrears

One of the major problems which undermines budget implementation is the accumulation of arrears over the course of the fiscal year resulting from ministries making commitments to suppliers without the funds (i.e. the cash) being available to pay for the goods and services.

When tackling arrears, the sources of problems need to be established. An accumulation of arrears may arise because:

- the budget provision is unrealistic relative to the minimum level of goods and services to be provided by a line ministry putting pressure on the officials to make commitments without warrant
- the overall budget figures are realistic, but officials in ministries make further commitments in excess of budget and without warrant
- line ministries do not record all the commitments they have made and these additional commitments are therefore not compared with the levels of warranted funds that are available
- line ministries are not efficient in processing payments to suppliers, leading to a build up of arrears

Lack of Commitment Control

The definition of a commitment differs from one system to another. Generally a commitment is a future obligation to pay a third party who is contracted to implement a project, or deliver goods or services; or an administrative reservation (blocking) of funds in anticipation of their use; or where a claim against the appropriation is recognised by law at the initial stages of the expenditure cycle.

Controlling the commitments made by line ministries is a key element of expenditure control and management which involves ensuring that the budget is controlled at the point where a ministry makes the commitment rather than when the cash is to be paid.

This means that limits are imposed when the commitment is entered into the purchasing system and are based on the availability of funds as defined by the value of warrants released. Therefore ministries can only commit funds when there are funds available: i.e. when level of funds authorised by warrants, less funds already committed equals balance of funds available.

The commitment control system can be operated at two levels:

- centralised commitment controls are performed by a central agency, usually Ministry of Finance
- decentralised commitment controls are performed by respective line ministries/spending agencies.

The introduction of a computerised financial management system or IFMIS, as described in Chapter 10: Accounting and Financial Reporting can provide for an automated process of controlling commitments. The computerised system will prevent an officer creating a commitment if the necessary warrant authorisations and procedures are not in place.

Budget Implementation Coverage not Comprehensive

The coverage of the budget implementation processes and financial regulations may not include all funds such as special funds which may be operated outside the central government systems and accounts (see Chapter 8: Budget Coverage, Presentation and Approval). Donor funds can also be implemented outside government systems where funds are provided directly to projects by donor organisations.

Thus these funds are not spent in line with legally binding control procedures, increasing the scope for misuse of these funds.

Over Spending and Under Spending

Generally, budget over spending is the result of line ministries not observing budget implementation rules and spending in excess of the budget limits as approved by Parliament and authorised by warrant.

Several reasons may account for this:

- As explained above the budget implementation rules can be very cumbersome which encourages budget managers and vote controllers to bypass them and thereby create overspending since payments made through these exceptional procedures are not controlled against the appropriations.
- Sometimes the overruns are often the result of off budget spending mechanisms (payments from special accounts) often referred to as "below the line" accounts.
- If the budget is not well prepared, i.e. if the actual cost of service delivery, project implementation, statutory social entitlements, and the impact of inflation on wages, etc are not taken into account additional funds will be required to cover these shortfalls during budget implementation
- In some situations, politicians will require additional funds to be spent during the year as the result of the introduction or change in policies such as agricultural subsidies or through new projects which were not included in the approved Budget.

There can be situations where unforeseen events will require the government to spend unbudgeted funds, or to incur unfunded liabilities. These liabilities (debts and obligations to pay as a result of past events) can occur because of: legislative changes which occur during budget implementation; compensation payments; and unforeseen events such as natural disasters

In some countries there will also be under spending of the budget, often in the capital budget. This is not necessarily a sign of effective budget implementation, rather that line ministries do not have the capacity to implement the projects in the capital budget.

In addition, if the revenue projections used to estimate the overall resource availability are over optimistic, the Ministry of Finance will need to reduce the actual level of expenditure during budget implementation by limiting warrant releases to keep these in line with revenue collections and avoid government borrowing.

Expenditure Tracking

A number of initiatives have been introduced to improve the accountability and transparency in the use of public expenditure including assessing whether the funds approved in the budget actually reach the targeted spending units and are spent on the intended activities.

Poverty Expenditure Tracking System (PETS), which when undertaken by the World Bank in Uganda showed that of the money that government had allocated for education from 1991 -

95, less than 30% was actually being received at the school level, i.e. reaching its intended target.

The Government Watch (or G-Watch) Project of the Philippine Governance Forum. G-Watch examined the expenditure for specific projects in health, education and public works. G-Watch selected certain projects in each of the three agencies identified following predetermined criteria to check the quality of the projects that were reported completed. In all cases, the projects proved what most people already knew in these countries: that government budget allocations and the reported actual expenses from such allocations are much higher than the actual quality and quantity of results produced by them.

The Concerned Citizens of Abra for Good Government (CCAGG), Philippines. CCAGG, on the other hand, mobilised local engineers and other professionals to measure the quality of roads and buildings constructed by the public works department in their province. CCAGG exposed the reason behind the unfinished roads and bridges in the province despite millions of pesos having been spent on the project.

Mazdoor Kisaan Shakti Sangathan (MKSS or Organization for the Empowerment of Workers and Peasants) in Rajasthan, India. MKSS, also tracking expenditure on governments projects, exposed expenses of the local government for clinics, schools and public toilets which were never built.

Weaknesses and Challenges in Tracking Systems

The above initiatives have highlighted the need to fully understand and assess the flow of funds through a government budget implementation and accounting system. These tracking initiatives have tended to focus on specific sector issues such as health spending rather than on reviewing the overall systems for budget implementation etc. Therefore the studies can identify specific issues within one sector rather than common issues across the whole PEFM system.

Cash Management and Cash Budgets

This section describes the importance of and the processes involved in cash management. It starts with an overview of cash management systems followed by a description of the common weaknesses faced by developing country governments in this area, the requirements of an effective cash management system, a description of cash budgets and the impact of these on effective budget utilisation. It concludes with an outline of the requirements for effective cash management including the institutional arrangements.

Cash management involves ensuring that the government is able to manage the inflows of revenue against the outflows of expenditure and to plan for borrowing for those periods where it is necessary to increase expenditure above the levels of inflows of revenue.

Cash management is an area that has often been neglected by governments which resulted in increasing levels of domestic borrowing and fiscal mismanagement. In recent years cash management has become of increasing concern as part of improving fiscal discipline and efforts are being made in a number of MEFMI countries to improve their cash management systems.

Some governments in the MEFMI region have introduced a Cash Budget system, which differs from an effective cash management system:

- **Cash Management**: this is a process of forecasting the inflows and outflows of cash over the financial year and planning for government borrowing or the use of accumulated surpluses in those periods where revenue is lower than expenditure. This approach requires effective coordination between the various stakeholders and a high level of fiscal discipline. The benefit is that it provides line ministries with some certainty about the level of funds they will receive throughout the year and are able to plan their activities and spending effectively.

- By comparison a **cash budget system** involves allocating funds to line ministries on a monthly or even weekly basis, based on the projected availability of cash, i.e. by comparing projected revenue and expenditure for the particular period. This means that line ministries have little certainty about the level of funds they will receive during the year, as described in more detail below. This makes effective implementation of their approved spending programme difficult.

Overview of Cash Management Systems

The cash management process involves:

- developing cash flow estimates based on determining expected cash requirements of line ministries, and for debt servicing etc. and projected revenue inflows including donor inflows
- managing the use of government cash balances and ensuring that government does not resort to unplanned domestic borrowing when there are idle balances in bank accounts
- monitoring planned cash flows against actual through regular reporting
- taking remedial actions as required, such as delaying warrant releases to line ministries, taking measures to speed up revenue collection and changing borrowing plans.

The purpose of developing and implementing an effective cash management system is to:

- Make funds (cash) available to line ministries as required to implement agreed activities
- Ensure that the government keeps within budgeted expenditure
- Prevent unanticipated borrowing that might disrupt monetary policies
- Ensure that tax revenue is collected in line with forecasts and efforts are made to improve revenue collection during the year
- Identify the need for in-year adjustment to the budget and reallocation of funds between ministries and activities (a budget management responsibility)
- Promote fiscal transparency, accountability and good governance.

The department with the main responsibility for cash management is the Treasury (or Accountant General) although the division of responsibility will vary from country to country. In some countries, the treasury department focuses only on cash and debt management functions, and in others, it also performs budget execution, accounting and reporting functions.

As noted below it is important that all departments within the Ministry of Finance are actively involved in the cash management process.

Common Weaknesses of Cash Management Implementation

The cash management function in many developing countries has been weak for the following reasons:

- Line ministries, departments and spending agencies are neither rewarded nor sanctioned for managing cash well or badly
- The main focus of budget execution is on the release of funds, and line ministries are not required to provide the Ministry of Finance with an indication of when they will require warrant to make commitments or cash to make payments
- Lack of effective coordination between the various departments and organisations responsible for cash management, i.e. budget department, accountant general, macroeconomic department and the central bank
- Lack of sufficient skills to design and implement an effective cash management system
- Lack of appreciation of the cost of ineffective cash management in terms of unnecessary cost of borrowing or interest on revenue foregone.

Cash Budgets

Cash management is by definition, the process of planning for and management of government inflows, outflows and borrowing. Thus government may decide to borrow in the short term to meet revenue shortfalls in order to enable the continuation of government programmes.

By comparison the implementation of a cash budget is when a government will only release warranted funds to ministries when there is cash available. This approach was introduced in a number of MEFMI countries during periods of fiscal crisis in order to keep government expenditure and borrowing under control.

The impact of cash budget systems was studied in Zambia by the World Bank, *(Dinh, H. T., Adugna, A. and Myers, B., 2002, 'The Impact of Cash Budgets on Poverty Reduction in Zambia: A Case Study of the Conflict Between Well- intentioned Macroeconomic Policy and Service Delivery to the Poor', World Bank Working Paper 2914)* which found that, while cash budgeting initially did bring macroeconomic stability, in the long term inflation levels remained high and the processes involved in cash management led to weaknesses in the allocation of resources to ministries during budget implementation.

This was because decisions were taken each month on the funds to be provided to each ministry based on the availability of cash, which meant that

- budget priorities would be set every month by a small team of Ministry of Finance officials

- this led to unpredictability in the flow of funds for line ministries reducing their ability to plan for the implementation of programmes and activities
- there was a build-up of arrears as ministries continued to make commitments to suppliers to implement their programmes but were unable to make payments to suppliers.

Therefore the implementation of a cash budget does not lead to the implementation of an effective PEFM system and needs to be seen as a short term measure to be replaced by an effective cash management system.

The Requirements for Effective Cash Management

An effective and efficient cash management system would involve the preparation of a cash plan for government and the regular monitoring and implementation of the plan to take account of changes to actual revenue collection and government spending.

The plan needs to be based on a sound analysis of the timing of government revenue and expenditure rather than simply dividing the total annual budget into equal monthly or quarterly amounts.

Preparation of a cash plan

- Line ministries should prepare budget implementation and cash plans to estimate when funds will be required based on the implementation of their activities. Some cash planning approaches use past patterns of monthly or quarterly expenditure as a guide. Ministries would submit their cash plans to the treasury in the Ministry of Finance
- Ministry of Finance would combine the line ministry cash requirements with the central requirements such as pensions, debt payment, etc.
- The revenue agencies would develop monthly revenue projections based on past patterns and forthcoming changes in economic performance, changes in tax rates etc for both tax and non-tax revenue receipts.
- The aid management unit would ask donors for information on the likely timing of donor inflows in the required format and at the appropriate time (see Chapter 13: External Resource Mobilisation and Management for further discussion of this point)
- The Ministry of Finance would use this information to develop an overall cash flow forecast for government from which any borrowing requirements would be developed.

Box 30. Work Planning and Cash Flow Plans

The introduction of an activity based budget preparation process provides the basis for line ministries to prepare a cash plan on the basis of when activities will be implemented and cash required. As illustrated in the example below, the timing of the implementation of the activity will not always be the same as the timing of payments and cash requirements.

Activity	Implementation period	Cash required
Child immunisation campaign	September-December	In July to procure vaccines
Education awareness materials developed	June-August	In May and September, designer and printing contractor to be paid 50% in advance and 50% on completion

Monitoring and Implementation of the Cash Plan

The cash plan should be updated on a regular basis, ideally on a weekly basis and should include:

- A review of revenue inflows, both tax and non-tax, line ministry expenditure and commitments and statutory expenditure for the previous month
- Identifying forthcoming changes or events that will require modifications to the future months plans
- Updating cash forecasts on the basis of these reports
- Making proposals for adjusting cash flows if the need arises and for changing domestic or external borrowing requirements.

The implementation of the cash plan involves:

- Informing line ministries of their budget allocations, i.e. warrant releases
- Informing the Accountant General of the funds to be used to pay Statutory expenditure, e.g. public debt, pensions etc
- Developing borrowing plans to be agreed with the central bank, guided by clear borrowing rules and procedures for both domestic and external borrowing
- Management of government bank accounts and cash balances to avoid unnecessary government borrowing when funds are already in government accounts.

In addition to establishing or strengthening cash management procedures, it is important to have in place experienced and skilled staff and effective institutional structures and procedures for cash planning within ministries of finance and line ministries (see below).

Box 31. Centralisation and Management of Government Cash Balances

In OECD countries government cash balances are centralised into a treasury single account (TSA), in which all revenue is consolidated on a daily basis and is under the management of the treasury or Ministry of Finance.

One of the key features of this arrangement is that government cash is consolidated from all government collection accounts, including cash in commercial banks, on a daily basis, and these funds are invested in interest bearing instruments. This means that governments can earn revenue from their cash balances and avoid unnecessary borrowing.

The above approach will only work where there are:

- Highly skilled staff who are able to manage the significant and complex arrangements for government cash balances
- Modern, computerised banking systems which enable automatic transfer of government funds between the government's accounts in the commercial banking sector (including in regions and districts) and in the central bank
- A developed financial market in which governments can lend or borrow on a short or medium term basis

In developing countries these conditions do not always apply:

- Modern banking systems are not yet in place
- The government may not be fully in control of all bank accounts, including special accounts set up for donor funds
- Financial markets are not sufficiently developed

Cash Management, Ian Leinart, IMF, Public Financial Management Technical Guidance Note, February 2008.

Institutional Structures and Responsibilities for Cash Management

The institutional framework for cash management is an important factor in the effectiveness of these systems. The structures and responsibilities for cash management vary from country to country, with some governments having the lead responsibility within the budget department and others in the treasury or accountant general's department.

The key to effective cash management is close coordination and cooperation between various departments and organisations, including:

- **Macroeconomic Division**: regular updating of macroeconomic framework and fiscal framework to review levels of resources available, including inflows of donor funds
- **Budget Department**: coordinate preparation of cash flow plans from ministries and updating of cash requirements on a regular basis, deciding on levels of funds to be approved for each ministry

- **Treasury or Accountant General:** updating of information on revenue and expenditure, including debt payments and cash balances held in government accounts
- **Central Bank:** input into decisions on the timing and extent of government borrowing.

Ideally these departments would be coordinated through a cash management implementation committee which would be vested with the overall responsibility and authority to draw up the annual cash plan and be responsible for regular monitoring and updating of the plan.

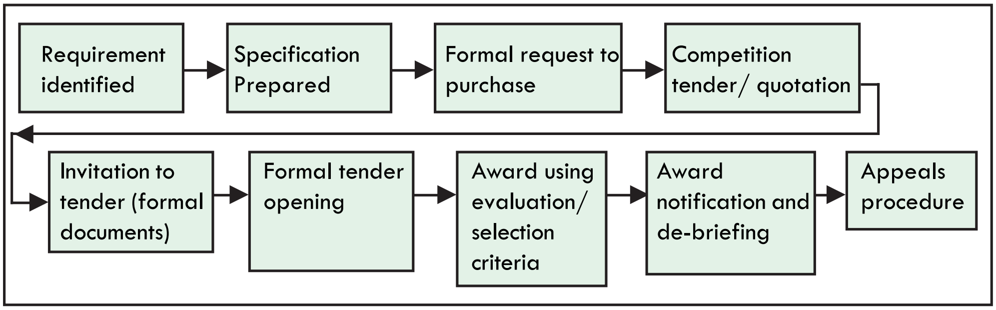
Procurement by Tender

Procurement is the process of acquiring goods and services, covering the stages of planning the purchase through to purchase and use of the goods and services including all running costs. Procurement in the public sector makes use of public funds and therefore needs to ensure that this is achieved within the financial legislation and regulations, meets government ethical standards, and secures value for money for the public.

In the procurement process, the objective is to obtain best value for money which is defined as the optimum combination of whole life cost and quality of the goods and services to meet the requirements of the users. The important issue is to focus on the whole life cost of the goods or services, not the lowest initial price. For example, the purchase of vehicles should not only take account of the price of the vehicles, but also future service and maintenance costs, fuel consumption, availability of spare parts etc.

The steps in the tender procurement process are as shown in Figure 10.

Figure 10. Overview of Tender Procurement Process



Specification of requirements: defining the procurement objectives and requirements is critical to the ultimate aim of achieving value for money (VFM). A vague or misleading statement of requirements can be very costly to correct at a later stage or may result in a wholly unsatisfactory product or service being provided. The establishment of the "Specification" is therefore essential. The writing of specifications requires a thorough grasp of the user need and sufficient time to get the specification right.

Tendering process: Goods and services should be purchased through competition i.e. a tendering process unless there are convincing reasons to the contrary: the Financial Legislation and regulations will usually require some form of tender process. The use of competition avoids any suggestion of favouritism or corruption, promotes competition in the private sector and increases efficiency and economy in the procurement of goods and services. There are different types of tender processes and the type used should be appropriate to the value and complexity of the goods or services to be acquired.

A full tender process is generally employed for higher value and complicated procurements and governments will usually have detailed procedures which are used for tendering processes. Small value purchases are often made through seeking three quotes for the supply of the goods and services or through the use of suppliers selected through a competition process.

The opening and evaluation of tender proposals should take place in controlled conditions to ensure fair treatment, and should exhibit a high degree of transparency. Evaluation of tenders should be carried out by a dedicated team with knowledge of the field that is the object of the procurement, but they should show no favouritism and "score" the tenders on the basis of pre-determined selection and award criteria.

Award of Tender: Once a supplier(s) is selected a contractual award should be made and the purchasing unit should inform all parties tendering of the result, offering a debriefing to explain the selection of winners and losers. Formal contract documents should be prepared and issued to the supplier, finance units and to those utilising the eventual contract.

Procurement Appeals: Many countries operate an appeals procedure in relation to the award of contracts as a check and balance on procurement units, users in government and suppliers. Such a process also acts as a control on potential corruption.

Procurement Best Practice

Ensure the correct specification and plan the procurement. If the requirements cannot be defined accurately for a procurement process, international and regional standards for the goods and services can be used to assist in specifying the needs. Outcome specifications (defines what is to be achieved rather than how to achieve it) can be used where it is appropriate (especially service contracts). When planning the timing of the procurement ensure that the funds are available, that there is sufficient time to carry out the procurement, and that there is a sound business case reason to commence the procurement process.

Use skilled trained staff. Procurement is NOT shopping: it needs specific skills to carry the purchase through to use of the goods and services. Employees need to be trained in the correct procedures and recognised methods to commence a purchase. All steps of the procurement should be recorded.

Separation of duties. No individual should be responsible for carrying out the whole procurement from purchase initiation to payment for the goods or service. The tasks for each stage must be vested with different people. An inability to ensure separation of duties is an invitation to corruption.

Clear legislation and guidance. Ensure that legislation is clear and focussed on the tasks that have to be performed in procurement. Guidelines similarly should be clear, preferably in a single document, (manual) which should be always kept up to date. Secondary and single issue guidance notes must always be consistent with the legislative framework and with the manual.

Make the right choice of procurement methodology. It is important to pick the "right tool for the job". For example two stage tendering (i.e. expression of interest followed by full tender) may be much more beneficial than a single "bid" tender. The selection of suppliers in a two stage tender process can cut down suppliers' costs and evaluation of tenders is only undertaken on those who have a realistic chance of bidding.

Threshold levels aggregation and disaggregation. If an estimate of a procurement is close to (say within 10%) a threshold specified for particular procurement methodologies it may be wise to use that methodology to allow for tenders to come in above the threshold. An estimate should not be understated to avoid a threshold specified in the law nor should requirements be split into more than one requirement to avoid a threshold simply to avoid the work entailed in using the more complex and time consuming methodologies specified for that higher level.

Award Criteria: It is important to have award criteria (scores for ranking tenders) which assist in making the award of the tender transparent and more efficient. The evaluation team assessing tenders should know the award criteria fully. The procurement function or division should always be represented on an evaluation team.

Advertise. Public procurement legislation and processes are based on competition policies worldwide: tenders should be advertised in the correct media to secure sufficient competition.

Business is an ally not an enemy. Procurement policies can be used to promote local businesses, particularly small and medium scale suppliers through dividing tenders into smaller contracts where appropriate to encourage small business growth and enhance competition.

Contracting Out

Contracting out government services involves handing over responsibility for the delivery of services to the private sector, while the service is still funded by government. This is different from contracting a private company to construct a road for example. Contracting out would mean contracting a company to manage the collection of road tolls and using these funds to maintain the road.

The reason for introducing a contracting out approach to service delivery is that the government becomes the "purchaser" of the service and can choose between options presented by the private sector to deliver the agreed services. It is based on the assumption that the private sector will be able to deliver more efficiently and at a lower cost than the government.

Governments can also enter into "Public Private Partnerships" (PPPs) in which the private sector will finance the initial capital costs of a large scale capital project such as roads construction and then recover the costs through the collection of revenue or rental paid by the government. The exact form of these partnerships can vary and one common approach is the build-operate-transfer (BOT) approach in which the private sector builds and operates the infrastructure and then after an agreed period the private contractor hands the assets back to the government.

Specifying the nature of the contracting out arrangements is a complex and potentially difficult process as incorrectly defined agreements can lead to government expenditure being higher through such a contracting out arrangement than if the government had taken responsibility for the construction and operation of the project itself.

Specific Budget Management Issues

This section sets out the issues and improvements required in specific aspects of the budget including asset management, debt management and personnel payroll management, service delivery management and project management.

Asset Management

Government assets include both financial and physical assets:

- Financial assets are shares in enterprises, investments, loans granted by government to public enterprises etc. Systems need to be put in place to ensure effective management of government loans etc.
- Physical assets need to be managed through the use of asset registers and procedures for the sale or disposal of government assets.
- Management of both financial and physical assets tends to be weak in developing countries, in particular:
- Management of on lending to parastatals and parastatal performance is a particularly weak area, although it is becoming of increasing concern and some governments are establishing specific units with these responsibilities. The MEFMI Public Debt Management Procedures Manual recommends that such a Unit be established
- Systems for managing physical assets have been in place for many years in most countries which included asset registers, recording of purchase and disposal of assets, etc. However in many cases these systems are no longer effectively maintained and used for planning, management and accounting. Some computerised accounting packages include modules for asset management which can support improvements in this area.

Debt Management

As explained in the MEFMI Public Debt Management Procedures Manual, governments require a debt office which can be located either within the Ministry of Finance or central bank. The management of public debt should be done within the following functional framework:

- Front Office which has the responsibility for mobilising funds including contracting loans, issuing guarantees and government securities.
- Middle Office undertakes analysis of government debt to enable the government to meet its financing needs and debt service obligations, with prudent levels of risk exposure

- Back Office maintains the database of the debt portfolio, and confirms debt settlements, and payments.

Ideally these functions and other stakeholders involved in the debt management function would be coordinated through a Debt Management Committee.

Personnel Management

There are a number of issues to be addressed during budget implementation in relation to personnel including:

- Ensuring effective systems are in place to pay civil service salaries so that payments are made on time and are accurate
- Ensuring that payroll systems are linked to the rest of central budget and accounting systems so that salary budgets can be based on actual establishments and consolidated financial reports can be prepared of all government expenditure
- Ensuring that the data in the system is kept up to date as officials enter the service, others seconded elsewhere and some retire.

Management of Service Delivery

In addition to the other weaknesses discussed above, weaknesses in public sector performance and the resulting low impact of public funds is often due to ineffective management of service delivery.

Common management problems with service delivery include:

- Lack of a clear set of performance indicators and activities at the start of the budget year
- Lack of a well defined work plan to identify when the activities will be implemented and clear responsibilities for implementation
- Conflicting policy environment in which the services are being delivered, for example
- Lack of skills in areas such as time management, people management, budget management etc.
- Lack of accountability and performance environment. Managers are not held accountable for the achievement of agreed performance levels.

Improving service delivery therefore can be achieved through strengthening the above processes, without necessarily increasing funding levels.

Project Management

The implementation of projects can be the most difficult stage in the project cycle, and specific project management techniques have been developed to facilitate the implementation of large projects. These project management tools and processes include:

- Work flow planning which can be supported through specific project management tools
- PRINCE: projects in a controlled environment (see Box 32 below)
- Logframe: the lograme approach can be used for both planning and monitoring the implementation of a project.

Box 32. PRINCE2 (Projects in Controlled Environments)

PRINCE2 is a project management approach which is used extensively by the UK Government and is widely recognised and used in the private and public sector, particularly for large information technology projects.

The key features of PRINCE2 are:
- Its focus on business justification
- A defined organisation structure for the project management team
- Its product based planning approach
- Its emphasis on dividing the project into manageable and controllable stages
- Its flexibility to be applied at a level appropriate to the project

The approach involves answering the following questions at the start of the project:
- What are we trying to do?
- When will we start?
- What do we need?
- Can we do it alone, or do we need help?
- How long will it take?
- How much will it cost?

The answers are the building blocks of project management - defining what we want to do and working out the best way we can do it.

See. www.prince2.com

Attributes of an Effective Budget Implementation System

The attributes of an effective budget implementation system include:
- The ability to ensure that priorities set during budget preparation are followed through in budget implementation even during periods of fiscal crises.
- Increasing delegation and authority of spending ministries while also increasing accountability and responsibility
- Ensuring that budget implementation rules and regulations are adhered to and applied.
- Effective cash management systems are in place to: (i) ensure that limited resources are allocated in line with priorities during budget implementation; and (ii) limit the need for domestic borrowing over and above prior determined borrowing requirement
- Ensuring commitment at all levels to budget priorities during budget implementation
- Integrating all resources into the budget implementation system, both donor and internal for example, privatisation proceeds and non-tax revenues
- Ensuring effective systems are in place for monitoring and reporting on the implementation of the budget.

Link Budget Implementation to Planned Performance

The introduction of a performance based or activity based budget provides the basis for better planning and monitoring of budget implementation. This can be achieved through:

- Preparation of work plans and cash plans based on the implementation of activities as described in Box 30 above
- Linking the requests for funds during the year to the planned implementation of activities, i.e. rather than authorising equal quarters of the annual recurrent budget to a ministry or department, the release of funds to be linked to the planned activities
- The initiation of an expenditure to be linked to the specific activities to be implemented so that the funds will not be authorised by a financial controller or accountant unless the activity was planned and included in the budget
- Requests for virement of funds to be justified by changes in the implementation of specific activities rather than only by line item
- The monitoring of budget implementation to focus on both financial and physical performance

The above would require a process in which each department within a line ministry would:

- Produce a well defined work plan and cash plan at the beginning of the fiscal year
- Review the work plan and cash plan each quarter and update the subsequent quarter's plans
- Produce a report each quarter that shows the financial and physical implementation of the activities, with a review of performance and proposed actions to address any performance constraints.

Balance of Control with Managerial Freedoms

Current reforms to PEFM systems focus on balancing the two requirements of aggregate expenditure control, and effective and efficient uses of resources in accordance with budget priorities. This second requirement is addressed through providing managers with greater freedom to manage their resources.

Many existing budget implementation systems involve excessively detailed controls which are time consuming, making budget implementation rigid, and do not give managers the flexibility in the allocation of inputs needed to implement their budgets efficiently.

Reforms in OECD countries have focused on providing increasing flexibility to allow operational managers to have control over use of funds, flexibility in changing the use of funds, authority for making commitments and spending. This managerial freedom means that decisions made during budget implementations will focus on effective and efficient use of resources for improved service delivery.

It will be important to determine the right balance between managerial autonomy and expenditure control. Administrators and managers should have flexibility to do their jobs and take actions needed to improve outcomes. However, increased autonomy should go with accountability and responsibility.

Review Systems and Regulations

As part of providing increased autonomy there is the need to review existing implementation procedures to identify constraints in the system that lead to delays in expenditure authorisation and release of funds, procurement and the spending of public funds, whilst also ensuring accountability.

In order to ensure compliance with budget implementation rules and control procedures, it is important to assess not only the systems themselves but also whether they are clearly defined, well documented and applicable in the current institutional environment. Control procedures can be strengthened through an audit trail which enables managers to trace all stages of budget implementation from budget authorisation and releases, commitment, procurement, delivery and verification, payment, reconciliation of bank statements to accounting for revenue and expenditure.

Transparency and Accountability

In recent years, a greater awareness of governance issues has focused attention on fostering public sector efficiency, transparency, and accountability.

Thus a well functioning budgetary system ensures transparency and accountability where:

- Managers and vote holders are held accountable for the delivery of agreed performance levels
- Managers and vote holders have increased authority to use public funds which is matched by increased accountability
- Transactions are conducted in a transparent and open manner. Transparency implies that:
  (i) managers and vote holders follow laid down procedures during budget implementation
  (ii) they have all the relevant issues and information before them when they make decisions
  (iii) transactions have been properly documented, reports have been prepared and submitted on time
  (iv) documents are available for public scrutiny.
- Transactions can be subject to independent, professional, and unbiased audit and review.

This principle requires that financial and operational information is subjected to independent assurances of integrity. It emphasises availability of documents and willingness of managers to allow external audit, review and public scrutiny.

Define the Government Sector Clearly and Comprehensively

Government should be defined comprehensively to include not only central government, state/local/provincial governments, and government financial and non-financial operations. This implies that the respective roles of the Executive, Legislature, and Judiciary should be clearly defined and widely understood (during budget implementation).

Also, the true extent of a government's quasi fiscal activities and the contingent liabilities of government should be identified and monitored by government. It means that the implementation of the budget should include all resources, even donor resources.

Chapter 10 Accounting and Financial Reporting

Introduction

Summary of Chapter

The focus of this Chapter is on public sector accounting and financial reporting systems. The Chapter starts with an overview of the accounting and financial reporting processes including the steps to be followed and the need to measure an accounting system against accounting standards.

The next section describes the basis of accounting, i.e. cash or accrual accounting, with the pros and cons of both types of accounting explained. This is followed by a summary of common weaknesses in public sector accounting and reporting in developing countries and the characteristics of an effective system.

The next section describes the process of financial reporting and stresses the importance of providing the appropriate information to the various users of financial information, including using financial information for improving the management of an organisation.

The last section in the Chapter describes an Integrated Financial Management Information System (IFMIS), the elements involved in designing an IFMIS and lessons from the recent experience in implementation of IFMIS's in developing countries.

Key issues

Accounting and financial reporting systems have faced a number of serious weaknesses in developing countries prior to recent reforms in some of these countries.

These weaknesses have resulted mainly from the use of manual or out-dated computerised accounting systems, which has led to delays in the provision of financial reports as well as inaccurate financial data.

In addition, the common weaknesses described in previous chapters on budget preparation and implementation also have an impact on the accounting and financial reporting processes. These include:

- Some major areas of revenue and expenditure remain outside the government systems, including donor funds
- Lack of integration between the various types of revenue and expenditure makes it difficult to have a strategic overview of key issues during budget implementation and in financial reports
- As noted in Chapter 9: Budget Implementation, the detailed expenditure controls encourage the bypassing of these controls and transactions may not be properly recorded

- The information presented in the financial reports is not always user friendly and does not always meet international standards.

Recent reforms to accounting and financial reporting have focused on the introduction of computerised financial management systems, which need to be accompanied by related improvements such as updating the legal framework, reforms to budget classification system and chart of accounts, making financial reports more user friendly as well as strengthening the process of holding line ministries accountable for performance.

Overview of Accounting Systems and Financial Reporting

Accounting involves the recording of transactions (revenue and expenditure) as they take place and financial reporting is the aggregation and presentation of financial information to a range of different stakeholders for a number of reasons and uses. These include:

- For management and monitoring purposes, i.e. to assess whether budget implementation is on track
- To ensure financial transactions are undertaken according to the financial regulations
- To present financial information to Parliament in order for it to perform its role in oversight of government operations.

In order for an accounting system to provide useful information to decision makers and to enable effective monitoring of government operations accounting systems need to provide accurate, user friendly information at the appropriate time, according to the various uses of the information as defined above. The content and format of accounting information is governed by a set of accounting standards (see Box 3 below).

Differences Between Private and Public Sector Accounting

In the private sector, accounting is concerned with measuring the annual profit earned by a company, and with maintaining a balance sheet of assets, liabilities and net worth. The payments, receipts and other transactions are recorded and the income and expenditure for the year is matched to calculate the company's profit or loss.

In the public sector accounting and financial reporting is focused on recording revenue and expenditure so as to compare the approved budget and the actual implementation and explain any significant differences. Payments, receipts and other transactions are recorded against the relevant budget figures and summary position statements are made at the end of the year and reported to Parliament.

Government Accounting Systems

A government accounting system involves the recording of transactions as they take place and the reporting of this information to a range of stakeholders. The system also includes the reporting formats, responsibilities and internal control procedures.

Government accounting systems serve five main purposes:

- Recording transactions for the receipt, transfer and use of government funds and property against the approved allocation in the budget
- Tracking changes in budget use during implementation such as virements and supplementary estimates etc through all the stages (release of funds, commitments, payment etc)
- The analysis and categorisation of transactions using a chart of accounts and a coding structure to compare actual transactions with agreed budgetary amounts
- The maintenance of reliable financial records through reconciliations and control accounts
- The regular and timely reporting of financial transactions for budgetary control, management and accountability purposes.

These systems can be either manual or computerised, or even in some case a combination of both.

Accounting Standards

Accounting standards are the set of rules that define how accounting and financial information should be used and presented. In the past, some countries developed their own national accounting standards, but recent concerns with the accuracy and reliability of financial information from the donor community, investors and other users, have increased pressure for the development and use of global accounting standards.

As explained in Box 3 below international accounting standards have been developed, which focus on:

- increased international comparability of the financial statements
- increased comprehensiveness, completeness, and quality in the presentation of financial information for various users of government financial statements
- increased accountability and transparency by governments as compliance with the global standards represent internationally recognised best practice
- reduced transaction costs on the part of users of government financial information as much of the information will be readily available as public information, and likewise governments should experience a decrease in the cost of providing different financial information to various users who might demand them.

Box 33. Public Sector Accounting Standards

The International Public Sector Accounting Standards Board (IPSASB) focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance and facilitating the exchange of information among accountants and those who work in the public sector or rely on its work. The International Public Sector Accounting Standards (IPSASs) sets out the financial reporting requirements by governments and other public sector entities.

The IPSAS Board aims to converge IPSASs with International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board, while at the same time also considering public sector specific issues and reflecting public sector emphasis within the standards.

See www.IFAC.org International Federation of Accountants, Financial Reporting under the Cash Basis of Accounting, 2003

Steps in Accounting and Financial Reporting

The process of accounting and financial reporting follows a number of steps:

- Capturing and recording transactions
- Analysis of financial information
- Bank and other reconciliations
- Preparation of monthly/weekly reports on revenue, expenditure, assets and liabilities
- Preparation of quarterly reports
- Preparation of annual public accounts or financial statements.

Capturing and Recording of Transactions

The starting point in the use of an accounting system is the initial recording of a transaction. The process starts with the recording of expenditure authorisations (i.e. the amounts approved against each ministry/department and item of expenditure in the Budget) against which transactions are recorded.

A manual-based accounting system usually includes the following books of account or aspects:

- Expenditure ledgers: for recording payments against the approved item of expenditure as indicated in the approved budget document
- Revenue ledgers: to record receipt of funds against the approved revenue codes
- Sub ledgers: these are used to record investments, advances or imprests, short term loans, trust funds and other funds
- Cash book: this is used to record daily receipts and payments and is supported by details of the payment or receipt voucher. The cash book is supposed to be balanced on a daily

basis and the information is provided to the Accountant General on a regular basis for posting to the main ledger.

One of the problems with the above manual system is ensuring that the information is recorded accurately and that the information in the various books is regularly updated (e.g. that when a civil servant presents invoices for travel expenses these are added as expenditure to the Expenditure Ledger and deducted from the Imprest Ledger).

Another key challenge is the payment of funds by development partners outside the government accounting systems either direct to the contractor or on a reimbursement basis.

Where donors pay on a reimbursement basis, the government pays for the goods or services and claims the funds from the donor organisation on presentation of the necessary documentation. The donor funds will then be paid into the government's account at the central bank and it can be difficult to link these payments back to the original expenditure particularly in a manual accounting system, especially if regular bank reconciliations are not completed.

These problems are addressed to some extent in a computerised system in that all accounting information (budget approvals, transactions, imprests, advances, virements etc) is recorded in one database and the links between the various transactions and accounts are automatically updated. Computerised financial management systems also allow for easy aggregation of information from all cost centres within government.

These computerised systems can also impose more rigorous controls on the budget implementation process. For example a system can restrict users from making a payment unless the necessary procurement procedures have been followed.

Chart of Accounts

All authorisations and transactions need to be recorded using the chart of accounts as described in Chapter 8: Budget Coverage, Presentation and Approval. This is to ensure that transactions are captured, classified and summarised in a common form that will facilitate monitoring and control as well as decision making.

As noted in Chapter 8, the chart of accounts may be broader than the budget classification which is used for budget preparation and presentation. The chart of accounts provides for the recording of revenue and expenditure and also for assets and liabilities.

In the public sector governments may not be recording all assets and liabilities in the way that a private sector company would, particularly where a cash based system is in operation. However it is important for the Chart of Accounts to provide for the recording of assets and liabilities so that the full range of financial reports can be produced, as explained below.

Liabilities are the requirement or obligation to make a payment in the future and include accounts payable, e.g. payments owed to suppliers etc, pension payments and debt outstanding. A commitment becomes a liability when the supplier has delivered the service.

Bank Accounts and Bank Reconciliation

As explained in Chapter 9: Budget Implementation all government funds are paid into and withdrawn from a consolidated fund which may be comprised of a number of different types of bank accounts, e.g.:

- Recurrent Expenditure Account for recurrent expenditure
- Capital Expenditure Account for capital or project expenditure
- Administration Account: Below the line accounts, imprests and advances, funds advanced to government officials for official travel
- Contingencies Account
- Reserve Account: provides for a reserve of money usually specified by the financial legislation.

In addition governments will usually have a number of bank accounts with the central bank to manage the different types of revenues and expenditures. In some countries line ministries will have their own bank accounts and in some cases these bank accounts are held with commercial banks.

However as noted in the cash management section of the Budget Implementation Chapter having a large number of bank accounts which have been set up for a wide variety of purposes such as special funds and donor funded projects creates a significant challenge for governments to keep track of and manage the funds in all of these accounts.

Line ministries will be responsible for paying revenue into designated bank accounts. As well as recording transactions, accounting staff should be responsible for bank reconciliation which involves checking the ministry's records with those of the bank to ensure that only duly authorised transactions are charged by the bank and that all bank lodgements are recorded accurately and on a timely basis. As the main purpose of bank reconciliations is to ensure that the accounting records are accurate, they should be undertaken by staff who are not involved in the original transactions).

Financial Reports

A number of financial reports will be produced by line ministries during the financial year including regular reports to the senior management of the ministry, reports to the Accountant General and Budget Department, quarterly reports that may be presented to Cabinet and Parliament, and annual accounts produced at the end of the financial year.

These reports generally compare actual receipts and payments to the approved budgetary amounts agreed by Parliament and released (warranted) by the Ministry of Finance.

The Basis of Accounting

The basis of accounting addresses the issue of when the financial transactions are recognised in the books of account. A transaction can be recognised when cash is paid for the service rendered (cash basis), when the organisation orders the goods or services (commitment basis) or when the organisation is invoiced for the goods or services (accrual basis).

This determines the basis of accounting. The bases of accounting therefore range from cash, at one end of the spectrum through to modified cash, modified accrual to full accrual at the other end of the spectrum. In practice many countries have adopted a mixture of cash and accrual bases. Many countries have adopted the modified cash approach which recognizes a transaction only when funds are spent and revenue collected, supplemented with additional details in other areas such as government debt and outstanding invoice payments.

The cash basis of accounting recognises transactions only when cash is received or paid. This requires a simple cash accounting system to cover cash receipts, cash disbursements, opening and closing cash balances. A cash based financial reporting system has the advantage of being simple and can be used to compare cash spent and collected with actual cash balances in the bank.

However, as financial management has become more sophisticated a number of problems in the cash accounting model have become apparent. These are:

- Important assets and liabilities are excluded in the financial statements, e.g. fixed assets, accounts payable (invoices not yet paid) and receivable (funds owed to an organisation), and pension liabilities. As a result accounting information does not provide a complete picture of the status of revenue and expenditure within government
- Since the accounting information does not capture assets and liabilities, there is no meaningful measure of the total cost of resources used within any accounting period.

In practice governments do not adopt a pure cash basis approach, but a modified approach to improve the coverage of financial information including:

- Certain assets and liability memorandum accounts are being maintained to support the cash accounting system e.g. advances, loan balances
- In some countries, cheques written after the year end for accounts payable at year end are passed through the books in the financial year to which they relate rather than the financial year in which they are drawn.

The above modifications have been adopted by countries when applying the cash basis of accounting. In addition, some form of commitment accounting has been adopted under which expenditure is recorded when the organisation commits itself to spend the funds. As explained in Chapter 7: Budget Implementation, Principles and Processes, a commitment is created when an order is placed or a contract signed. However, in some countries, funds are regarded as committed when released to a spending unit.

Common Weaknesses in Accounting

Timely submission of quality data on expenditure

Until recently, many developing countries' accounting systems had deteriorated and were at least partially manual which, combined with problems in retaining qualified accounting staff, resulted in delayed and inaccurate government accounts. Processing of accounting transactions was delayed for long periods and the recording of transactions and reporting on them was of very low quality.

For example, as the accounting system is put under stress, and accountants are also under pressure, unauthorised approaches are used such as using suspense accounts to record transactions on a temporary basis, where the accountants hope to "post" them at a later time to the correct line item in the government accounts. In addition, advances are not cleared promptly.

The effect is that many countries experienced large backlogs in regularising their accounts causing delays in the submission of data and finalisation of the annual accounts. This then also delayed the external audit function and audit queries were not properly addressed because they are raised many years after the transactions occurred. At this time it will be difficult to hold officers accountable.

These weaknesses are being addressed through the introduction of computerised financial management systems as described below.

Information not comprehensive and disaggregated

The information being captured is not comprehensive and the use of separate systems means that it is not possible to aggregate all the information.

As noted above even in a simple cash based system it is important to track expenditure from the commitment to the payment stage and as explained in Chapter 9: Budget Implementation, some governments do not have effective systems of commitment controls. Therefore information is not always collected on commitments nor is this information provided to the Ministry of Finance for use in cash management.

In addition, some transactions are recorded in suspense or "below the line" accounts, and this information is not always aggregated with other financial information. The use of these funds is also not always transparent.

Management of a large number of government bank accounts

Another weakness in government accounting systems is in management of a large number of bank accounts and the difficulties of consolidating information on the total level of funds in these many government accounts.

In some countries, the main treasury bank account coexists with other public bank accounts, for example, public enterprises and agencies entities are allowed to open accounts in private banks. This fragmentation of funds makes it more difficult for governments to effectively manage government funds and generally attracts additional cost to the government. Often government is borrowing at high interest rates, while unused government funds accumulate in bank accounts that earn a low rate of interest, if any. In order words, commercial banks use the government's money to lend back to them at a profit.

In many countries, governments have been required to open a different bank account for each donor funded project. More recently the problems associated with the proliferation of bank accounts has been recognized and many governments are now seeking to consolidate the government bank accounts so as to improve the management of government funds.

Difficulty in managing and accounting for external resource (aid) flows

Managing and accounting for external resource inflows depend on: having in place a sound chart of accounts that can accommodate donor inflows and outflows; recording and accounting systems to track and account for aid inflows; ensuring that all donor funds are included in the budget; and the level of integration of recurrent and capital budgets.

However as described in Chapter 13: External Resource Mobilisation and Management, a significant proportion of external resources remain outside government budgeting and accounting systems and thus governments are not able to effectively manage and account for all the funds available to them.

Characteristics of an Effective Accounting System

An effective accounting system, whether manual or computerised, should have the following characteristics:

- Adequate reporting systems to track and monitor expenditure at each stage of the expenditure cycle (commitments, verification, and payment)
- There should be effective procedures for recording of transactions to ensure completeness and accuracy of the records, audit trails to track transactions throughout the process and availability of supporting documentation
- All expenditure and revenue transactions should be recorded in the accounts in accordance with the accounting bases being adopted (i.e. cash, modified cash, modified accrual), ensuring consistency in the treatment of similar items according to the same methodology and using the same accounting standards
- The accounting information should be comprehensive including all funds at all levels of government, information in secondary systems such as commitment ledgers, suspense accounts, debt management systems and sources of funds, such as earmarked revenues, and donor funds
- A common chart of accounts should be used by all ministries, departments and agencies for revenue, expenditure, assets and liabilities
- The accounting system should specify in clear terms how transactions undertaken at the end of the financial year are recorded by specifying the year end closure dates. Some countries have complementary periods e.g. ten days inside the new-year to record year end transactions. In other systems transactions cease ten days before the year-end to ensure transactions are recorded in the current year
- Accounting systems should have adequate internal controls to restrict unauthorised expenditure
- The Accounting Standards to be adopted should be clearly communicated and procedures clearly defined and well documented, (see Box 33 above)
- The accounting system should produce regular reports, which are accurate and meet the user needs as described in more detail below.

Financial Reporting

The end products of the accounting process are financial reports which enable policy makers and managers to monitor and control financial performance effectively.

Financial reports fulfil a number of roles in that they:
- are a structured representation of the financial position and financial performance of an organisation
- should be used for decision making in the financial management of a line ministry and government as a whole
- demonstrate how an organisation has used the resources entrusted to it by providing information about the sources, allocation and uses of financial resources
- enable Parliament to hold ministries accountable for the use of public funds
- enable the evaluation of financial performance as an input into future planning and policy formulation.

Financial Reporting Systems

The primary aim of a financial reporting system is to demonstrate how the government has spent the approved expenditure, collected the planned revenue and managed its financial resources compared to the annual budget agreed by Parliament.

There are specific types and levels of financial reporting in government based on the purpose to be served by the financial reports. There are three major purposes:
- accountability and Parliamentary control of appropriations
- monitoring of fiscal development and economic management
- accountability for service provision.

In addition to the reporting of government expenditure and revenue, reporting systems are also an important part of the control and management of government resources. Reports are produced to monitor the implementation of budgetary appropriations and sub-allocation to agencies and cost centres. They provide the basis for management decisions and audit of the activities. Reports are therefore required which show budget allocations and relevant expenditure and receipts which are provided at periodic intervals, according to the nature of the activity.

The Content of Financial Reports

There are two main types of reports to meet the three purposes mentioned above:

Regular management reports

- Regular reports on the operation of ministries submitted to the Ministry of Finance on a daily, weekly and monthly basis. For example the Statement of Expenditure
- Quarterly reports presented to Cabinet or Parliament.

Financial Reports (Statements) Submitted to Parliament

Annual Financial Statements are presented to the Public Accounts Committee and audited by the external audit organisation, e.g. office of the auditor general
The management reports are used to assess performance in budget implementation, while the financial reports are prepared for accountability purposes.

Usually the reports will cover the funds managed within the government's Consolidated Fund. However, there is increasingly an interest in reporting on the management of resources outside the Consolidated Fund including lower levels of government, parastatals and the use of donor funds which are sometimes off-budget.

Where government financial statements are prepared under internationally recognised accounting standards, and in particular, the International Public Sector Accounting Standards, the following financial statements are the minimum requirements:

- The Statement of Financial Performance
- Cash Flow Statement
- Statement of Changes in Equity [Net assets]
- Statement of Accounting Policies and Notes to the Financial Statements.

Table 35. Government Financial Reporting Requirements

Standard Reports	Contents
Summary report on the execution of the government operations.	Government transactions for accounting period. The report should cover at least two budget years to allow the user to make comparisons. The report should be prepared in accordance with IMF's Government Finance Statistics Manual 2001
Statement of domestic arrears.	Contains and distinguishes between arrears to the private sector, arrears to sub-national government entities, and arrears to the non-government public sector.
Report on medium term and long term external debt	Debt Outstanding and Disbursed (DOD) for medium-term external public debt, classified into the following categories: ▸ DOD without arrears, with interest arrears, and with principal arrears. ▸ Directly contracted debt and guarantees. ▸ Broad categories of creditors (e.g. IFIs and Commercial Creditors). ▸ Broad categories of beneficiaries of guarantees (e.g. industrial and agricultural enterprises owned by the state). ▸ Debt instruments (loans and other obligations)
Report on grants	Donor pledges, receipts and related disbursements.
Report on lending	Loans contracted, interest and principal repayments over the period, and arrears by major category of beneficiary.
Statement of cash flows	Flows of cash revenue and cash payments, and opening and closing cash balances covering all government cash and bank accounts

Line Ministry Reports

In addition to the above statements, annual reports should also be prepared by each line ministry which summarise:

- The performance of the ministry in achieving the planned objectives, outputs (targets) and activities
- Major policy issues addressed during the period
- The financial performance of the ministry including any off budget donor funds
- Planned policy changes, major programme changes, expenditure issues for the forthcoming year.

Principles of Reporting

Financial reports should be governed by the following principles:

Completeness: The information reported should encompass all the relevant financial operations of government.

Legitimacy: The form and contents of financial reports should be appropriate for internal and external use and comply with rules and regulations and acceptable standards.

User friendliness: Reports should be written in simple language and presented in a way which will be easy to understand and interpret by users and other interested parties. The reports should not be overloaded with information to dilute their intended purpose.

Reliability: That information and data presented in the reports is reliable and verifiable and free from material misrepresentation and bias.

Relevance: This implies that information provided responds to the purpose(s) for which it is provided and that it serves the specific needs of various stakeholders and users.

Consistency: This indicates that once an accounting or reporting method is adopted, it should be used for all similar transactions unless there is good cause to change it and the effect of any change should be shown in the reports. Consistency in the methodology, scope and coverage of financial reports is required over time for trend analysis.

Timeliness: As noted in the common weaknesses of accounting systems discussed earlier, government accounts may be delayed due to outdated systems and capacity constraints. An effective reporting system needs to ensure that financial information is provided on a timely basis, which is usually defined in the government's financial legislation and regulations. Timely reporting is of essence since the passage of time usually diminishes the usefulness of information. The audit report and audited budget outturn statements should be reported to Parliament and made public within at most 12 months of the end of the financial year.

Comparability: of financial information enhances its usefulness and therefore helps users to make relevant comparisons among similar reporting units. The financial statements and audit report should be in a similar format each year.

Usefulness: of information is important since it should contribute to an understanding of the current and future activities of the agency, its sources and financial management of funds. For example, reports on the operations of line ministries and agencies should be useful to managers and administrators and other stakeholders.

Users of Financial Information

Different users of financial information will have different information needs based on their uses of this information as shown in Table 36 below.

Table 36. Users of Financial Information

Role	Stakeholder	Purpose of Reports	Information Required
Accountability and control of budgetary appropriations	The Legislature	Provide assurance to Legislature that expenditure and receipts conform to statutory authorisations and financial regulations	Budget outturn reports and summary position statements. Audit report on regularity and legality of financial transactions.
Fiscal development and economic management	Ministry of Finance and other central ministries	Policy makers need to be provided with relevant fiscal data to monitor overall macroeconomic and fiscal management and to take appropriate measures to correct deviations from the intended pattern of expenditure, revenue and financing items.	Summarised statements showing actual revenue and receipts with surplus or deficit financing
Cash flow planning	Ministry of Finance and other central ministries	Regular information about the revenue inflows, expenditure, commitments and borrowing to ensure efficient budget implementation	Financial statements showing actual revenue and receipts with surplus or deficit financing provided from the central accounting system, usually on monthly cumulative basis for comparison with budgeted amounts. Periodic (quarterly) reviews and revision of underlying budgetary assumptions.
Departmental budget control	Administrators and management of line ministries and agencies	Enable ministries or departments to monitor the implementation of budgetary appropriations and sub allocation to agencies and cost centres. Provide basis for management decisions and audit of the activities.	Statements showing allocations and relevant expenditure and receipts to be provided at periodic intervals, according to the nature of the activity.
Accountability and transparency	Development partners	Provide assurance to development partners that expenditure is applied for intended purposes, and there is accountability and transparency	Statements showing actual expenditure linked to outputs and policy priorities. Audit reports on regularity and probity.
Assessment of credit worthiness	Financial markets	Use information about the government's finances to assist with the assessment of the government's credit worthiness and to make judgments about the value of its debt and the appropriate level of interest rates and exchange rates.	Financial statements showing actual revenue and receipts with surplus or deficit financing compared to balances from the central bank and overall debt position
Financial accountability	Citizens	Need information on the costs and performance of programmes that affect them. Only available with programme budgeting.The internet allows detailed budget outturn reports to be published so that citizens can look at the specific areas of interest.	Statements on actual budgetary expenditure linked to programme performance. Audit report on legality and regularity.

Moving from Book Keeping to Financial Management

As improved and automated accounting systems are introduced, government accounting staff and managers can begin to move from simply recording financial information to ensure compliance with regulations, to the use of financial information for improving the functioning and performance of line ministries and government as a whole.

Table 37 below shows how the various reports and financial information can be used for improving the management of line ministries.

Table 37. Using Financial Information for Improving Management

Report	Information	What can the information tell us?
Expenditure reports against approved budget or expenditure limits, showing variances	Actual expenditure incurred by ministries or departments compared with budget to date or expenditure limits	Whether ministries or departments are spending within their appropriations with explanation for variances. It also shows the extent to which funds have been released for approved programmes and the progress of ministries or departments in budget implementation This information can be used to identify problem areas during budget implementation
Reports on revenue generation against budget	Actual collections against budget	Whether revenue targets have been met and which departments are not collecting revenue as expected
Reports on expenditure by activity, output or performance	Expenditure by output	Provides comparative information on the physical performance and cost efficiency of ministries or departments
Detailed expenditure reports by ministries or departments	Details of expenditures incurred by ministries or departments	Provides information on expenditure by sub item showing which areas are the high spenders and whether that relates to output achieved
Expenditure trend analysis	Actual expenditure over a period of time	Shows expenditure trends and whether the trend meets expectations based on past performance

Introduction and Implementation of IFMIS

Introduction

Systems of financial management consist of procedures for forecasting expenditure and revenues, budget preparation, budget execution, accounting and financial reporting, tax administration, personnel and payroll management, programme management and auditing.

Often these sub-systems have been implemented through separate information systems, responding to specific needs, (e.g. donor assistance to improve on budgeting or accounting) but with little attention given to other areas to ensure consistency and improve interrelationships. As a result the benefits from such reforms fall short of their full potential. Data are duplicated and difficult to reconcile, while some major areas are not covered by these stand-alone systems.

Recent improvements to government accounting systems have focused on the introduction of Integrated Financial Management Information Systems (IFMIS), which are:

- Based on the use of computerised accounting packages, either built specifically for a government, i.e. bespoke, or an off the shelf package, i.e. existing system which is customised for the needs of the government
- Integrated in that the system covers all aspects of the budget preparation, implementation, accounting and reporting processes
- Associated with the introduction of improved Information Technology Communications such as networked systems to improve the transfer of data
- Linked to extensive training and change management activities

The advantages and intended benefits of an IFMIS include:

- Integrating a system of checks and balances which ensures transparency of operations through audit trails and controls which ensure accountability of administrators and managers. For example the use of controls on the creation of commitments
- Providing more accurate and timely financial information
- Enabling the consolidation of large volumes of data
- Enabling the production of reports in various ways to meet the needs of different stakeholders
- Enabling the integration of processes, information, and interdependent and interacting financial management components or sub-systems
- A system which can provide for the decentralisation of budget implementation such as the line ministry being able to produce cheques which may not have been possible within a manual system. These decentralised procedures need to be firmly established within a clear accountable framework.

Such systems can contribute to both overall fiscal control and operational efficiency at the agency level. However, to fulfil effectively these functions, information systems must be appropriately designed and integrated.

The development of an effective IFMIS needs to take account of the following technical issues:

System definition: This describes the budget preparation, implementation, accounting, financial management and related non-financial processes such as procurement, performance measurement, etc. These processes need to be described at the start of the IFMIS procurement process so that potential suppliers can respond to the extent to which their systems meet these requirements. System definition should take account of the existing financial management systems but should also include a review of these systems, providing an opportunity to improve and streamline existing processes.

Information technology architecture: the design of the systems for transferring data needs to be defined based on existing and planned improvements in a government's information system, i.e. government networks, telecommunications infrastructure and reliability etc. In some cases the implementation of an IFMIS will include the establishment of government wide networks to ensure reliable and timely data transfer.

Degree of decentralisation in the system: while all levels of government will be operating according to the same financial and accounting rules, as explained above, an IFMIS can have varying degrees of controls and managerial freedoms. During the design phase it will also be necessary to agree on the levels of these controls, e.g. will line ministries be responsible for issuing their own cheques or will this be centralised in the Ministry of Finance?

Degree of external integration: while an IFMIS aims to include all systems of financial management there will be a need to link to other systems with the data to be shared. For example an IFMIS will need to share information with a debt recording system and to other systems outside government such as banks, suppliers, employees, etc., with which government has major financial relationships.

Integrated Financial Management Information System Software

An IFMIS can be implemented either through a system developed specifically for a government or through the purchase and customisation of an existing accounting package.

The advantages of using an off the shelf accounting package include:

- Established packages are fully developed, and demonstrably work. They will have been de-bugged
- They will be supported by manuals, designed for ease of use, and have built in audit trails and security
- They will be regularly upgraded to take account of new developments, e.g. new versions of operating systems
- The system is developed and well tested, and will continue to be maintained and supported by a software house which should assist with problems
- Data integrity and security (especially important in accounting systems) is well established, and there will be proper audit trails.

The main disadvantage is that they are largely designed for the private sector and will need some customisation for the public sector.

Implementation Challenges

In recent years there have been mixed experiences of IFMIS implementation with some governments having some degree of success and others being faced with significant delays and cost over-runs.

Some of the lessons learned from these experiences include:

- Keep it simple – the more complex and sophisticated the system is, the more extensive its scope significantly increases the risk of failure which in many cases has been total
- There needs to be a clear vision and expectations of what the system is to deliver so that an appropriate software package is procured
- There needs to be a realistic estimate of the cost and timeline for implementation of the new systems
- Significant attention needs to be paid to training and capacity building in both the PEM processes and in the use of the software packages
- Sufficient provision needs to be made for the cost of maintenance and technical support once the system is installed
- Government officers need to be closely involved at all stages through the system design and implementation, even if this slows the process
- Avoiding dependence on foreign suppliers and/or expatriate staff
- The effectiveness of the new system will be determined to a large extent by factors external to the system: accurate, timely and comprehensive input of data; efficient maintenance of databases; systems management; and ability to use the information provided
- Factors external to a computer system will also influence its effectiveness. For example, the degree to which financial procedures and accounting classifications have been standardised, etc.
- Difficulty in sustaining system operations after initial funding support.

CHAPTER 11 PERFORMANCE MONITORING AND EVALUATION

Introduction

Summary of Chapter

In this Chapter we cover the processes of monitoring and evaluation (M&E) of an organisation's performance.

The Chapter starts by defining why and how performance is measured, including a definition of the various types of performance indicators. The next section provides an overview of the various approaches to performance M&E.

This is followed by a description of the ways in which performance M&E needs to be linked to all the stages in the PFM cycle and suggestions on how to undertake performance monitoring as part of budget implementation and a detailed performance evaluation. The last section presents an overview of a performance monitoring and evaluation system and detailed steps on establishing a performance M&E system.

Key Issues

The introduction of a performance focus into budget planning and management is one of the key areas of PEFM reform. As explained in Chapter 7: Budget Preparation, Principles and Processes, performance information can be used in a number of ways in budget preparation, e.g. the indicators can be shown alongside a line item budget or a full performance based budget can be prepared.

However in many cases the systems and processes are not established to monitor the actual implementation of the planned performance. This means that the efforts put into a performance based budget cannot be fully realised if it is not possible to measure the actual achievement of performance. At the same time separate performance information systems may be established which are not linked to the performance as set out in the budget.

Thus it is important to establish effective performance monitoring and evaluation systems and processes which involves the following steps:

- Line ministries identify the appropriate performance indicators that will best measure their performance
- Assess existing systems and identify the new systems for collecting the appropriate information, in the form required and at the time required
- Establish the institutional framework including who is responsible for collecting and reporting on the information, to whom and how often, will there be any sanctions and incentives for good or poor performance, etc
- Develop new systems and reporting procedures
- Undertake regular monitoring and evaluation processes linked to the financial management cycle and integrated with the financial monitoring and reporting processes.

Introducing a performance monitoring and evaluation system also involves developing a performance management culture, i.e. a move to a focus on outputs and outcomes rather than control of detailed inputs. This involves providing key stakeholders with useful information, creating the capacity to produce and analyse information, a willingness to hold officials accountable for performance and changes in incentives to encourage greater performance.

All of these issues require strong political commitment to changing the ways in which governments operate.

Overview of Performance Monitoring and Evaluation

Measuring performance involves deciding what it is specifically that is to be achieved (i.e. performance indicators), collecting information to assess the extent to which the performance has been achieved and using this information to make decisions about future plans.

Programme Monitoring and Evaluation

Most governments will be undertaking the monitoring and evaluation of financial performance through regular financial reports as described in Chapter 10: Accounting and Financial Reporting and Chapter 12: External Audit. Governments will also undertake regular monitoring and detailed evaluations of projects, particularly those implemented with external funds. Development partners will usually bring in external consultants to undertake evaluations during project implementation, such as a mid term review and at the end of the project (project completion and evaluation report).

This Chapter focuses on the monitoring and evaluation of an entire ministry programme such as a basic education programme, a food security programme, skills development programme, rather than on an individual project.

Within a programme several elements can be monitored and evaluated:

- The policy framework for the programme
- The recurrent funded outputs and activities
- The projects within a programme.

Programme monitoring and evaluation focuses on whether the programme is achieving its intended objectives and agreed levels of efficiency and effectiveness. Performance monitoring and evaluation requires the definition and measurement of performance indicators as described below. This means that performance can be quantified and analysed in a verifiable manner based on actual performance data.

Why do we need to measure performance?

It is important to measure performance in many situations:

- In one's own life: did I achieve my goals of being promoted at work?

- In an organisation: did the organisation contribute to the achievement of sectoral objectives?
- As a country: have the poverty reduction targets been met?

In this Chapter we highlight the importance of linking performance information to the PEFM system particularly the PFM cycle, so that:

- When preparing the budget performance information can be used to decide where to allocate resources so as to achieve tangible results
- Line ministries can communicate to the Ministry of Finance, Cabinet, Parliament and the public about the outputs (services) to be delivered with the funds approved
- There is a basis for monitoring whether the planned services were actually implemented
- A more meaningful basis is used for holding ministries accountable for the delivery of services rather than simply whether budgeted funds have been spent
- It will be possible to measure whether the services provided by government are having an impact.

Measuring Performance

In this Section we explain:

- What are performance indicators?
- Defining appropriate indicators
- Defining performance measures

What are performance indicators?

- Performance indicators identify the specific issue to be measured, i.e. primary school pupils
- Performance measures define the way it will be measured, primary school pupils enrolled, pass rates of primary school pupils etc.

There are a number of different types of performance indicators which are linked to each other:

- **Outputs**: goods and services delivered by an organisation
- **Outcomes:** the results of the delivery of these services to which a number of different organisations contribute, i.e. a line ministry cannot be held solely responsible for the outcome
- **Impact:** the effect on the outcome on longer term results, i.e. similar to an outcome but with a longer term horizon.

This follows the logic that:

- If an organisation produces an output
- It will have an outcome or result
- The result will have a longer term impact.

This logic can therefore be used to work backwards from a desired impact to the outputs that an organisation should be producing. The process of defining outcomes and outputs is described in detail in Annex 2: Preparation of Plan Documents. Ideally outcomes and outputs are linked to the achievement of an objective as shown in the example below.

Box 34. Ministry of Tourism Example of Performance Indictors

Objective: To improve support to the private sector tourism development
Performance measurement: how will we know this has been achieved? What will measure effective support to the private sector?

Outputs:
What does this support involve? What does the ministry produce? E.g. revised and appropriate legislation; marketing of the country internationally; updating of licensing system

Outcomes: if there is an improvement in the quality of services to the tourism sector this will result in the following:
- Increased number of travel agents promoting the country
- Increased number of tourists visiting the country

Impact: what will increased number of tourists result in?
- Increased levels of income
- Increased employment
- Increased economic growth.

Types of Output and Outcome Indicators

Outputs can measure:
- The level of services provided by an organisation, for example the number of people trained
- A tangible product such as a policy document, reports etc. or a building constructed
- The result of a work process such as a visa applications processed

Outcome indicators are the intermediary indicators and can measure:
- The change in beneficiary status, e.g. number of people attending health clinics, education pass rates, or women involved in the political process

Impact indicators can measure:
- The change in beneficiary status, e.g. health status, education pass rates, women involved in the political process
- Economic indicators such as: economic growth, agricultural production, tourists visiting the country, poverty indicators, employment rate
- Changes in factors such as: environmental status; crime rate; levels of corruption; investor confidence.

Defining Performance Indicators at the Appropriate Level of Detail

It is very important to define the outputs and outcomes at an appropriate level of detail. If they are too detailed, the number of indicators becomes unmanageable as does the effort of collecting a large amount of data, and the information becomes less meaningful.

Therefore in defining both outcome and output indicators it is important to limit the indicators to be used in measuring performance to a few key indicators:

- Those outcomes and outputs which will measure the key service areas of the organisation e.g. pupils educated in schools; roads maintained; national accounts produced in the Ministry of Finance
- Avoid including indicators which make up only a very small part of the services or activities of the organisation or are low priority
- Ideally include outcomes and outputs for which data is already being collected or could be easily collected
- Limit the number of outcomes and outputs to approximately 5-6 per objective per programme.

Table 38 below presents examples of outputs at the wrong level of detail and those that are correctly defined.

Table 38. Examples of Outputs at Different Levels of Detail

Too Detailed	Explanation
Procurement of stationery	This is a very detailed activity
Printers purchased	This is a detailed activity
Training workshop held	This is an activity
Appropriate Level of Detail	
Farmers trained in horticultural production	This is a core business of the department and it can be measured
Backlog of court cases reduced	This is a key service of the organisation and can be measured
Patients treated for TB	This is a key service and the ministry probably already collects this information
Kilometres of rural roads rehabilitated	This is a key service area for the ministry and it distinguishes between rural and urban roads

Performance Measures Information

In addition to the Outputs and Outcomes indicators additional information can be used to measure these indicators, i.e. performance measures:

- Quantity: how many children were educated
- Quality: how well were they educated, i.e. did they pass?
- Timeliness: were the services delivered on time?
- Cost: was the output produced at the least cost?

Therefore it is possible to define a few key outcomes and outputs and to add this type of information to be measured to make the measurement more meaningful as illustrated in the examples in Table 39 below.

Table 39. Examples of Outputs with Performance Measures

	Performance measure			
Output	**Quantity**	**Quality**	**Time**	**Cost**
Environmental Policy Produced	100 copies of report	Stakeholder feedback during consultations was very positive. This can be measured through evaluation questionnaires	Produced within six months	Total cost $10,000
Annual Accounts Produced	For all 27 organisations within government	No audit queries were raised	Within the required time frame of six months	Total cost

In defining these performance measures they should have the following characteristics:

- Be meaningful, i.e. relate to issues that are of importance to the programme. If the annual public accounts are usually of low quality and have a number of audit queries, this is an issue to be measured
- They should be clear, with no ambiguity, and no doubt about what information means
- Consistent, relate directly to the issue they are describing
- The data presented should be accurate
- The data should be produced on time.

Difficulties of Defining Performance Indicators in the Public Sector

As noted in Chapter 7: Budget Preparation, Principles and Processes in the section on performance budgeting, defining performance indicators in the public sector can present some challenges. These include:

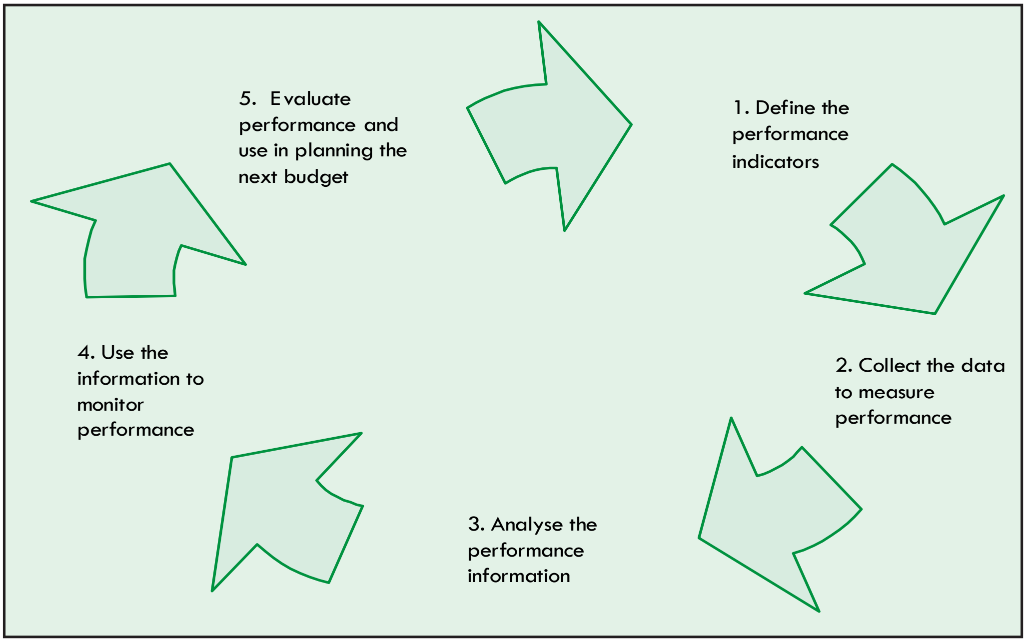
- For some sectors defining performance indicators is relatively easy, where the ministry produces a clearly identifiable and measurable product, such as pupils educated, kilometres of road constructed, patients treated
- In other sectors particularly the ones that are more administrative in nature, defining indicators can be more difficult. However in most cases it is possible to identify some output indicators. For example the outputs of a Ministry of Finance are focused on improving financial management and the outputs can include ministries trained in financial management, new systems introduced, legislation and regulations updated.

In defining the performance indicators it is important that the measurement of this performance does not lead to “perverse incentives” i.e. that make the people whose performance is being measured behave in unintended ways. For example if the police are measured on the basis of crime levels reported in police stations, it is possible that the police officers will not report all crimes in order to avoid a poor performance record. In this case it is important to be clear about what is the issue that is to be improved and therefore to be measured. In the example given it is not the crime level but the solving of crimes. Therefore the performance measure for the police would be the percentage of the crimes reported that are solved, i.e. the issue that is of concern.

Stages in the Performance Monitoring and Evaluation Process

The process of performance monitoring and evaluation involves the stages in the cycle shown below.

Figure 11. Performance Information Cycle



The above diagram illustrates that the cycle includes both performance monitoring and evaluation:

- **Monitoring** is the collection and reporting of performance information during the budget implementation stage of the cycle, i.e. at stage 4 in the cycle reports are produced on a regular basis to report on progress of budget implementation, this can be on a monthly or quarterly basis
- **Evaluation**: is at the last stage in the cycle, when the information collected during the implementation phase is analysed and reported.

The information used during these two stages in the cycle may be at different levels of detail:

- During the monitoring stage ministries may be reporting on detailed activity implementation
- During the evaluation stage ministries are more likely to be analysing and reporting on progress in the delivery of outputs and outcomes

Linking Performance to the PFM Cycle

The important issue to note is that performance information is used throughout the stages of the PEFM Cycle (described in Chapter 1) as outlined below.

Using performance information in the planning stage involves reviewing previous performance of:

- A sector using outcome indicators
- The organisation using output and financial performance.

This review should enable an organisation to identify good and poor performance, identify the reasons for the performance and any issues that need to be addressed in the next plan/budget cycle.

Using performance information in the budget implementation stage involves monitoring both physical and financial progress during budget implementation, so that organisations are monitoring not only whether they have spent the funds but the activities being implemented with the funds. This enables the organisations to take remedial actions during the year rather than waiting until the end of the year.

Using performance information in the audit/ evaluation stage involves using information to undertake a more detailed evaluation and/or performance audit of programmes and services. Therefore governments can assess not simply whether funds were used according to the financial regulations but whether the funds resulted in the agreed services and the intended benefits. Performance Audits (Described in Chapter 10: External Audit) can be undertaken without a formal performance M&E system being established as the auditors can collect available information on outputs and outcomes. However these processes are made more meaningful if good performance information is available.

Ensuring that performance information is integrated effectively into the PFM cycle means that:

- The use of performance information is valued by all stakeholders
- There is a close link or integration of performance information systems (i.e. the technical systems) and other systems such as financial management systems (IFMIS), statistical systems, etc. so that information can easily be combined into joint reports
- The needs of the various stakeholders are identified so that reports meet their needs.

Approaches to Performance Monitoring and Evaluation

With the introduction of a performance focus in budget planning and reporting, governments have also introduced performance monitoring and evaluation processes, some of which (such as the US Government) are defined in the legal framework.

In MEFMI countries the performance focus has been introduced into the PFM cycle to some extent through poverty focus, although there are only a few governments that have established systems for monitoring line ministry outcomes, outputs and activities.

Poverty Monitoring Systems

In MEFMI countries the most commonly implemented M&E systems are poverty monitoring systems as part of the Poverty Reduction Strategy (PRS) initiative. An effective PRS monitoring system is a key component of ensuring the effective implementation of a PRS as it supports decision making, allows improved policy/program design and implementation, fosters accountability, and promotes dialogue.

The PRS monitoring system will involve a number of organisations who will be focused on monitoring a range of indicators:

- Bureau of Statistics: Poverty indicators through household surveys and other specific poverty monitoring tools
- Ministry of Finance/Planning: high level outcome indicators such as economic growth, and may also commission specific poverty impact studies
- Line Ministries: outcomes and outputs which are poverty focused
- Local Government: outcomes and outputs which are poverty focused and implemented at the local government level
- NGOs, researchers, think tanks, consultants, donor organisations: beneficiary studies to monitor and evaluate the impact of the PRS and their own activities.

In addition to these organisations that are involved in the collection, analysis and reporting of poverty information, there will also be a group of users of the information ranging from government decision makers, to Parliamentarians, civil society groups, the donor community and researchers.

According to the World Bank website on PRS the lessons from experience of developing PRS monitoring systems include:

- The need for strong political support for the PRS and monitoring system
- The need for effective coordination and involvement of all stakeholders
- Systems should build on existing elements and processes, starting with something simple rather than designing a "perfect" system
- There is no blueprint for appropriate institutional arrangements, but rather appropriate arrangements depend on country circumstances, such as existing data collection systems, management system, and reporting mechanisms
- Efforts need to focus on strengthening existing primary data producing systems, integrating

responsible agencies into the PRSP process, and establishing good relationships between the central units and these agencies

- Systems should also be built with the ultimate purpose of feeding back into policy making processes. In numerous PRSP countries, there is still little evidence of widespread effective use of monitoring outputs for decision making
- Strengthening demand and promoting the use of results in policy and budget decisions will require clearly defined relations, incentives, and activities which reward performance effective dissemination and communication of data and analysis, as well as building analytical capacity among decision makers. The introduction of sustainable monitoring systems that effectively feeds back into decision making processes requires strong political will and commitment to establish and enforce the required incentive structure.

Balanced Score Card

This approach was developed for use in the private sector in recognition that traditional management and financial information systems do not provide full perspective of organisational performance and effectiveness. It contains a number of perspectives: financial, customer, internal business process, staff and organisational learning and/or innovation. The financial information includes more than simple profit or loss, e.g. cost per service delivered, external earnings, cost recovery, etc. Other information includes customer satisfaction surveys to assess the quality of service, staffing capacity and capability, and innovation measures to address the company's long term objectives.

Triple Bottom Line

Companies are also focusing on wider issues of environmental and social impact and the "triple bottom line" approach focuses on three aspects of organisational effectiveness - financial effectiveness, environmental impact and social impact.

Results Based Management in the US: PART

The United States Government introduced the Government Performance and Results Act in 1993 which requires federal agencies to identify both long term and annual goals, collect performance data, and justify budget requests based on this data.

According the website of the Office of Management and Budget:

Initial implementation of the approach did not meet expectations: performance measures were meaningless, vague, too numerous, and often compiled by people who have no direct connection with budget decisions.

In order to improve the value of the performance focus a rating tool has been introduced to assess the effectiveness of federal programmes. The PART questionnaire is administered by the Office of Management and Budget. The PART evaluation covers four critical areas of assessment-purpose and design, strategic planning, management, and results and accountability.

One lesson learned from these reviews, and past efforts, was not to try to do too much at one time. Thus, the administration plans to review approximately one fifth of all federal programs every year, so that by the 2008 budget submission time, every program will have been evaluated using this tool. Initial results from the PART found that many federal programmes are not collecting appropriate information to measure whether they are delivering the intended outcomes.

A key feature of the PART is that departments are required to collect and make use of performance information, so that if the information is not available to demonstrate performance, the programme receives a lower rating. This increases the incentives for federal managers to collect performance information.

However performance ratings are not used to decide on the level of budget allocations. Lower ratings do not automatically translate into less funding for a program just as higher ratings do not automatically translate into higher funding for a program. Instead in some cases poor performance will lead to additional funds to develop better monitoring and evaluation processes.

Undertaking Performance Monitoring and Reporting

This section sets out practical steps for undertaking performance monitoring and evaluation. Performance monitoring is a regular process of monitoring the implementation of a ministry's activities and related outputs, while evaluation is a more in depth process of analysing the efficiency and effectiveness of a ministry project, department or programme.

Programme Performance Monitoring and Reporting

Performance monitoring takes place during the budget implementation phase and involves the collection and analysis of information on a ministry's programme outputs and activities on a regular basis. Governments will be reporting on financial performance on a regular basis and the introduction of a performance basis to the budget means that regular reports need to focus on both financial and non financial information (i.e. physical or service delivery information).

Governments will also be monitoring and reporting on project performance on a regular basis which should include an assessment of both physical and financial performance. The main differences from financial and project performance is the focus on the whole programme, the policies and both recurrent and development (capital) outputs and activities.

This Chapter focuses on performance monitoring for a programme and not individual projects. Thus the performance of both the recurrent and development budgets and their related outputs and activities should be monitored.

The example in Table 40 shows that monitoring the programme performance involves reviewing progress in recurrent and development budget outputs and activities, rather than only focusing on project progress.

Table 40. Example of Programme Outputs and Activities

Programme	Recurrent Outputs	Recurrent Activities	Development Outputs	Development Activities
Youth Skills Development	Curriculum Developed	Stakeholder workshops	Youth Training centre constructed	Tendering for construction
	Trainees Trained	Running courses at Training Centres		Construction of training centre

This involves consideration of:

- What were the activities planned for a particular period, usually a quarter?
- What has been the progress in their implementation against the plan?
- What have been the reasons for poor or good performance?
- What are the issues that need to be addressed in the next quarter?

The table below presents the kind of information that could be produced each quarter to monitor and assess performance and to identify the activities to be implemented in the forthcoming quarter. This monitoring would be linked to the preparation and updating of quarterly work plans and cash flow plans as described in Chapter 9: Budget Implementation.

Table 41. Review of Performance

Outputs	Activities	Qtr 1 Planned	Qtr 1 Actual	Performance	Reasons	Issues to be addressed in next quarter
Curriculum developed	Stakeholder workshops	1	0	The workshops were not held	Delays in contracting curriculum specialist	The curriculum needs to be developed
Trainees trained	Running courses at training centre	0	0	Training to start in Qtr 4 when training centre is complete		
Training centre constructed	Tendering for construction	1	1	Tendering completed	Construction to start in Qtr2	Ensure construction completed to allow training to start

Reasons for poor or good performance can include:

- Delays in the release of funds
- Lack of available staff and/or equipment
- Ineffective management processes, i.e. all the above were available but the activities were not planned by the responsible officials
- Other departments within the ministry or in other organisations did not play their role in the activities

Reporting on performance during budget implementation is most likely to involve reporting on:

- Implementation of activities (both recurrent and capital/development)
- Financial performance (including all expenditure and revenue)

Some of this information may be very detailed and it is important to use and present the appropriate level of information to different users, as shown in the table below.

Table 42. Different Levels of Monitoring Information

User	Information	Use
Technical department	Detailed activity implementation	Analysis of activities, are they in line with planned implementation, what factors need to be addressed in the next quarter
Head of line Ministry	Summary of activity report, with overview of activity and financial performance, highlighting progress and problem areas	For monitoring progress in the implementation of budget, identifying problem areas and ensuring remedial actions are taken. To feed into funds required for next quarter
Director of budget	As above	As above
Cabinet/Parliament	Higher level summary of financial and activity reports	To be informed on progress of budget implementation

The next section presents practical suggestions for undertaking a detailed programme evaluation.

Performance Evaluation

At the stage of performance evaluation, i.e. at the end of the PFM cycle, there should be more information available on a ministry's performance to report on:

- Outcomes
- Outputs
- Financial performance

Therefore the scope of an evaluation will be wider than that of the annual monitoring processes: ideally it will also focus on more than a year's data and will be a more in-depth assessment of an organisation or programme.

This is because:

- There is less time during implementation to undertake detailed analysis of problems and solutions
- It will be more difficult to implement major changes during implementation of the budget: it is likely that they will need approval and further analysis before being incorporated into the following year's plan and estimates
- An in-depth evaluation can provide more information for improving the following year's plan and estimates, in terms of the efficiency of expenditure
- During evaluation, information on outcomes should be available and progress in terms of effectiveness can be measured
- Analysis can also be undertaken of the reasons why government outputs may not result in the expected outcomes during evaluation, which will involve additional research that would not be possible as part of routine monitoring.

The stages involved in undertaking a performance evaluation are described below.

Deciding on the Evaluation Issues and Methods

Where an organisation is undertaking a detailed evaluation it is important to:

Decide on the area to be evaluated: Some of the issues to consider in selecting the appropriate areas include:

- Whether substantial resources are allocated to this area
- Whether there has been a Cabinet or other directive to assess the area
- Whether the area has high public visibility
- Whether the area has strong linkages to other key areas
- If the monitoring information has highlighted problems in implementation
- If extension, termination or postponement of the area has been proposed
- If it has not been evaluated before, or for some time.

Responsibility and process for the evaluation

Once the specific topic is agreed, a decision will need to be made as to who will be responsible for the evaluation (in house or consultants), terms of reference will need to be developed, a steering committee will need to be established to manage the evaluation, and a timetable and budget will need to be agreed.

The scale of the above will be determined by the scope of the evaluation. If it is relatively small in scope, it could be done as part of the tasks of the relevant unit in the ministry. However if it is larger in scope, other organisations would need to be involved and a steering committee set up to manage the inputs from the various organisations.

Different levels of evaluation can be undertaken to meet the different needs of various stakeholders and to respond to interest in a particular issue. In some countries, there is a rolling process of evaluating government programmes, so that within a five year period, all programmes within a ministry will have been evaluated.

Define the evaluation methodology to be used

As explained in the introductory sections, a variety of approaches can be used for undertaking an evaluation including:

- Analysis of existing data
- Collection of new data
- Undertaking case studies
- Beneficiary/stakeholders questionnaires/interviews
- More scientific approaches, such as development of models that enable the effects or causes of the programme including macroeconomic models

The most appropriate approach to be used will depend on the scope and size of the evaluation, for example undertaking a fairly simple evaluation would best make use of existing data, while an extensive evaluation would require the collection of new data, case studies etc.

Programme Evaluation Topics

In undertaking a programme evaluation, there are a number of key topics to be assessed:

- Past performance against planned targets: financial, outputs and outcomes
- The efficiency of programme in delivering agreed services
- The effectiveness or impact of services
- The appropriateness or relevance of the programme in meeting stakeholder/beneficiary needs
- Alternative ways of achieving the ministry objectives.

The sections below cover the types of analysis that can be undertaken for a programme evaluation, using an appropriate example.

Table 43. Example of Programme Outputs

Programme: Youth Skills Development			
Objective	**Outcomes**	**Recurrent Outputs**	**Development Outputs**
To increase the skill levels of youth	Skill levels of youth trained	Curriculum Developed	Youth Training centre constructed
	Youth employment rate	Trainees Trained	

Assessing Previous Performance

At the start of the evaluation process data should be collected on previous years financial and outputs performance and undertake the following types of comparisons:

- Trends in performance. Did performance improve over the period, e.g. did the number of trainees increase over the period?
- Planned versus actual in the current year in financial performance and in the number of trainees engaged
- Among departments/divisions both for previous and current years.

In reviewing these indicators, the assessment needs to focus on:

- The performance in terms of comparison between planned and actual performance
- Identifying the reasons for these variations and identifying issues to be addressed to improve weak performance and/or build on good performance.

The efficiency of the programme in delivering agreed services

The programme can also be assessed in terms of its efficiency in two areas:

- Technical efficiency. Was the technical process the most efficient means of producing the outputs?
- Cost Efficiency. Are there other less costly or most technically feasible ways of producing the outputs?

The performance information (i.e. outputs and activities) can be used to assess the **process** from which the inputs result in the outputs, a determinant of the efficiency with which the department is able to produce or deliver its outputs.

For example, if the planned outputs for a youth training programme is 5,000 youths to be trained, the process is the way in which the training is provided.

In this example, if contracting out the training to a private training organisation was the chosen approach to delivering the training, was this the most efficient approach, e.g. were the largest number of people trained, in the shortest time at the lowest cost?

Assessing the efficiency would involve collecting data on the number of youths trained and the inputs used to deliver the training. This information can be used to assess whether the processes and inputs were the most efficient means of delivering the outputs.

If, for example, the training is undertaken by contracting a training institution to run the courses, the efficiency of the training would be assessed by considering:

- The number of trainees per course: There will be an optimum number of trainees per course. A number that is lower than the optimum is not making the most efficient use of training and a number of trainees that is above the optimum is likely to have a negative effect on the trainees ability to learn
- The cost per trainee per course charged by the training organisation: These costs can be compared with training courses provided by other training organisations

Options for increasing efficiency could include:
- Increased level of outputs (trainees) per course. The courses would be marketed more actively to increase the number of people attending the courses
- Reducing the cost of the outputs. By using an alternative process or strategy, the cost of delivering the outputs may be reduced.

Assessing the Effectiveness or Impact

Assessing the effectiveness of a programme involves identifying whether the policies and activities resulted in the agreed objectives and outcomes, i.e. have they had the intended impact.

In the evaluation phase, the way that the training was delivered needs to be assessed to identify whether the training had the intended outcomes and impact. The training approach should also be compared with alternatives to evaluate whether the outcomes could be achieved more effectively through the alternative options.

In order to evaluate the effectiveness of an organisation's programmes, it will be necessary to have sufficient information on outcome levels. For new activities and outputs there will be a time lag between the introduction of the activity, and the resulting outcome.

Similar to the efficiency analysis, it will also be important to assess the link between the outputs and outcomes. Do the outputs result in the outcomes? Are the government outputs the most appropriate means of achieving the outcomes? Are there more effective alternatives?

As there will be other factors that affect the achievement of the outcomes (e.g. weather, world prices, demand and supply) these will need to be analysed to assess their impact on the achievement of the outcomes and measured to reduce their negative impact or increase their positive contribution. This is similar to the SWOT analysis described in Chapter 4: Planning Approaches.

Other factors that will also need to be taken into account when assessing the outcomes include the impact on other stakeholders affected by the programme, as well as the environmental impact of the programme (as described in more detail in Chapter 4: Planning Approaches).

In the above example, the outputs are the 5,000 youths trained. The outcomes would include:

- The skill levels of the youths who have attended the training
- The number of these youths who become employed following the training
- The number of youths who start their own businesses after the training
- The number of youths who are unemployed after the training

Data needs to be available to undertake this analysis and can be used to assess:

- The skills levels of the people who have been trained. This needs to be measured through a test to assess the skills that have been acquired
- The percentage of the people trained who became employed, started their own business or who remained unemployed
- What are the relative shares of these groups? Are there more trainees in employment or with their own businesses, than those who are unemployed? What can this tell us about the effectiveness of the training?
- What could be the reasons for the poor or good performance at the outcome level? What is the relevance of the content of the courses, quality of trainers, any follow up provided after the courses?
- What are the measures that need to be undertaken to build on a success or address a weakness?

The main focus of the evaluation is to understand why specific programmes and activities have or have not been effective and to identify ways of improving the situation in the next round plan.

The effectiveness of a programme can also be assessed in more depth by undertaking detailed research such as:

- Beneficiary survey to gather information on the effectiveness of youth training through administration of questionnaires to all stakeholders including the trainees, employers, potential employers etc.
- Detailed research on the training methods used etc.

Thus the purpose of the programme evaluation is to create a process of continuous learning, where organisations review their performance and make further improvements to their programmes, rather than continuing to implement the same programmes every year.

Alternative Ways of Achieving Ministry Objectives

In addition to the assessment of efficiency and effectiveness, consideration should be given to identifying alternative ways of achieving the ministry's objectives.

The programme can also be assessed to identify whether it was appropriate. Was it:

- The most appropriate means of achieving government objectives? Could the services be better delivered by NGOs, churches or the private sector? Is the delivery of training services an appropriate role of government?
- The most appropriate means of building skills amongst youths. Are there more effective ways of developing youth skills, such as distance education programmes?

Report the Evaluation Findings

Reporting evaluation findings is a critical. There is little point in undertaking the evaluation if the results are not disseminated to the relevant stakeholders and used in the planning of the next year's budget. The stakeholders can include:

- Programme managers
- Planning staff
- Senior management of the ministry
- Ministry of Finance
- Development partners
- Beneficiaries of the programme.

One of the key issues to be addressed in reporting evaluation findings is how the information is to be used as described below. The findings can be used to:

- Better plan for the next budget cycle based on the results of the evaluation
- Hold line ministries accountable for their performance in the delivery of the outputs and outcomes.

Setting up a Performance Monitoring and Evaluation System

This section describes the suggested steps in setting up a performance monitoring and evaluation system including:

- Setting up the necessary institutional framework
- Defining the indicators to be measured
- Developing the data collection and analysis methods and systems
- Defining the reporting arrangements, including recipients, timing, formats and use of the information.

Overview of a Performance M&E System

Most organisations will be already collecting some form of performance information that can be used in a performance M&E system. Some of this information is collected in a very systematic manner, with specific systems for the collection and analysis of data, including:

- National statistics collected by the bureau of statistics
- Poverty monitoring systems in the Ministry of Finance or a planning ministry
- Some ministries have comprehensive management information systems, often in ministries of education, health, roads, agriculture etc.

Other organisations collect information as part of their daily activities, but this information is not used in a systematic way for measuring performance. These include:

- Regular reports on activities or services provided by the organisation
- Work plans as part of a performance management system.

In addition organisations outside government may also be collecting information that can be used to measure performance, such as NGOs who undertake beneficiary assessments. Therefore many organisations already collect information that can be used for performance measurement.

What is required is to develop an effective system for using this information and making it available to a wider range of stakeholders.

An effective M&E system will make use of existing information collection and reporting systems, bringing them into an integrated system, rather than each line ministry attempting to collect all the information itself.

The performance monitoring and evaluation system needs to take into account the following:

- The institutional framework
- Definition of appropriate indicators
- Deciding on the appropriate systems to collect and analyse results
- Strengthening existing systems and building new systems and processes
- Ensuring that the information is used for planning the next budget cycle activities
- Ensuring that the information is used for evaluating the performance of chief executives and heads of departments.

Setting up the Institutional Framework

The institutional framework for a performance M&E system includes defining:

- **Responsibilities for deciding on the performance to be measured:** Will each department be able to define its own performance indicators or will these need to be approved at a high level within the ministry, by the Ministry of Finance, Cabinet or even Parliament, i.e. when Parliament approves the Budget are they also approving the performance indicators?
- **Responsibilities for collecting, analysing and reporting on performance:** As noted above, different organisations are responsible for collecting and analysing a range of performance information. Mechanisms need to be established to ensure that the various stakeholders are able to provide the necessary information, in the required form and at the appropriate time to feed into the performance M&E system
- **Responsibilities for evaluating performance**: These need to be defined for the various types of evaluation that will take place, i.e. ongoing evaluation of programmes by the departments themselves. Line ministry planning units may undertake more in-depth evaluations, or the Ministry of Finance/planning may undertake detailed evaluations as may donor organisations. Ideally a plan for these evaluations would be developed so that there is no duplication of effort, and the evaluation processes can support each other
- **Accountability:** How will the performance information be used to hold officials responsible or accountable for the delivery of the performance? This also includes the specifics of who is accountable for the performance (i.e. the head of the department)? How (is this official accountable) and to whom (the head of the ministry, Ministry of Finance, Cabinet or Parliament)? When are they held accountable in the process, and what happens if achievement is "unsatisfactory", i.e. what sanctions and incentives will be in place for good or poor performance?

As part of this institutional framework the following issues also need to be addressed:

Creating an environment that values results

Simply putting in place the basic infrastructure (indicators, data collection, and financial management) will not be enough to build and use performance information systems to continually ensure that scarce resources are used most appropriately in pursuit of national objectives.

Other systems may also need to be revised to build in a performance focus such as performance management systems and performance contracts, contracts between central and local government, between government and parastatals etc.

Using the information in decision making process

Ensuring that the system which brings more transparency, accountability, and visibility results in improved budget decision making and management will require significant sensitisation of key stakeholders such as Cabinet, Parliament and civil society.

Likewise, the information from an M&E system is crucial to those outside the sector who are expecting results, wanting to see demonstrable impact from government programmes (and taxes), and for building trust that the government is indeed, striving to better the life of its citizens.

Integrating the performance focus with wider reforms

In the medium to long term, there are wider public service implications for moving to a performance focus which are necessary to make the shift sustainable. In the longer term an increased focus on performance and accountability needs to be matched with increased freedom for managers and organisations to manage their resources, so that they can make the best use of limited resources in order to deliver the agreed results.

This involves reviewing the existing frameworks for financial and personnel management (which are usually covered under civil service reforms) to develop a medium term plan for providing ministries and managers with greater freedom, but within a framework of sufficient aggregate controls and accountability mechanisms.

Agreeing on Indicators to be Measured

As noted above defining appropriate indicators is a key part of an effective performance system. If there are too many indicators the system can become unmanageable. If the "wrong" indicators are being measured perverse incentives can arise, and if indicators are not measuring the priority issues within a department or programme, the real impact of government services will not be measured.

In addition to defining the indicators, the specification of the indicators is also an important part of the process, particularly where there are many parts of an organisation collecting data on the same issue.

In setting up systems to collect performance data the following issues need to be taken into account:

- Clearly defining what is being measured so that issues that will provide useful feedback on performance are monitored. There is no point in putting a lot of effort into collecting information on issues that are not relevant to key areas of performance
- Ensuring that the process of data collection starts with a few key areas rather than developing large systems that collect a lot of information that is not analysed and used in the planning and policy making process
- Where different people are collecting the same data in different locations (e.g. school enrolment), that the information is very clearly defined so that everyone is collecting the same information. For example, if district officers are collecting information on the number of crop demonstrations that have been undertaken, the scope and type of crop demonstrations needs to be defined so that all offices are collecting the same information.

Reviewing and Establishing Data Collection Systems

Once the indicators have been agreed upon the next step is to assess:

- Existing systems: Whether information is already being collected to report on these indicators, and if so is the data accurate, relevant and collected on time.
- The need for new systems: To collect the data currently not being collected.

Existing systems (e.g. an education management information system) needs to be assessed to ensure that the data is accurate, timely and in the appropriate format for use in a performance M&E system. The issues to be considered include:

- Does the system collect and report on data that can be used to measure performance for the agreed performance indicators?
- Is this data accurate?
- Does it cover the necessary scope, by geographical area, type of beneficiary, agro-climate zones etc?
- Is the frequency and timing of the data consistent with the requirements of a regular reporting system, i.e. if a ministry is to report to the Ministry of Finance on a quarterly basis, is the existing information produced on a quarterly basis?
- Are the systems for collection and analysis effective? Are there areas where these could be improved? For example what kind of computerised systems are being used to store and analyse the data?
- Is the information currently presented to key stakeholders including decision makers? Is the format in which it is presented useful?
- Is the information used for policy analysis and planning? If not, why?

Collecting Information for New Indicators

Plans need to be developed for the collection of data which is not being collected:

- What is the data to be collected, (precisely defined)?

- How will it be collected, what method will be used - from a report or from a survey?
- Who will be responsible for collecting the data, how often?
- How will the data be sent to headquarters or whoever is responsible for analysing the data?

The above analysis may not require the development of a whole new system. In some cases additional data can be added to existing data collection systems. For example, a health information system may be collecting data on patients treated for TB but it will not have a specific set of data for patients treated with ARVs. Therefore this data requirement can be added to the existing data collection and management information system.

There are a variety of data collection methods:

- Staff completing a form on a regular basis, e.g. to report on the number of cheques signed
- Staff preparing a report which includes information on the number of patients treated and analysis of this information
- Undertaking an assessment of a work process, e.g. answering a set of questions about the results of an agricultural demonstration
- Stakeholder or beneficiary evaluations, e.g. workshop participants completing a workshop evaluation questionnaire.

Where there are either no existing systems or existing systems do not cover the information required, new processes will need to be set up to collect the data including:

- Designing the formats for the collection of the data in the field
- Training the staff who are to complete the forms
- Designing the procedures or systems for sending the data to a central point for analysis, including simply sending reports by post or through computer based systems.

Data Analysis

Line ministries will also need the capacity to analyse and interpret the data sent from the field and capacity constraints can be a major factor. Some ministries will need to develop such capacity from scratch while others may need to strengthen existing capacity. This will involve agreeing on the following issues:

- Who is responsible for analysing the data? Will this be the Planning Unit or does the ministry have a specific M&E section?
- What systems will be used to analyse the data, e.g. statistical packages?
- Is there capacity to collect, analyse and report on data? Will additional training be required?
- What form will the analysis take?

Using and Reporting on Performance Data

Reporting on performance needs to take account of the following issues:

- To whom is information provided? It is important to know who the users are so that formats and presentations can be tailored to their needs

- How often and in what format will the performance information be presented? It is important too that such information is provided at the appropriate times, so that it can be made use of, and in a format that meets the needs of the users
- Using the performance information: It is also important that the use of the information is clearly defined at the start so that the information is not collected and then ignored. Ideally the information will be used for both monitoring and reporting on performance and also in the evaluation and planning of future activities.

CHAPTER 12 EXTERNAL AUDIT

Summary of the Chapter

This Chapter describes processes and types of external audit. The Chapter starts by explaining the responsibilities for external audit within government and regional and international audit bodies, with a brief overview of the types of audits undertaken in the public sector.

The next section provides details of the approaches used in the various types of audits – financial audit, performance audit and special audits such as compliance audits. This is followed by a description of the processes followed by an auditor in undertaking an audit, and an overview of the common weaknesses in public sector audit in developing countries.

In the final section the prerequisites for effective public sector audits are outlined and guidelines for the presentation and follow up of audit reports are provided.

Key Issues

External audit is a key stage in the PEFM cycle that involves an independent assessment of:

- The appropriate processes and regulations that have been followed in the implementation of the budget
- Whether the funds spent by the government are in line with the approved budget and revenue collected as planned
- Whether the expenditure has led to the planned improvements in services provided to the public.

Having an independent body to audit government accounts is usually defined in the Constitution and is an important part of the oversight of the Executive, as described in Chapter 2: Institutional and Legal Framework.

There are various types of audit:

- The audit of government accounts at the end of the financial year in which the Auditor General will give an opinion on whether the financial statements are correct
- More specific audits which can include performance audits, financial audits, compliance audits, controls audits, forensic audits, and computer audits.

Some of the common weaknesses faced by external audit organisations in developing countries include:

- Procedures are not always followed, where these are not available or clearly defined
- Difficulties of retaining well qualified and motivated staff
- Audit findings are not always acted upon.

Recent reforms to external audit processes are focusing on improving audit procedures and capacity building initiatives.

Overview of External Audit

External audit consists of systems and procedures that are designed to ensure that:

- The processes of planning and use of public resources conform to laid down rules and regulations
- Line ministries, government agencies and departments deliver the required goods and services as defined and approved by government.

When these systems and procedures are ineffective, there is the likelihood that resources will be misused, misapplied or misappropriated.

External audit therefore has an important function within the Public Expenditure and Financial Management system. The auditing process, together with internal controls are aimed at providing Parliament, government and citizens with reasonable assurance that taxpayers' money has been spent in accordance with the Budget as approved by Parliament and in line with financial regulations, and that public managers and administrators have managed public assets in an efficient and effective manner.

Government Audit Organisations

In most countries the constitution requires the setting-up of independent audit institution (supreme auditing institutions (SAIs), also known as the Auditor General) to audit and review government activities including financial transactions, programme performance and other activities. Audit institutions are answerable to Parliament and their reports are often submitted to Parliament through a Public Accounts Committee (PAC) of Parliament.

The roles and functions of the head of an SAI may include the following:

- Audit of public accounts or annual financial statements
- Audit of foreign exchange transactions
- Examination of accounts of projects and programs financed fully or partly with public funds
- Auditing of statutory commissions, corporations, parastatals and public enterprises
- Examination on receipt of Accountant General's report on public accounts
- Submission of special audit reports to Parliament
- Submission of Auditor General's report to Parliament.

There are a number of international and regional Audit Bodies including The Southern African Development Community Organisation of Supreme Audit Institutions (SADCOSAI) that was established as an independent organisation in 1991. Subsequently, in 1996, the Assembly of English Speaking Supreme Audit Institutions in Africa was conceived as a loose association of Auditors General at the initiative of the International Organisation of Supreme Audit Institutions (INTOSAI). With effect from 1 January 2005, the Auditors General agreed to regroup the English speaking SAIs in the region to form one effective organisation called the African Organisation of English Speaking Supreme Audit Institutions (AFROSAI-E) with its own statutes and annual membership fees.

AFROSAI-E currently consists of twenty-one English and two Portuguese speaking SAIs. The governing board comprises of the heads of all the SAIs that are members of AFROSAI-E. Each board member is assigned to one of the four committees that were established to consider and make recommendations on matters pertaining to human resources, finance, audit and capacity building. The organisation is managed and administered from a secretariat situated at the office of the Auditor General in South Africa.

See: http://www.afrosai-e.org.za

Auditing standards are guidelines to aid auditors in fulfilling their professional responsibilities. Public sector audit organisations adopt the Generally Accepted Auditing Standards (GAAS) which focus on:

- Adequate technical training and proficiency
- Independence
- Due professional care
- Adequate planning and supervision
- Proper study and evaluation of internal control
- Sufficient competent evidence
- Reporting standards.

Private Sector Audit Firms

Private auditing firms play a crucial role in auditing the public sector. They are contracted by the government auditor to perform specific audits where capacity is lacking or to assist in meeting heavy work loads. In all cases auditing firms are required to apply and adopt both the government auditing requirements and professional auditing and accounting standards.

Types of Audits

All audits begin with objectives which determine the type of audit to be conducted and the audit standards to be followed. There are two types of government audits, as defined by their objectives, that is, financial and performance audits. However there are also special audits conducted to supplement financial and performance audits as described below.

An Auditor General's Office will undertake two types of audits:

- The audit of government accounts at the end of the financial year (Attestation Audit) in which the Auditor General will render an opinion on whether the financial statements of government are correct
- Audits of specific issues within an organisation which can include performance audits, financial audits, compliance audits, controls audits, forensic audits, and computer audits.

Financial Audits

The purpose of a financial audit is to give assurance that the financial statements are not misleading and that they give a true and fair view of the financial situation of the government, line ministry, department or an agency.

Financial statement audits determine:

- Whether the financial statements of an audited entity present an accurate picture of the financial position, results of operations, and cash flows in accordance with generally accepted accounting principles
- Whether the entity has complied with laws and regulations for those transactions and events that may have a material effect on the financial statements
- Whether financial reports and related items, such as accounts, or funds are fairly presented
- Whether financial information is presented in accordance with established or stated criteria
- Whether the entity has adhered to specific financial compliance requirements.

Financial related audits will include the audits of all the sub systems of the accounting system including but not limited to: payroll system; acquisition and payment systems; computer based systems; procurement procedures; inventory; capital acquisition' and payment procedures. Audits may also include projects and programmes financed fully or in part from public funds and external resources.

Performance Audits

Performance audits examine the extent to which government programs or activities have achieved expected performance. It is a systematic process of objectively gathering and evaluating evidence about the performance of an organisation's operations, services and functions.

Therefore the process provides information and assurance about the quality of the management of public resources. It assesses the economy, efficiency, and effectiveness of the operations of organisations by examining resource use, information systems, delivery of outputs, and the impact or outcomes.

There are two main types of performance audits:

- Economy/efficiency audit
- Programme results audit

Economy and Efficiency (Productivity) Audits

The purpose of this type of audit is to assess the economy and efficiency of the use of public resources. It involves a review of management systems and an evaluation of the economy and efficiency of operations to determine whether:

- Resources are necessary and sufficient for operations at authorised service levels
- The management system provides the capacity for adequate control over costs
- The costs of operations are reasonable, relative to the results achieved.

Economy and efficiency audits include determining:

- Whether the entity is acquiring, protecting, and using its resources (such as personnel, property and space) economically and efficiently as well as the causes of inefficiencies or uneconomical practices

- Whether the entity has complied with laws and regulations concerning matters on economy and efficiency.

Economy and efficiency audits may, for example, consider whether the entity:
- Is following sound procurement practices
- Is acquiring the appropriate type, quality, and amount of resources when needed at the lowest cost
- Is protecting and maintaining its resources
- Is avoiding duplication of effort by employees and work that serves little or no purpose
- Is avoiding overstaffing
- Is using efficient operating procedures
- Is using the minimum amount of resources (staff, equipment, and facilities) in producing or delivering the appropriate quantity and quality of goods or services in a timely manner
- Is complying with requirements of laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources
- Has an adequate system for measuring and reporting performance on economy and efficiency.

Programme Results Audits (Effectiveness)

A programme audit aims to assess the effectiveness of the operations of organisations in producing outputs and intended outcomes. It involves the review of the management system and an evaluation of the results of the organisation's operations to determine whether:
- Goals and objectives are appropriate to the entity's mission and activities
- The goals and objectives structure are internally logical
- The management system provides the capacity for adequate control over programme results
- The entity effectively is achieving its stated goals and objectives
- Operations result in a new benefit to the community.

Programme audits include determining:
- The extent to which the desired results or benefits established by the legislature or other authorising body are being achieved
- The effectiveness of organisations, programmes, activities, or functions
- Whether the objectives of a proposed new, or ongoing program are proper, suitable, or relevant
- Any factors inhibiting satisfactory performance
- Whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost
- Whether the programme complements, duplicates, overlaps, or conflicts with other related programs
- Ways of making programs work better
- The adequacy of management's system for measuring and reporting effectiveness.

Special Audits

There are special audits conducted to supplement financial and performance audits namely:

- compliance audits
- controls audits
- forensic audits
- computer audits.

Compliance Audits

This form of auditing involves checking individual transactions after the fact to ensure that the appropriate authorisations and documentations have been complied with. It involves a review of management procedures and of operations to determine whether:

- All expenditure is properly authorised
- All activities required by policy are being carried out
- The management systems provide for adequate control and compliance with applicable laws and policies
- Operations actually conform to applicable laws and policies.

Fraud and corruption are often identified through compliance audits, which are designed to ensure that laws, rules, agreements and regulations are observed. Non observance may point to a fraudulent transaction, although not all cases of non observance are fraudulent.

Controls Audits

Controls audits are designed to ensure that appropriate controls are in place and are functioning as designed. Controls audits can have features built into them to ensure that fraudulent transactions are flagged or made difficult, if not impossible, to transact.

Forensic Audits

Forensic auditing has been developed to deal with corruption and fraudulent activities that the normal financial and programme audits are unable to detect. For example the use of computer technology to conduct criminal activities exceeds the audit skills required to conduct a financial or compliance audit, and this presents new challenges to the auditor.

Computer Audits

Computer audits are designed to provide assurance that computer generated financial records were correctly prepared and comply with the accounting policies and standards of an organisation.

Computer audits explore the risks associated with equipment malfunction, system design errors, calculation correctness, and human error, and these together will provide assurance that the computer systems will deliver accurate and correct information. Computer audits can also be designed to test whether laws, rules, and regulations are observed correctly, making a computer audit potentially useful in detecting fraud and corruption.

Stages in the Audit Process

Auditing is carried out in stages: audit planning; information gathering; assessing risk; identify internal controls; evaluating and testing controls; developing observation/findings; and audit reporting as described below. The methods used to carry out the phases can vary among auditing organisations around the world.

Audit Planning

Preparation for the audit involves determining the scope of the audit, the timing of the audit assignment, identifying staff for the assignment, and also determining whether there is the need to contract a consultant or an expert to augment the team. Assigning the right calibre of staff to the assignment is important so as to ensure audit efficiency and meet acceptable auditing standards. The plan should include logistics and the budgetary support necessary for the assignment. This stage will assist the auditor to develop an effective and efficient audit plan and audit program.

Gathering information

The audit generally begins with what is referred to as an "entrance conference," which is used to introduce the audit team to the management staff and key employees of the agency that is being audited. The audit team will collect such information as the agency's legal mandate and obligations, by laws, policies, and its relationship with third parties, for example, where the agency is undertaking a special project for a donor, or working together with a non government organisation (NGO) on a project. Information gathered will assist the auditors to understand the functions of the agency and its operations, and thereby familiarise themselves with its plans, budget and policies.

Risk Assessment

Risk assessment involves two steps. The initial step is identifying risks associated with or arising from the activities of the agency, while the second step involves ranking the risks based on their potential impact on the organisation.

Basic risk assessment involves asking questions, for example, how great will the impact be if this risk event occurs? There are two types of risks; "inherent" and "control" risks. Inherent risk refers to risks the organisation faces by the very nature of its activities. Police officers, for example, face safety risks in engaging in law enforcement activities. Control risk assesses the probability of a risk occurring given the control procedures that are in place (or not) to prevent it. Thus auditors assess risks by evaluating the controls and making judgments about whether the controls are likely to be effective or not.

Identify Internal Controls

Internal controls are established by management and administrators to ensure that operational and administrative systems and procedures are efficient and effective. Controls are established to:

- Provide reliable data
- Safeguard assets and records
- Promote operational efficiency and effectiveness in service delivery
- Encourage adherence to rules and regulations.

Thus when controls are absent or weak, the result is that the accounting system is not likely to detect errors and is more likely to produce inaccurate information. For example, in a purchasing system, authorised invoices are checked by an accounts clerk for arithmetic accuracy before processing. The check for arithmetical accuracy constitutes a control.

Evaluate and Test Controls

Generally, control procedures aim to ensure that:
- Recorded transactions are valid
- Transactions are properly authorised
- Existing transactions are recorded
- Transactions are properly valued
- Transactions are properly classified
- Transactions are recorded at the proper time
- Transactions are correctly posted.

The question for the auditor is whether the internal controls identified are adequate and effective and whether to place reliance on them or not. By definition, controls are considered adequate and effective when their existence will reduce the likelihood of errors to an acceptable level. In this case, the auditor will be confident to rely on the controls to conduct the audit. On the other hand the controls could be described as weak, that is, there is the likelihood that errors are being committed. The auditor will then not rely on the controls. Information obtained during the review is then used to identify the adequacy and/or the weaknesses of internal controls and the extent to which the controls can be relied on.

Methods applied by auditors to review and test internal controls include: review of procedures manuals, narrative descriptions of the systems and procedures, flowcharts, internal control questionnaires, and walk through tests where a transaction is followed from its origin to final destination.

Observation/Findings

This is the stage when the auditor records his observations from the evidence gathered, summarise the findings and provide: an opinion on the audit conducted. Generally the auditor will determine whether the financial statements are fairly stated.

For each audit, during the planning stage, the audit team will develop a report format for setting out the audit findings and recommendations. Audit reports may take the form of a complete report that describes the audit objectives and fully describes the conclusions along with the evidence that supports those conclusions, or they may be provided in summary form.

The content of the report will depend on the objective and scope of the assignment and the nature of operations of the organisation being audited.

All audit reports must contain:
- An explanation of the origination or reason for conducting the audit
- Sufficient background on the audited activity to enable readers to understand its findings
- A clear statement of the audit objectives
- A description of the scope and methodologies
- The audit findings, and conclusions
- Comments by management of the organisation on the audit report.

Weaknesses in Audit and Recent Reforms

An efficient and effective audit process provides Parliament, government and/or citizens with assurance that public funds have been spent in accordance with the budget for their intended purpose. However, certain weaknesses constrain the auditor's performance including:

Systems and procedures. Audit rules and regulations are not followed by both the auditor and the auditee often because they are not well defined and sometimes not available.

Logistical support. Lack of logistics such as transport can be a constraint for undertaking effective audits.

Computer technology. This is a major challenge to auditors particularly when Ministries of Finance may have introduced computerised financial management systems while auditors may have little or no training in computer systems and applications.

Adequate staff and training. Often there are insufficient audit staff to meet the workload, and those who are in post do not receive sufficient training and therefore lack the requisite skills for modern auditing work.

Professional qualifications. Developing countries are faced with the difficulty of retaining qualified staff due to low salary levels, and therefore audit offices will often have very few auditors with professional qualifications. This affects the quality of audit work.

Remuneration. Remuneration packages are not attractive enough to attract, retain and motivate auditors.

Findings not acted upon. In many cases the findings of auditors are not acted upon either due to the general lack of accountability within a government, or lack of skills within the organisation being audited to follow up on the audit findings. This acts as a de-motivating factor that can affect the performance of an auditor.

Resident auditors. In some countries, auditors are permanently assigned to line ministries and large agencies and the result is that they may compromise auditing standards.

Most countries are reforming the external audit function as part of PEFM reforms. The reforms are focusing on ensuring that auditing procedures are clearly defined and up to date, audit manuals prepared and implemented and audit staff are trained. Computer auditing is an area where auditors are being trained.

Principles of Effective Auditing

Specific principles and standards for the audit of government organisations and programmes have been adopted around the world.

These were promulgated by the International Organization of Supreme Audit Institution (INTOSAI) the world body of supreme audit institutions (SAIs). These principles and standards have been adopted by all SAIs around the world and are incorporated in a country's constitution and audit laws.

Among the most important of these auditing standards are those dealing with independence, due professional care, audit coverage, professional skills, and due diligence among others.

Independence

In all matters relating to the audit process, it is essential that the audit organisation and its auditors are not influenced in any way by the auditee, that is, government. Therefore the audit organisation and its auditors should be free from personal and external impairments to independence. This is essential to ensure that its work will not be influenced by any relationship it might have with the entity being audited.

Independence will mean that the audit organisation and its work are protected against outside influence, for example, where its mandate and terms of reference have been laid down in the national constitution and audit laws. Again independence also implies that the audit organisation should not be part of "government" in terms of its reporting relationship and must report directly to the institution overseeing its functions, which in most cases is the Parliament.

Government auditors, including hired consultants and internal experts and specialists, need to be aware of their independence and not compromise it.

Due Professional Care

Due professional care should be applied in conducting the audit and in preparing related reports. This principle places responsibility on the audit organisation and its auditors to follow all applicable standards in conducting government audits. They should use sound professional judgment in determining the principles and procedures which are applicable to the audit work to be conducted and follow them through. Where due to exceptional circumstances applicable standards are not followed, the auditors should disclose the fact that an applicable standard was not followed and document the reasons why it was not followed.

Again, exercising due professional care involves using professional judgment in establishing the scope, selecting the methodology, and choosing tests and procedures for the audit.

Quality Control

Audit organisations conducting government audits should have an appropriate internal quality control system in place to guarantee quality of audit assignments conducted. The internal quality control system established by the audit organisation should provide reasonable assurance that it: (1) has established, and is following, adequate audit policies and procedures, and (2) has adopted, and is following, applicable auditing standards.

The nature and extent of an organisation's internal quality control system depends on a number of factors, such as its size, the professional skill of its personnel, the nature of the audit, and its organizational structure.

Audit Coverage

Government audit should cover all public financial operations of revenue, expenses, assets and liabilities regardless of whether they are reflected in the national budget or not. In pursuance of this, government audit should cover all institutions and organisations using public funds whether or not their activities are reflected in the national budget. This would include private enterprises financed by state subsidies, extra budgetary funds and partially or wholly funded parastatals. Government audits should be extended to the privatisation process and general sales procedures of government to ensure due process and value for money in these transactions.

However, there may be organisations and institutions engaged in activities which Parliament and government are unwilling to expose to public scrutiny. Those activities are usually (but not always) involved in national security matters. Auditing these organisations presents special problems because of the need to maintain secrecy of sensitive information. However to minimise this risk the audit organisation should enter into special arrangements with such organisations to safeguard secret information such as a requirement that anyone who is involved in the audit or is privy to the audit results has an appropriate security clearance.

Qualifications and Professional Skills

The auditing function encompasses a wide range of technical skills in areas of accounting, financial management, administration and operations. It is essential that auditors possess the requisite professional and technical skills required for conducting effective and efficient audit. The general rule is that for each individual audit it is essential that the audit team, as a whole, possesses the knowledge and skills required for that particular audit. For example, if the audit organisation is auditing computer related operations, it is recommended that the audit team must include (and preferably be led by) a fully qualified auditor with experience in computer related audits. Where the audit organisation encounters a situation where a specialised skill is required, the organisation should be able to obtain the needed skill outside the organisation.

Presenting and Reporting on Audit Findings

In many countries, the circulation of Audit Findings is specified as part of the laws that have established the audit organisation. In most MEFMI countries, audit findings are to be submitted to Parliament through the Public Accounts Committee and be made available to the public. In most cases, the audit organisation has the latitude to provide copies of their reports to organisations and individuals with interests in the auditee or the topic and also to organisations and institutions that have the responsibility to act on the findings and recommendations contained in the reports.

Professional auditing ethics require that the entity that has been audited should always be informed of the findings and should be given the opportunity to seek clarification and respond to the issues raised before the findings are published. Again it is appropriate to formally inform the Ministry of Finance of audit findings that have budget and financial implications.

Acting on Audit Findings

Generally, and by law, auditors are authorised only to report on their findings, and rely on other organisations and institutions to ensure that corrective actions have been taken on their recommendations. Such corrective actions will invariably involve organisations taking steps to improve their adherence to rules and regulations, reliability of financial and operational data, adequacy of internal controls and the economy, efficiency and effectiveness of programmes and operations.

Organisations and institutions empowered to ensure that corrective actions have been taken include Parliament, the Ministry of Finance, a line ministry, or an operating agency. The auditor may lack the authority to force any of these institutions to act. On the other hand, the audit organization may have the power to order corrective actions for certain kinds of irregularities, e.g. to request the entity or an individual found to be culpable to refund illegal payments or misappropriated funds.

Audit organisations bear the responsibility to encourage and facilitate response to their findings through the following:

Clear findings. Auditors must state as clearly and specifically as possible the nature of the problem they find and the consequences if corrective actions are not taken. They should avoid general, vague, open ended statements which cannot elicit a specific response. The auditor should ensure that the reader of the findings can easily appreciate the nature of the problem and the importance of correcting it. For example, an observation such as "money has been misapplied" is not helpful. They should indicate in their report:

- Which internal controls or policies or procedures were breached or have failed
- How much money was wasted or misapplied because of that breach or failure
- The financial consequences or unintended impact of the breach.

Convincing evidence. The auditor should provide convincing and credible evidence to support his or her findings.

Cost effective recommendations. To encourage effective responses to audit findings, it is incumbent on the auditor to suggest a reasonable and cost effective solution for the problem identified. If there was a failure to observe a specific internal control procedure, for example, the audit report should specify specific action(s) needed to prevent a recurrence. If the solution requires a change in law or regulation, the auditor should describe this with as much precision as possible. Again, it is essential that the suggested corrective actions are cost effective.

Communication and dissemination of audit findings. It is the responsibility of the auditor, to design an effective strategy to communicate and disseminate its report findings in as clear and concise a manner as possible. A well thought out communication strategy helps to convince recipients of the wisdom of acting on the recommendations.

Sanctions for Non Compliance with Rules and Regulations

As noted in the introduction, government audit institutions are answerable to Parliament through the Public Accounts Committee. This constitutional provision firstly insulates the audit institutions from central government and also allows Parliament to apply sanctions and other corrective measures for non compliance with financial rules and regulations. Sanctions for non compliance vary from country to country but will generally involve public officials:

- Being surcharged if their actions and/or inactions caused financial loss to the state
- Being prosecuted in the courts of law
- Demoted to lower ranks
- Dismissed from the civil service.

CHAPTER 13 EXTERNAL RESOURCE MOBILISATION AND MANAGEMENT

Introduction

Summary of the Chapter

This Chapter describes the systems, processes and issues arising in the mobilisation and management of external resources, i.e. aid flows. It starts with an overview of the history of aid mechanisms and flows, and a description of the types of donor organisations and aid instruments.

The next section describes recent initiatives to improve the alignment of donor funds and procedures with those of recipient governments and the harmonisation of donor support as outlined in the Paris Declaration.

The next sections set out the issues in relation to donor participation in all stages of the public financial management cycle including:

- donor funds and policies in the planning stage
- donor funds in the setting of the resource envelope and ministerial ceilings
- donor funds in the budget preparation and implementation stages
- Ensuring that donor funds are reported on and donor funded activities are monitored and evaluated as part of the government M&E systems.

The final section describes the issues to be addressed by MEFMI countries in strengthening their aid management capacity.

Key issues

Developing country governments have been the recipient of significant levels of donor funds for several decades. The form in which these funds have been provided has been changing in recent years from:

- Initially most donor funding was provided through development projects largely managed and controlled by donor organisations and external consultants and then through balance of payments support and policy funding to provide macroeconomic support to governments in fiscal crises, linked to a range of conditionalities, including most recently poverty reduction strategies

- In recent years some development partners have started to channel their funds into governments' own budget priority areas using government systems and procedures

This most recent change to the provision of donor funds (General Budget Support) is linked to a wider initiative known as the Paris Declaration in which donor organisations have agreed to make more use of recipient government systems and to harmonise donor procedures so as to reduce the burden for recipient governments in managing a large number of development partners each with their own requirements.

Making the most of this initiative is a key challenge for developing countries and requires having effective Public Expenditure and Financial Management systems in place. Without such systems donor organisations will be less willing to channel their funds through government systems and are likely to return to project based funding.

This requires that governments have systems in place to demonstrate that scarce resources (both domestic and donor) are allocated and effectively used in line with agreed priorities, and that governments can report on a regular basis with accurate information on the use and impact of these funds.

History of Aid Mechanisms and Flows

Until recently external resources were channelled to recipient governments through two main instruments: projects and programmes which were often linked to conditionalities to be met by recipient governments. Weaknesses in these approaches as described below have led to the introduction of new mechanisms and approaches to the provision of aid to developing countries.

History of Project Support

Projects have been the main vehicle for concessional loans and grants to developing countries, driven by the thinking that investment was the main constraint to growth and that projects were the most effective means of delivering capital investment.

As noted in Chapter 4, capital or development projects have a number of weaknesses some of which relate to the ways in which donor organisations have funded these projects.

These include:

- Projects are often donor driven in that development partners play the major role in the identification, planning and design of projects with limited government and beneficiary involvement
- Projects often involve the establishment of project implementation units separate from government systems, which undermines government capacity and creates incentives for governments to take advantage of the lack of accountability
- There is often no link to government budgets, policies and priorities
- The recurrent costs arising from projects are usually not planned for. Therefore there is no provision in budgets for the running costs of a completed project which usually has to be borne by the recipient government
- Until recently most donor organisations were reluctant to channel their funds through government systems. A large part of the development budget became recurrent in nature, funding activities such as provision of drugs, training and policy advice

- Recipient governments had to manage a large number of projects, funded by a large number of development partners, each with their own procedures, creating a significant management burden for the government (often referred to as transaction costs)
- The conditionalities imposed by development partners linked to the release of funds for these projects created a high degree of uncertainty in the availability and flow of funds
- As such a large proportion of the budget was outside the government's own budget and financial regulations, this was beginning to undermine the accountability of recipient government's systems.

The World Bank Aid Effectiveness Report in 1998 drew attention to these issues, and within the donor community there was recognition of the "fungibility" of funds, i.e. that if donor funds were spent on high priority programmes and activities, governments could spend their own funds on low priority areas within weakening systems for managing public expenditure. This undermined donor efforts to ensure that their funds were spent effectively on priority areas.

One response to this was the introduction of the Sector Wide Approach in which groups of development partners work with the government to support and provide funds to a set of commonly agreed strategies within a sector (see Section in Chapter 3 on SWAps).

History of Programme Aid

Programme aid was linked to the fulfilment of a set of conditionalities by recipient governments, initially through Structural Adjustment Reforms of the 1980s and 1990s by the International Monetary Fund and the World Bank, with support from some of the bilateral development partners. The aim was to support the balance of payments gap and promote economic policy reform at the same time.

There has been significant research into the impact of the conditionalities and although macroeconomic conditions were improved with the aid inflows, the conditionalities themselves appear to have been ineffective in improving economic policies. The main reason put forward for this is that without political commitment to the reforms within the recipient government these reforms will not be effectively sustained. However many of the reforms being linked to the provision of programme aid were implemented, such as economic liberalisation and privatisation.

These assessments of project and programme aid have led development partners to change the nature of aid relationships to one of working with recipient governments in a partnership arrangement and to make use of government systems as much as possible. This coincided with an increased focus on poverty reduction as an overriding objective of aid and the introduction of Poverty Reduction Strategies which provide the basis for the new partnership arrangements (see Chapter 4). The needs of developing countries also changed from one of foreign exchange requirements (as the macroeconomic situation stabilised) to the need to fill the fiscal gap, i.e. the difference between the funding needs and funding availability.

At the same time donor funding mechanisms were modified to address these concerns and general budget support GBS was introduced particularly by the bilateral aid development partners in Europe. Although the exact modalities differ between donor organisations, relatively large volumes of aid are channelled through GBS mechanisms. Multilateral agencies are also changing their adjustment lending away from conditionality driven balance of payments support to budget support through instruments such as the "Poverty Reduction Support Credits" and "Poverty Reduction and Growth Facility".

Coordination and harmonisation of donor support is another key feature of the new approach to aid management as described in more detail in the next section.

Levels of External Resources

When development partners give assistance with a grant element of at least 25% this is classified as Official Development Assistance (ODA). Total official development assistance from member countries of the Development Cooperation Directorate (DAC) fell by 4.5% in 2006 to USD 104.4 billion, representing 0.31% of members combined gross national income (GNI). This was the first fall in ODA since 1997, although it was still the highest level recorded with the exception of 2005.

The reason for this decline was the high level of ODA in 2005 due to the Paris Club debt relief operations. In 2006, debt relief still represented a substantial share of net ODA. Net ODA to all developing countries for projects and programmes fell slightly for the fourth consecutive year and loan repayments exceeded new disbursements, however aid flows to Sub Saharan Africa excluding debt relief rose by 13% between 2005 and 2006.

See: OECD Aid Flows 2006 and Aid Statistics on the DAC website where up to date data can be downloaded.

Despite this increase in aid flows to Sub Saharan Africa it is unlikely at current rates that the pledges made by the Group of 8 industrialised countries (G-8) in 2005 to increase aid by USD 50 billion in real terms between 2004 and 2010 and to double aid to Africa over the same period will be met.

For further information on monitoring of aid flows against donor pledges, *www.africaprogresspanel.org and www.africanmonitor.org.*

Types of Development Partners

Bilateral Development Partners. These are the developed country governments which provide aid funds to developing countries and whose policies are set by their own Parliaments. They are often (but not always) managed from inside the developed country foreign ministry.

Within the group of bilateral development partners there are now emerging development partners such as China which has its own areas of interest and funding mechanisms.

Multilateral banks. Multilateral banks include the World Bank, African Development Bank, and the European Investment Bank which are owned and governed by member-state shareholders.

The European Commission. The European Commission is governed by the European member states and in Africa works under the policy and partnership framework called the Cotonou Convention which covers the period 2000 to 2020. This is a successor to the Lome Convention which covered the period 1975 to 2000.

Global Funds. These are normally focused on one issue and can be quasi multilateral (owned and policies set by a group of donor member countries but usually without African membership) or bilateral (owned by one government) or philanthropic (funded by wealthy people or corporations). Flows of money from the USA (public and private) are increasingly delivered through these types of instruments.

The major Global Funds include:

- The Global Fund for AIDs, TB and Malaria – known as "GFATM"
- The Global Alliance for Vaccines and Immunisation – GAVI
- The Fast Track Initiative (for Education) - FTI
- The US President's Emergency Plan for AIDS Relief - PEPFAR
- The President's Malaria Initiative – PMI
- The Millennium Challenge Corporation (MCC) – a US public sector organisation which works alongside but totally independently from USAID
- The Clinton Foundation
- The Bill and Melinda Gates Foundation.

As well as these main types of development partners, some countries also have public development banks and export credit agencies which provide hard and soft loans and equity to developing countries. These banks and agencies can lend to the public, parastatal and private sector.

The United Nations is speaking strictly not a donor and is governed by the governing bodies of the UN. Each part of the UN has its own board and decision making structure.

International Monetary Fund. The IMF is an international organisation of 185 member countries. It was established: to promote international monetary cooperation, exchange rate stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.

More information can be found on the Development Cooperation Directorate (DAC) of the OECD website: www.oecd.org/dac.

Aid Instruments

Development partners all have different definitions of the ways in which they give aid. There are some attempts to agree on common descriptions of types of aid instruments but these are not binding.

The DAC Guidelines and Reference Series Harmonising Donor Practices for Effective Aid Delivery, Volume 2: Budget Support, Sector Wide Approaches and Capacity Development in PFM OECD/ DAC, provides an overview of the various types of aid instruments.

In addition these are described in Aid Instruments, Foster and Leavy, ODI. The set of development institutions that deliver aid is also referred to as the aid architecture: ODI 2006 Reforming the Aid Architecture.

Project funding involves the provision of a discrete amount of funds for a particular set of activities. Project funding can be either in the form of grants or loans and although some development partners are moving towards the use of new aid instruments many donor organisations continue to use the project approach.

Common funds are usually used in the implementation of Sector Wide Approaches in which several development partners provide their funds into one account which is disbursed and assessed against one common performance framework. Normally these are applied against specific activities and so can be audited separately from government funds.

Sector budget support (SBS): The approaches to sector budget support vary. Sometimes this is used to provide donor funds to a sector but which is then mixed with government funds and not linked to or earmarked to any specific activities. But some development partners define it more loosely and funds are linked to specific activities within a sector. The EC definition of SBS is General Budget Support (i.e. with no earmarking of funds to specific activities) with a policy dialogue and performance framework linked to one sector. The EC does not require earmarking of the flow of funds to the sector.

SBS is not the same as a Sector Wide Approach (known as a SWAp) as described in Chapter 3 on planning approaches. The purpose of a SWAp is to coordinate government and development partners within a sector to achieve agreed objectives and targets. Within the SWAp arrangement a number of different aid instruments can be used, including project funding, technical assistance, programme aid as well as sector budget support, i.e. disbursed through government systems.

General Budget Support: This approach provides aid funds to the Consolidated Fund of government without any earmarking to specific sectors or for specific activities. Participants have included multilateral institutions, such as the African Development Bank, European Union and World Bank, and governments of Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Sweden, Switzerland and the United Kingdom.

The use of the funds is determined in exactly the same way as government own revenue, i.e. governed by a government's own legal, planning, budgeting and accounting framework as described in Chapter 2.

The common attributes of the provision of aid through General Budget Support include:

- Donor funds are paid into the Consolidated Fund as described in Chapter 9 Budget Implementation

- The use of funds is determined by the government's budget preparation processes and is approved by Parliament
- The provision of aid is based on policy dialogue with the recipient government linked to budget priorities
- The provision of General Budget Support should reinforce recipient government ownership of national priorities as reflected in budget allocations
- Provision of General Budget Support should focus on enhancing the performance and accountability of recipient government PEFM systems
- Transaction costs (i.e. the administrative burden of dealing with many development partners) incurred by recipient governments in receiving budget support should be minimised
- GBS should be delivered in a way that improves predictability in the flow of aid funds.

See DAC Guidelines Volume 2 pages 13-14 and the following pages which explain the details of how development partners should put this into practice.

General Budget Support is an important tool to provide governments with flexibility in the allocation of funds, particularly in countries where donor flows dominate the budget.

Development policy lending and investment lending. The World Bank and the African Development Bank have two main types of instruments: budget support (development policy lending) and projects (investment lending).

Development policy loans provide quick disbursing for external financing to support policy and institutional reforms. They typically run for one to three years. Originally designed to provide support for macroeconomic policy reforms, including trade policy and agriculture, development policy loans have evolved to focus more on structural, financial sector, and social policy reform, and on improving public sector resource management.

The World Bank provides all its Development Policy Lending to IDA countries (the world's poorest countries) through its Poverty Reduction and Support Credits. PRSCs tend to be less predictable in the medium term than the budget support from bilateral development partners. The World Bank rarely gives more than 30 – 40% of its programmes in IDA countries as budget support.

Investment loans finance projects in the form of goods, works, and services in a broad range of sectors. They typically run for five to ten years. Originally concentrated on financing hardware, engineering services, and construction, investment lending has come to focus more on institution building, social development, and developing the public policy infrastructure needed to facilitate private sector activity. The World Bank and African Development Bank can now provide recurrent financing through investment loans.

Loans versus grants. The concessional arms of the World Bank (The International Development Association (IDA) and African Development Bank can give soft loans or grants. Soft loans have a long grace period, a long repayment time and low interest rates. Both these banks use the same methodology to assess whether a country should receive all its funding as grants or as loans. The methodology for both Banks is based on the same debt sustainability analysis, which analyses countries' risk of debt distress. This risk is assessed on the basis of the methodology proposed in the joint IMF-World Bank debt sustainability framework (DSF) for low income countries.

Balance of payments support. Balance of payments support was first provided to developing countries in the 1980s by the World Bank and IMF and aimed primarily at correcting problems of debt sustainability, exchange rate over valuation and trade imbalances. In the early years of structural adjustment donor funds financed specific imports, and as governments liberalised their economies this was no longer necessary. The emphasis moved to policy actions to which governments had to agree but there were no limitations on how the funds would be used. These funds were paid into the Central Bank and with no accountability for use of the domestic counterpart portion of the funds. When a donor provided foreign exchange funds to support the balance of payments, this increased the domestic currency available to the government, which could be used to increase expenditures, reduce borrowing or reduce taxes. The choices on how total flows affected the macro balances were normally determined as part of a country's agreement with the IMF.

More recently the World Bank conditionalities associated with policy lending are focused on the allocation of government funds in line with priorities, with less emphasis on the macroeconomic adjustment than was previously the case.

The International Monetary Fund now uses two main instruments for low income countries.

The Poverty Reduction and Growth Facility (PRGF) and the Policy Support Instrument. The framework for the PRGF was agreed in 2000 and requires the IMF to align its conditionality to PRSPs. Under the PRGF, the IMF provides loans as programme financing, linked to macroeconomic and structural conditionality. Normally the PRGF will include conditions to limit the fiscal deficit as well as other key macro targets.

The Policy Support Initiative (PSI) is a new instrument which provides for a policy/technical dialogue and a performance framework but with no financing or programme attached. The PSI has been designed because many countries (often called by the Fund "mature stabilisers") do not need access to funds from the IMF or do not want to borrow from the IMF. But they do want the IMF's advice and the IMF's statements of approval as a signal to the private sector and to development partners of whether a government's macroeconomic management is on track.

Technical assistance (TA). Technical assistance still tends to be defined as a separate type of aid instrument by many development partners, although in practice it simply finances consultants, training etc. The financial flows associated with technical assistance are often not considered in discussions of total aid flows and are therefore excluded from issues of transparency, predictability and value for money.

However the value of TA flows to Africa is significant and should be considered as part of the overall aid flows. In Mozambique the value of TA is half the wage bill but it remains very difficult for government to exert preferences over TA, for example setting limits on TA per sector or even choosing between TA and budget support.

Box 35. Tying of Aid

Aid is tied when the donor requires that the goods and services to be procured with their funds are sourced from a specific country, usually the donor country. This has benefited the donor economies and can be seen as a significant advantage to companies in these countries. However this is at a cost to the recipient countries. It has been estimated that tied aid raises the costs of many goods and services by 15-30%, as governments are not able to seek the most cost effective contracts and may receive goods and services which are not appropriate to their needs.

Recently development partners have recognised the negative implications of the tying of aid and have undertaken to minimise this practice.

The 2001 DAC Recommendation on Untying Official Development Assistance was amended in 2006 and there has been significant progress in the untying of aid. In a report monitoring the Paris Declaration it was shown that of the 34 countries surveyed, 75% of aid is untied.

Common Issues on Aid Instruments

The major issue in terms of aid instruments is the degree to which donor organisations will change from project/programme support to General Budget Support and/or Sector Budget Support. General Budget Support is still a relatively small share of all aid. In Mozambique, for example, it is only about 25% of all aid flows. Although some development partners appreciate and articulate the strong benefits that budget support bring to the management of budget and to building the influence of democratic processes, it also seems that many development partners are becoming wary of providing additional shares of their aid as general budget support.

This seems to be because donor governments view budget support as inherently risky. The risks are perceived as three fold:

- There is a risk of corruption, i.e. that funds will be misspent as development partners do not control the use of the funds
- The risk that donor country constituencies will demand that budget support be stopped abruptly in response to political shocks or events (for example Ethiopia in 2006)
- Some development partners also find it difficult to clearly link improved recipient government performance to budget support and are therefore concerned about their ability to justify additional aid provided through general budget support to their own Parliaments.

While some development partners want to give a higher share of aid as budget support, this is not the case with all development partners. There appears to be a growing consensus among European bilateral development partners to embrace Sector Budget Support, which is broadly a move upstream from projects and from common funds. Development partners appear to see this approach as less risky and less vulnerable to abrupt political decisions.

Box 36. The Pros and Cons of Multi Donor Budget Support Programmes

Multi donor budget support programmes are designed to provide increased budget support. The main benefits of such programmes for governments can include:

- Common benchmarks for assessing the country's performance, based on the country's PRGF and PRS,
- Improved dialogue between development partners/creditors and the government,
- Funding commitments based on government's poverty reduction strategy and MTEF budget process,
- Realistic triggers for performance based disbursements,
- Regular disbursement schedules agreed and followed,
- Common review processes, and reporting, auditing and banking arrangements,
- Regular meetings, timed in order to facilitate the budget process and minimise additional technical work.

The potential drawbacks can include the following:

- Risk of all participants suspending disbursements if the government goes off track with the IMF,
- Conditionalities for disbursements turn into the highest common multiple amongst the development partners and creditors. Donors/creditors may need to be unanimous on whether performance linked triggers have been met,
- Lack of consultation and agreement amongst development partners/creditors which can mean that meetings often focus on donor issues rather than dialogue with government
- Excessive time taken to negotiate a joint framework. In Mozambique, a 21 page Memorandum of Understanding between the government and 15 development partners, required 19 drafts and took more than one year,
- Heavy burdens of joint review processes on key government officials and donor representatives.

See: Empowering Developing Countries To Lead The Aid Partnership: Alison Johnson and Matthew Martin, Development Finance International, February 2005

Donor Alignment with Recipient Government Procedures

Development partners have recognised the weaknesses and constraints imposed on recipient governments having to manage a large number of development partners each with their own requirements. This has led to two initiatives:

- Aligning donor procedures with government procedures as much as possible
- Development partners using harmonised approaches in which groups of development partners work together to coordinate support to recipient governments.

Much of the impetus for these changes has come through the work of the OECD Development Assistance Committee (DAC), Working Party, a partnership that pools the experiences of development partners and partner countries, with the aim of learning lessons and disseminating best practice. DAC's mandate is mainly to provide guidance for the development partners.

Box 37. DAC Task Force Needs Assessment Survey

The DAC Task Force Needs Assessment Survey was undertaken through Task Force meetings and the Needs Assessment Survey was commissioned in eleven countries. The process resulted in recipient governments identifying the donor practices that put the highest burden on partner countries in terms of ownership, aid transaction costs and aid effectiveness.

Respondents were asked to name the three most important burdens with regard to effective aid delivery. The responses were then aggregated into seven categories, as shown below in order of importance:

- Donor driven priorities and systems
- Difficulties with donor procedures
- Excessive demands on time
- Delays in disbursements
- Lack of information
- Demands beyond national capacity

Key Areas for Improvement (in order of importance)

- Simplify procedures and systems
- Harmonise procedures
- Align procedures on partner systems
- Share information
- Untie aid
- Respect national priorities and strategies
- Use of coordination structure
- Rely on budget support
- Rely on SWAps

Source: DAC Harmonisation Guidelines

Using Government Systems and Procedures: Paris Declaration

The most important policy framework with respect to making it easier to manage donor flows is the Paris Declaration on donor harmonisation and alignment (see box below).

This involved a series of commitments made by development partners in 2005 to improve the transparency and predictability of their funding and to increase the amount of funding which flows through the government budget, procurement and audit systems.

Box 38. Paris Declaration

1) **The Paris Declaration goes beyond previous agreements**
More than a statement of general principles, the Paris Declaration lays down a practical, action orientated roadmap to improve the quality of aid and its impact on development. The 56 partnership commitments are organised around the five key principles: ownership, alignment, harmonisation, managing for results, and mutual accountability.

2) **Twelve indicators to monitor progress in achieving results**
12 indicators of aid effectiveness were developed as a way of tracking and encouraging progress against the broader set of partnership commitments. Targets for the year 2010 have been set for 11 of the indicators and are designed to encourage progress at the global level among the countries and organisations adhering to the Paris Declaration.

3) **The Paris Declaration creates stronger mechanisms for accountability**
The Paris Declaration promotes a model of partnership that improves transparency and accountability on the use of development resources. It recognises that for aid to become truly effective, stronger and more balanced, accountability mechanisms are required at different levels. At the international level, the Paris Declaration constitutes a mechanism where development partners and recipients of aid are held mutually accountable to each other and compliance in meeting the commitments will be publicly monitored. At the country level, the Paris Declaration encourages development partners and partner governments to jointly assess mutual progress in implementing agreed commitments on aid effectiveness by making best use of local mechanisms.

Source: www.oecd/dac

Table 44 below presents the list of indicators for the Paris Declaration, the targets for each indicator, an assessment of progress made in each indicator as described in the OECD/DAC report on monitoring the Paris Declaration for 2006 and a recent update which shows progress in 2007.

Although there has been some progress in achieving the targets, there is a need for significant progress in all areas.

Table 44. Progress in Meeting the Paris Declaration

	Paris Declaration Indicators	Targets	Progress in 2006	Progress in 2007
	OWNERSHIP	**TARGET FOR 2010**		
1	Partners have operational development strategies - Number of countries with national development strategies (including PRSs) that have clear strategic priorities linked to a medium-term expenditure framework and reflected in annual budgets.	At least 75% of partner countries have operational development strategies.	Only five governments met the six criteria for sound operational development strategies, with the most common failing being the weak links between a national plan and the actual budget formulation and execution.	Countries with sound operational strategies have increased from 13% to 20%, but also far short of the 75% target.
	ALIGNMENT	**TARGETS FOR 2010**		
2	Reliable country systems - Number of partner countries that have procurement and public financial management systems that either (a) adhere to broadly accepted good practices or (b) have a reform programme in place to achieve these.	(a) Public financial management – Half of partner countries move up at least one measure (i.e., 0.5 points) on the PFM/ CPIA (Country Policy and Institutional Assessment) scale of performance. (b) Procurement – One third of partner countries move up at least one measure (i.e., from D to C, C to B or B to A) on the four point scale used to assess performance for this indicator.	Government PFM and procurement systems have been assessed using the CPIA ratings: 17% of governments surveyed have moderately weak systems, 28% moderately strong. However the analysis shows that PFM systems of the same level of quality are not used equally by development partners: in countries that have moderately strong systems, use of these systems by development partners varies from 14% to 56%	There has been some improvement: 36% or 10 of the 28 countries surveyed have improved the quality of their PFM systems.
3	Aid flows are aligned on national priorities - Percent of aid flows to the government sector that is reported on partners' national budgets.	Halve the gap - halve the proportion of aid flows to government sector not reported on government's budget(s) (with at least 85% reported on budget).	Recipient governments recorded USD 14,861 million in their accounting systems of the USD 19,933 disbursed. For almost all countries and development partners, disbursements were under recorded, sometimes very substantially, as a result of weaknesses of both governments and development partners' ability to release funds on schedule and extent to which governments can record expenditures.	There has only been a small improvement: from 42% in 2005 to 48% in 2007
4	Strengthen capacity by co-ordinated support - Percent of donor capacity-development support provided through coordinated programmes consistent with partners' national development strategies.	50% of technical co-operation flows are implemented through co-ordinated programmes consistent with national development strategies.	Low levels of coordinated technical assistance, often due to lack of government leadership and strategy for capacity development, difficulties of defining what is meant by coordinated technical assistance	There has been progress in this area: the target has improved from 48% in 2005 to 60% in 2007.

	Paris Declaration Indicators	Targets	Progress in 2006	Progress in 2007
7	Aid is more predictable — Percent of aid disbursements released according to agreed schedules in annual or multiyear frameworks.	Halve the gap — halve the proportion of aid not disbursed within the fiscal year for which it was scheduled.	Half of the surveyed governments received 70% or less of the projected disbursements and for some development partners this is worse. Reasons include: development partners not able to provide reliable projections in time and usable form, under inclusion of donor funds in the budget, development partners not realistic about ability to disburse according to schedule, tendency to over estimate disbursements.	There has been an improvement in the predictability from 41% to 46%, however there is far from the target of 71% of funds disbursed as planned.
8	Aid is untied — Percent of bilateral aid that is untied.	Continued progress over time.	Of the 34 countries surveyed 75% of aid is untied.	Untied aid has increased from 75% in 2005 to 88% in 2006 although this excludes donor funded technical assistance and administration costs
	HARMONISATION	**TARGETS FOR 2010**		
9	Use of common arrangements or procedures — Percent of aid provided as programme based approaches.	66% of aid flows is provided in the context of programme based approaches.	Survey focused on use of common arrangements with programme based approaches (PBAs). Showed that increasing number of development partners are using PBAs and SWAps	There has been limited progress in this area: from 43% to 46% of total aid delivered through PBAs.
10	Encourage shared analysis — Percent of (a) field missions and/or (b) country analytic work, including diagnostic reviews that are joint.	(a) 40% of donor missions to the field are joint.	The proportion of coordinated or joint missions remains very low, an average of 18% across countries, most taking place in the area of PFM through PEFA and CFAA. Some governments have taken the lead in declaring certain periods of the year mission free or quiet periods when governments can focus on issues such as budget preparation.	There has been a slight improvement in this area with 20% of missions being joint missions with several donors, and 40% of analytic work.
		(b) 66% of country analytic work is joint.		

Donor Harmonisation

Development partners have committed to work together to reduce transactions costs for governments in their dealings with development partners. The aims of this approach are to:

- Establish joint mechanisms for coordinating donor support
- Setting up sector groups with one donor taking lead in a sector to reduce the number of meetings/coordination governments have with the donor community
- Allow development partners to realise their own efficiency savings by sharing roles and tasks and reducing staffing

Box 39. Tanzania Joint Partnership Framework

An example of such an approach is the Joint Partnership Framework in Tanzania in which all 14 GBS development partners have agreed to a partnership framework memorandum, which outlines principles of cooperation and harmonisation and aims to reduce transaction costs for the government. There are joint processes of appraisal, review and dialogue with the governments. Review of the performance assessment framework (PAF) is structured around working groups to share the burden among the development partners, expected to evolve through poverty monitoring and review process.

With the move away from projects and towards common funds and sector budget support, development partners are having to communicate much better with each other and in many countries there are now quite complex processes for donor co-ordination.

In some countries these processes have stayed informal but in others there are formal structures. There are no common approaches and the structures vary a great deal between countries. The scope of structures also varies between countries from joint decision making to simple sharing of information.

Common Donor Structures and Groupings

European Heads of Mission (EU HOMs) meetings: The EU is run on a “Troika” system with an incoming chair, an incumbent chair and an outgoing chair, with the chair rotating every six months. The EU HOMs meetings discuss and track mainly political and human rights issues under the framework of the Cotonou Convention and normally have regular political dialogue with government. This grouping could signal the first sign of concern with, for example, a political situation and could often be involved in European donor decisions to halt budget support.

European Heads of Co-operation Meetings: These structures are important in some countries and provide a platform to agree common European positions. For example to implement the European Code of Conduct on Division of Labour (see below).

Wider Development Partners Meetings: Often chaired by the UN these can be meetings of the whole donor group that try to reach common positions or discuss issues, normally involving the multilaterals, US and Japan as well as the Europeans.

Structures to Manage Common Budget Support: In many countries where development partners have agreed to one common Performance Assessment Framework (PAF) for budget support there will be a Budget Support development partners group. This group will usually reach collective views on government performance and will often lead a dialogue with government on key aspects of performance. There is usually a government counterpart to the group (e.g. in the Ministry of Finance).

Sector Level Working Groups: In many countries there are groups of development partners that operate at sector level. Such groups can perform a range of functions, e.g. stewarding and monitoring finance, provide policy challenge or debate to government and agreeing coherent policy positions among development partners. In some countries with many development partners, the development partners agree that only one lead donor should represent the development partners in dialogue with government – with the aim of reducing transaction costs and reducing power imbalances.

Division of Labour Amongst Development Partners

In some countries government and development partners have agreed that it should be possible to reduce transactions cost even further by reducing the number of sectors that development partners are involved in. The EU development partners have agreed on a code of conduct that requires each EU donors to only be involved in only three sectors.

Although the sectors are defined quite broadly this can present an opportunity to streamline the interaction with development partners. But there are also risks to fiscal planning, for example if development partners exit very quickly from sectors without making their plans known in the context of the MTEF etc.

Government/Donor Meetings

Development partners will meet with recipient governments on a regular basis for:

- Presentation of government requirements to the development partners (Donor Round Table Conferences, Consultative Group Meetings)
- Regular meetings to discuss and agree on donor funding levels, conditionalities and policy framework
- Regular monitoring meetings to monitor the implementation of PRSPs and the budget.

Consultative Groups (known as “CGs”) used to happen fairly frequently. Countries presented their plans, policies and “financing gaps” and called on development partners to fill the gap. With the move towards budget support and more predictable financing the old style CG has started to disappear. Dialogue with development partners takes place as part of the discussion of the medium term expenditure framework or MTEF and the budget.

Many governments find that they need to meet development partners on a regular basis and have instituted monthly, quarterly or semi-annual meetings (such as the Donor Assistance Group in Ethiopia, the mini-Consultative Group in Ghana, the G14+ Group in Mozambique and the Development Assistance Committee in Tanzania). These meetings are often linked to multi-donor budget support programmes, which have the advantage of focussing on budget support. However, the quality of dialogue depends on the level and degree of engagement of in country donor representatives.

In some cases new types of meetings are being held for governments to put forward their future plans and scenarios, presenting financing gaps in relation to MDGs and showing exactly what could be achieved with more aid. These are called "Resources and Results CGs". On the other hand development partners need to be ready to respond, and many development partners still have top down aid allocation models which are not flexible enough to respond to specific sector plans.

Managing Donor Coordination and Aid Flows in the Public Financial Management Cycle

The Public Financial Management Cycle is presented in Chapter 1: Overview of Public Expenditure and Financial Management. The following sections set out ways in which donor funds should be integrated into and channelled through recipient government systems and processes.

To summarise, donor involvement at the key stages in the PFM cycle:

- **Planning stage**. During the estimation of the fiscal framework, the setting of budget ceilings, preparation of national and sector/ministry plans and priorities, donor information is required on the likely funds to be provided over a three year period for setting ceilings. Donor input and discussion of government priorities is required in the setting of ceilings, links to Poverty Reduction Strategies etc.
- **Budget preparation stage**. Ideally all donor funds would be included in the government budget documents
- **Budget implementation**. Donors are involved in developing processes for release of donor funds into government accounts, internal controls and processes for effective budget implementation, making use of government procurement systems etc.
- **Reporting**. As donor funds are channelled through government accounts, government are able to report on expenditure and inflows, and systems need to be put in place for development partners to report on donor funds outside the government system
- **Monitoring and evaluation**. Making use of government systems for reporting on performance, importance of agreed performance indicators rather than separate indicators for development partners and government, as well as common systems for collecting performance information and for undertaking joint evaluations
- **Audit**. Development partners need to rely on auditor general reports, rather than external audits.

From the donor perspective, donor organisations face their own constraints in their ability to meet the above requirements by their own financial regulations:

- **Planning and setting ceilings.** Donor organisations may be constrained by their own legal frameworks in their ability to provide predictability in the flow of funds for more than one year in advance to support the MTEF approach
- **Budget preparation and implementation.** Donor organisations may also be unable to pass their funds through government systems, if their own governments perceive existence of high level of fiduciary risk (i.e. donor funds will be misspent)

- **Reporting.** Donors need an ability to provide information of donor funds outside the government system
- **Audit.** Development partners may not be able to rely solely on government audit systems and may need to require external audits, so as to minimise the fiduciary risk.

In order to address some of these concerns donor organisations will make use of some level of conditionalities.

Improving Donor Participation in the Planning and Budget Stage

Effective planning and budgeting are dependent on including all donor flows in the estimation of total resources and encouraging development partners to allocate their funds in line with government priorities. This Section describes how development partners need to be involved in the planning and budget preparation stage of the PFM cycle.

The starting point is for governments to have well defined priorities and policies set out in some form of development plan or the Poverty Reduction Strategy, as described below. Governments also need to have realistic estimates of the total resources that will be available over the medium term, including donor funds, and need to be able to make policy choices about the types of donor assistance they seek.

Aid in the Preparation of Plan Documents

The preparation of a plan document, (e.g. Poverty Reduction Strategy, Growth Strategy or sector level investment plan) should involve donor organisations in two ways:

- **Discussion of sector level priorities**. Where development partners are providing significant levels of funding they are likely to want to participate in sector discussions. Conditionalities for aid are often linked to sector level issues
- The plan document should involve the costing of programmes and activities and compare these costs with the available funding, including donor funding. Therefore it is important for development partners to provide information on likely aid flows as an input into an assessment of the funding gap.

Although development partners acknowledge government priorities in principle, there are still difficulties with some development partners/creditors earmarking (1) budget support to specific sectors, thereby reducing inter-sectoral flexibility of funding and (2) sector support to sub sectors or projects, thereby reducing intra sectoral flexibility. Development partners sometimes use earmarking to be able to participate in sectoral reviews and thereby impose additional conditionalities through this process. Sectoral and sub sectoral coordination and review processes can then become very onerous and time consuming for development partners and government alike. Senegal has 23 such groups.

Aid in the Macroeconomic Framework

There are a number of macroeconomic issues that relate to aid management. These include:

- The level and type of aid flows in the overall expenditure framework, i.e. the sustainability of aid flows

- The impact of aid flows on the economy
- Macroeconomic issues and management as part of the dialogue with and conditionalities set by development partners.

Level and Composition of Aid Flows and Sustainability of Aid Flows

Recipient governments will need to estimate the level of funds available as part of developing the macroeconomic and fiscal frameworks as described in Chapter 4: Planning Approaches and Chapter 6: MTEF. In developing the fiscal framework governments will need to estimate the levels of donor flows, from the various donor organisations and also identify the types of aid flows, i.e. grants, loans, provision of in kind support, etc.

This will involve working with the development partners to obtain reliable estimates of donor flows for the period covered by a Medium Term Expenditure Framework (MTEF). As noted in the section above, obtaining reliable estimates of donor flows is problematic.

In addition to obtaining these estimates, governments will also need to make policy decisions on the levels and types of aid to be incorporated into the fiscal framework, including:

- The level of aid, i.e. the degree of dependency on aid flows a government is willing to take on
- The level of borrowing
- The type of aid, the proportion of grants and loans, the types and conditionalities of loans etc.

Levels of Aid

While developing country governments are in need of donor inflows, there can be both positive and negative impact on the economies of these countries.

With the recent increases in aid flows and debt relief, governments need to take account of their ability to absorb these levels of funding.

This is an issue both from a macroeconomic perspective, i.e. the impact of significant increases in government expenditures and inflows of foreign exchange on the economy (on interest rates and the exchange rate, sometime referred to as the Dutch Disease) and also at the sector level, i.e. whether line ministries have the capacity to spend the increased levels of funds.

Recent studies have shown that some governments have saved part of the increased aid flows and used the funds to pay off their debts. See: Foster and Killick, What would Doubling Aid do for Macroeconomic Management in Africa, ODI 2006. However development partners also put pressure on governments to expand expenditure on priority areas such as health and education. The IMF Paper suggests a more smooth approach to spending over the medium term, with aid flows being a stable share of GDP.

Sustainability of Aid Flows

Whether the budget after grants is consistent with a sustainable macroeconomic framework can be a contested area – particularly if development partners are financing a large share of recurrent costs. For example the IMF may argue that this is unsustainable and argue for overall recurrent costs to be lowered, e.g. through wage bill ceilings. Development partners may tend to argue for higher recurrent costs – arguing that aid flows will be sustained and that recurrent costs need to increase to reach the MDGs. Government will normally have to find a balance between these two positions.

Another issue relating to sustainability is whether aid flows are creating unsustainable contingent liabilities (e.g. created by parastatal borrowing).

Borrowing Ceilings

It is important for governments to make clear decisions on the overall levels of borrowing in order to keep their debts sustainable. Governments will establish projections of annual borrowing levels, either in nominal amounts or in terms of the impact on national debt sustainability as part of the budget preparation process. However, in practice these projections may be treated as merely indicative. Some governments are becoming more firm in their borrowing strategies, e.g. Nicaragua and Uganda are setting legal annual external borrowing ceilings, at a level designed to maintain debt sustainability.

Concessionality of Aid

As Highly Indebted Poor Countries (HIPCs) have analysed their debt stock and developed debt strategies as part of the HIPC initiative, they have become increasingly aware of the need to be strategic in the choice of donor funds. Some governments are establishing policies for a minimum grant element on loans as part of a national debt strategy, instead of just relying on a ban on non-concessional borrowing which is standard in IMF PRGF conditions. However, they face difficulties in getting these policies formally adopted and ratified by Parliament, because development partners are not providing enough concessional funds.

Tanzania has enshrined a minimum grant element (50%) for new borrowings in its government Loans, Guarantees and Grants Act of 2003, and has rejected loans which do not meet this level. Other governments have tended to establish a “strong preference” for higher concessionality (between 40 and 65% as a minimum), with some exceptions for essential projects. For example, Rwanda’s latest PRGF loan is for just SDR 4 million or 5% of its IMF quota. Other countries following the same policy are Mauritania, Senegal, and Uganda.

Types of assistance

Many HIPCs have a clearly stated preference for programme assistance i.e. not tied to specific projects. Eleven HIPCs have established multi donor budget support programmes, whereby pooled funds are released on a regular basis, to support poverty reduction spending. While HIPCs welcome these moves, most of them have been led by like minded development partners in the country. The programmes also have several risks which require careful consideration up front, as described in Box 40 below.

Channels of assistance

Developing country governments want aid to be channelled through government systems in line with the Paris Declaration. This can be achieved by shifting towards more programme aid and by ensuring that the Ministry of Finance leads negotiations on all prospective new financing and the Minister of Finance has the sole authority to sign loans and grants. In Burkina Faso and Tanzania, line ministries are required by law to submit a request for any loan or grant to a National Committee responsible for advising the Minister of Finance on whether it can be contracted.

Where developing countries have increased aid monitoring procedures and budget support, this has resulted in higher budget aid flows. In Tanzania, budget accounting for aid has risen from 15% in 1996 to 55% in 2003 (OECD DAC 2002).

Medium Term Estimates of Donor Flows

Under the Paris Declaration development partners have committed to use Government budgeting and planning cycles and to improve the predictability and transparency of aid.

This means that development partners should provide governments with an indication of aid flows for the next three years in advance as an input into determining the resource availability as part of the Medium Term Expenditure Framework (MTEF). These estimates of donor inflows enable governments to increase predictability in the flow of funds over the medium term, although line ministries may not pay as much attention to the two forward years of the MTEF, as described in Chapter 6: Budget Preparation in the Section on medium term planning.

Some development partners might be reluctant to provide this information if the understanding is that these have to be firm commitments for the three year period. As explained in Chapter 4 and 6, the two forward years of the MTEF are indicative figures and are rolled over each year. Therefore projections of donor flows for the two forward years may also only be indicative.

In some countries development partners have their own MTEF processes which set their own fiscal ceilings and so they may well be at a point in their own cycle which makes it hard to be certain about the medium term. Other development partners have annual appropriation (such as the US) so again outer year projections are not firm indications of the likely levels of aid flows.

Organisations such as the IMF and World Bank have extended the programming of their support:

- Programming of concessional financial assistance under PRGF covers a three year period, conditions and triggers are based on annual programmes, two semi annual disbursements, the first on approval of an annual programme and second on completion of mid term review
- World Bank support generally covers fours years (with some flexibility within Country Assistance Strategy), sets annual amounts for poverty reduction support credits (PRSCs). These are then approved annually by the Board, then disbursed against disbursement triggers
- Programming of EC aid is based on a five year horizon with budget support granted on the basis of a three year agreement
- DFID can provide up to 10 year commitments for programmes, including recurrent cost financing and in some countries have 10 year development partnership agreements which give a loose indication of future flows.

Criteria for Deciding Levels of Donor Funds

Development partners decide on levels of funding based on two elements:

- Most development partners have formulae and systems for allocating aid between countries
- The specifics of how these funds are spent are decided upon and outlined in a country strategy document.

Aid Formulae. These formulae often have an element to assess relative performance (better performing countries get a bigger slice of the cake). So if a country's performance does not improve as fast as its neighbour, its aid allocation may be reduced.

IDA Allocation Criteria. The main factor that determines the allocation of IDA resources among eligible countries is each country's performance in implementing policies that promote economic growth and poverty reduction. This is assessed by the Country Policy and Institutional Assessment (CPIA).

The IDA Performance Based Allocations are based on the overall country score (IDA Resource Allocation Index (IRAI)), as well as portfolio performance and governance assessments which constitute the IDA Country Performance Rating (CPR). In addition to the CPR, population and per capita income also determine IDA allocations.

Some development partners have absolute performance systems, so that if the performance of a recipient government is good, then more aid is available. For example at the Mid Term Review of EC Country Strategies, up to one third extra is potentially available for good performers.

There is a need for more flexible donor funds to combat exogenous (e.g. climate or commodity price) shocks or to respond to changes in their own priorities (e.g. as a result of changes of governments or revisions of PRSPs).

Box 40. Managing Uncertainty of Donor Inflows

Uncertainty about volumes of aid has led the government of Uganda to "discount" donor projections in preparing the fiscal framework, i.e. the average amount by which donor disbursements have fallen short of commitment over the last five years, adds realism to the government financing plans and associated monetary policies and targets

Some multilateral agencies, such as the IMF, IDA and EDF, have limited scope to top up country allocations to meet unforeseen shocks, and these additional funds can take time and be surrounded by cumbersome conditions. A few bilateral development partners (eg the Netherlands and the United Kingdom) have contingency facilities or ability to vire funds for flexibility. However, developing country governments rarely have information on these opportunities.

A few HIPCs (Benin, Cameroon) have insisted on including alternative scenarios in PRGF documents to show their need for greater funds to reach the MDGs. Others have agreed more realistic forecasts of "shocks" in PRGF or HIPC initiative documents, but this has not increased donor allocations of contingency funds. As a result, African governments are advocating a special anti shocks facility (Martin and Bargawi 2004).

Country Assistance Strategies

In some cases development partners will be in the middle of their own country strategy process (DFID Country Assistance Plan, World Bank Country Assistance Strategy) and will not have decided on the specific support they will be providing or know what they are doing by sector, but should still have a reasonable idea of the overall resources to be provided to a government.

Each donor has its own approach to developing a country strategy which sets out the framework within which development partners will provide aid to a particular country. Normally they are developed for a 3 – 5 year timeframe, set out the rationale for a donor to chose sectors of focus and explain what resources the donor will commit and which instruments will be used. Most development partners start the process with an early consultation with government, civil society and other development partners and usually require formal agreement by government.

In some countries, as part of the harmonisation process, development partners are producing Joint Assistance Strategies, e.g. Tanzania, and Uganda. The country strategy process is an important opportunity for governments to set out clearly what they want from a donor, e.g. which sectors of engagement, which instruments, etc.

Conditionality and Predictability

One of the biggest risks of having large donor flows is unpredictable behaviour. The actual flows of donor funds can differ from the MTEF projections and budget allocations for many reasons. The main reasons are the application of conditionality and the application of aid allocation formulae.

Conditionality

Historically development partners used conditionalities and the associated threat of withholding funds to encourage changes in economic policies. In practice this means that development partners can have a significant impact on a government's budget if they decided to withhold funds.

Developing country governments want development partners to minimise the number of conditionalities beyond policies designed through PRSP processes, including those under PRGF programmes agreed with the IMF. Governments are particularly keen to discourage bilateral conditionalities beyond PRGF. However, in spite of some progress in streamlining IMF and World Bank conditions, there is no evidence that aggregate conditions are falling (Martin and Bargawi 2004).

Conditions Precedent

Conditions precedent severely delay initial disbursements in many aid agreements. Developing countries prefer development partners to eliminate all conditions precedent except a legal opinion that the agreement conforms to national laws. However development partners frequently impose numerous conditions precedent, including financial and project related institutional conditions such as project implementation units. While recipients continue to advocate removal of such conditions, they have seen little progress.

Recently some development partners have agreed to avoid halting donor flows within the budget year unless there is a very major breakdown in performance, usually a major corruption scandal, human rights abuse or political event.

In practice this means that groups of budget support development partners have agreed to behave as follows:

- To agree with government a performance assessment framework which takes the government's own targets for annual performance (usually a mixture of process and output indicators) and agreeing targets for year n-1
- In year n to assess performance in year n, before the start of budget preparations for year n+1 (for example to review performance in 2006 in April 2007, before budget preparations for 2008 start)
- Based on the assessment of performance to agree firm commitments for budget support well in time for budget preparation for year n +1
- To diverge from this commitment if, and only if, there is a serious breach of trust (often described as a breach of underlying principle).

Applying this approach has seen an improvement in predictability in many countries. The use of a common performance framework by many development partners has also streamlined the burden of separate conditionality frameworks and separate negotiations.

Because budget support is only a small share of aid, this still means that there can be sources of unpredictability from other aid instruments. Governments have started to apply the same approach to sector aid, i.e. using sector specific performance frameworks and making commitments in advance.

There are still weaknesses with this approach and it could still be improved. The common criticisms are:

- From the donor side, it remains difficult and requires discipline to allow performance in year n to affect disbursement in year n+1
- From the government side, the performance framework can be very artificial and focus on a small set of performance indicators (although better than old style conditionality, it can still divert attention from wider approaches to performance management).

The World Bank still has major problems fitting this approach with its own approaches. World Bank PRSCs still require the use of policy specific "prior conditions" and "triggers".

Predictability

The DAC Guidelines on Donor Harmonisation include good practice for improving the predictability in aid disbursements:

- Review of performance should be prior to the period in which the funds will be disbursed, i.e. the year before the budget year in which the funds will be released
- The conditionalities and process of meeting conditionalities should be clear
- The HIPC Initiative is unusual in that once a government reaches a completion point, budget support will be provided as the government will have already met the conditionality requirements through reaching the completion point
- Development partners should avoid using the same disbursement criteria, so that if there is an issue with one conditionality criteria, not all donor funds are delayed by the same issue

- Avoid a situation where all development partners have to agree on the interpretation of the implementation of the conditionalities. Development partners in a joint framework agreement could agree on the circumstances under which their support would be adjusted on a collective and individual basis
- Identify performance problems early before the point at which they would affect the disbursement of funds
- Allow for partial disbursements in case of partial fulfillment.

There is always a risk of unpredictability with donor flows and so the macro framework needs to consider this, in particular to consider ways to ensure that unpredictable flows do not hinder service delivery. In the context of high aid dependency and possible aid volatility then a dialogue with the IMF should include:

- How the fiscal target is set, if the target is a deficit before grants then there is a risk that unexpected aid flows can't be spent. For countries with high aid flows it makes more sense to target net financing (i.e. the government's recourse to the banking sector)
- Whether there is an adjuster and whether it is big enough to smooth probable fiscal shocks, IMF programmes allow governments to increase domestic borrowing up to a certain limit in the event of a shock (e.g. a natural disaster or if donor funds are less than expected).

Furthermore, while development partners make pledges at Consultative Group or Round Table meetings, their ability to make actual disbursements is weak. As a result, some development partners have huge pipelines of undisbursed funds (the EU's is currently •20 billion). At a country level, this can lead to disbursement shortfalls of 30% compared to pledges (as in Ghana).

Mozambique and Tanzania have improved predictability of budget support disbursements by liaising more closely with development partners through MDBS processes. Tanzania has also advanced its aid projection exercise by two months to allow more time for improved forecasting of external resources. Uganda and other HIPCs have another strategy. They ignore donor disbursement projections as being too optimistic, and instead 'discount' them in the budget to lower levels, which reflect past donor performance.

The third problem in this area is that many development partners disburse funds late in the developing country's budget year. To overcome this, Bolivia, Tanzania and Uganda have requested development partners to front load budget support at the beginning of the financial year. In Tanzania, this has increased first half year disbursements of budget support to 80% in 2003-04, improving budget implementation.

Moving from MTEF to Budget Ceilings

Much of the aid indicated in the MTEF will be "off budget," i.e. not included in the budget documents as approved by Parliament and managed outside government budget implementation systems. This means that the figures for donor funds will differ in the budget ceilings or MTEF and the actual budget documents. Thus it is difficult for the Ministry of Finance to exert control over the total funds being used by line ministries during budget implementation. In some countries this is addressed through publishing annexes in the budget documents that show the donor funds that do not pass through the government system.

These problems highlight the need to have a large part of aid as budget support and ensuring that as much as possible of the remaining aid flows are managed through the budget and subject to budget management discipline.

Government Actions to Improve Donor Funds in Budget Ceilings

Despite these constraints it is important for governments to capture donor flows in an MTEF. This will allow government to adjust sector ceilings/allocations taking account of aid flows to different sectors, negotiate with development partners to move into and out of under and over supported sectors, and develop overall allocations that reflect the desires of government and not of development partners.

In order to achieve this, governments need to:

- Give development partners advance notice of the MTEF process and when they will need to give information, making reference to the commitments in the Paris Declaration
- Encourage development partners to make any major decisions about exit or entry into new sectors before the MTEF or setting of ceilings starts
- Make sure that commitments come from the most senior level of the donor agency possible, and if necessary ask for confirmation from headquarters
- Build the information up from the sector level and verify top-down management of the donor organisation
- If necessary, have discussions mid way through the process to determine if development partners are prepared to reallocate funds to meet government's desired ceilings.

Donor Practices and Concerns During Budget Implementation

The budget implementation stage is when donor organisations are most likely to resist using government procedures and systems, as this involves giving up control over the use of their funds.

Even where development partners are still in control of their funds during budget implementation there are some processes that can be put in place for recipient governments to have increased predictability and transparency in the flow of donor funds.

Improved donor practices during budget implementation include:

- **Cash flow plans.** Development partners need to provide an indication of the timing and the volume of donor funds by type of funding to feed into the government's own cash flow plans (see Chapter 9 on Budget Implementation).
- **Disbursement procedures.** Under General Budget Support funds are transferred to the government's account and released according to government regulations. Where funds are reimbursed to governments after payments have been made the procedures for claiming these reimbursements can be very cumbersome and lead to delays in the release of funds by development partners. Some payments will be made directly by development partners for project support, technical assistance, food aid etc. Development partners need to provide information to the recipient government on these funds to enable a comprehensive picture of total resources provided to the government.

- **Internal controls and procurement processes.** As indicated in the Paris Declaration development partners are being required to make more use of government systems where possible. As noted below where development partners have concerns about government systems, efforts need to be made with the recipient governments to improve the systems.
- **Management of bank accounts.** Where separate bank accounts are held by development partners, they need to provide information to the Accountant General on these bank accounts so that governments have a total picture of funds which have been approved for its use (i.e. even if these funds are provided directly to projects) in the banking system.
- Where funds are outside the government budget systems, the donors should **provide regular information to government on flows and uses of these funds**, covered under Section on reporting.

Donor Disbursement Procedures

Donor funds can be disbursed to recipient governments in a number of ways:

- Budget support: funds are disbursed into the government's accounts
- Advance cash payments: prior to funds being spent and linked to specific activities
- Cash advances linked to availability of government matching funds or counterpart funds
- Reimbursement based on claims, i.e. after funds have been spent
- Direct payments by development partners.

Advance cash disbursements have the advantage of providing funds immediately, whereas donor reimbursement based on claims can cause lengthy delays and heavy documentary requirements. However, there is little evidence that development partners are being more flexible in this respect.

On the other hand, direct payments by development partners to foreign suppliers are highly problematic, as governments are often not informed of the actual disbursements. This is especially true for technical assistance provided by expatriate experts, who are hired and paid by the donor, and for food/emergency aid, which is provided as aid in kind. Some governments have instituted a quarterly survey system which allows them to track all these payments, even if they do not go through the budget, in order to have a more comprehensive ability to monitor aid flows.

Procurement procedures

The aim is for developing country governments to strengthen their own procurement procedures and capacity so that all development partners adopt them, thereby eliminating multiple donor procedures. A number of governments, such as Ethiopia, Mauritania and Uganda, are taking the lead in developing national procurement procedures. The DAC 2005 survey results show that 34% of development partners have adopted national procurement procedures for project aid, although there is a wide variation between countries, and most development partners continue to insist on their own procedures.

There are efforts to harmonise donor disbursement and procurement procedures and improve co-ordination. Various developing countries (14 African countries) have completed national harmonisation and alignment action plans to provide a framework for improving donor performance. However, these initiatives are seen as focusing more on harmonising donor procedures, rather than on aligning development partners behind HIPC government procedures. They are also seen as too focussed on the miniature procedures rather than sufficiently considering the larger policy issues.

Changing Donor Behaviour

In practice development partners (except the US and Japan) do seem increasingly prepared to have their aid managed through the budget. But there are still constraints and problems.

The main problems seem to be:

- Development partners have to adhere to the discipline of the annual budget cycle, i.e. must have the information on projected aid flows ready with firm commitments for the forthcoming budget year, for all types of donor funds. In Mozambique all the G19 budget support development partners have committed to make firm commitments before the budget process starts. In practice this means that by the end of May in year n, all development partners must have planned and organised their own headquarters to approve funds for year n+1 (starting in January). This has not been easy but is starting to work
- Development partners will need to be familiar with normal end of year fiscal management, when development partners put any unspent funds into project bank accounts or common-fund bank accounts, so that these funds can be rolled over. This is not the same for aid managed through the budget (assuming no roll over)
- This means development partners have to improve their own capacities for cash management and agree cash disbursement plans with government
- Development partners must adhere to the audit requirements of government or funds must be tagged in electronic financial management systems in such a way that donor audit requirements can be easily managed, while development partners develop confidence in government led audit.

Managing Fiduciary Risk

One of the reasons that different development partners are moving at different paces to put aid through country government systems is because they have different levels of risk tolerance. Development partners as a group do not yet have a common view on whether using government systems is actually more or less risky than using imposed project management systems. Some development partners point to the strong evidence of corruption associated with isolated project management approaches. But others have Parliaments and managements with very low willingness to expose funds to the possibility of corruption by developing country governments, fearing a wider backlash against aid and aid budgets.

Most development partners make decisions about using government systems based on a risk/return assessments, i.e. balancing risks with the benefits to governments of alignment. Before putting aid through government systems nearly all development partners will require some kind of assessment of risk. For budget support development partners there is now agreement to use a common methodology to do this, the PEFA as described in Chapter 1: Overview of PEFM.

As well as the PEFA there is an agreed OECD methodology for assessing procurement risk. This method is being adopted by the World Bank for its Country Procurement Assessment Reviews.

While the PEFA and the Country Procurement Assessment Reviews provide common assessments the process does not involve a common response from development partners. Different development partners will still react differently. Some development partners will make decisions at country level, while others will require decisions to be taken at their headquarters.

At the sector level development partners will also assess sector specific fiduciary risk, i.e. systems within a line ministry, normally issues such as procurement, corruption and financial management standards. The World Bank probably requires the most rigorous approach and has specific methodologies for looking at procurement and financial management standards.

In response to fiduciary assessments, development partners may insist on safeguards before proceeding. Safeguards are meant to provide a halfway step towards using government systems, i.e. they are actions that development partners require to buttress government systems and reduce risk. Safeguards can be a mix of ex ante and ex post actions.

Examples of safeguards include:

- Agreeing to use government procurement laws but requiring independent procurement firms to operate all procurement
- Agreeing to put money through the treasury but requiring independent audit
- Requiring procurement audit
- Putting funds through government systems but asking for audits more frequently than the normal audit plan/cycle would allow
- Insisting on Public Expenditure Tracking Surveys (see Chapter 9 on Budget Implementation)
- Insisting on value for money audits.

Monitoring and Reporting on Donor Flows

The monitoring and reporting of donor activities and flows involves a number of aspects:

- Monitoring the implementation of improvements to the provision of donor assistance, including the monitoring of the Paris Declaration
- Monitoring the implementation and impact of donor funded activities through regular monitoring activities and detailed evaluations
- Reporting on the use of donor funds, both by donor organisations to their own Parliaments and within

Monitoring and Evaluation of Donor Funded Activities

Donor organisations have their own monitoring and evaluation processes to assess the impact of their assistance to developing countries. These processes are undertaken through:

- Regular reports by country staff on overall progress and specific projects
- Missions to recipient countries to monitor progress in the field
- In depth evaluations of specific topics usually contracted to teams of consultants
- Development partners are also working with civil society groups and research organisations to undertake more qualitative research on the impact of donor assistance, particularly in seeking the views of beneficiaries.

Most donor organisations spend significant resources on the monitoring and evaluation function and will have dedicated departments with this responsibility. However the fact that each donor organisation has its own M&E functions and approaches has placed a heavy burden on recipient governments in terms of meeting these needs. In addition, the use of external consultants to undertake M&E activities does not assist in building the capacity and systems of recipient governments and results in parallel processes.

As explained in the Section on donor harmonisation above, development partners are now being encouraged to collaborate in their monitoring and evaluation processes through:

- Scheduling joint missions of visiting donor staff
- Undertaking joint donor evaluations of donor supported projects/programmes with full involvement of the relevant government officials
- Using and building government monitoring and evaluation systems rather than setting up or requiring separate systems.

However as noted in Table 44 there has been limited progress in this area.

Reporting on Donor Flows

One of the key issues facing governments in managing donor funds which are outside the government systems is the lack of up to date information on the levels and types of these flows. Governments require information from donor organisations on:

- Previous levels of inflows to be used in analysis of performance and reporting
- In year levels of inflows so as to produce comprehensive reports on financial performance
- Projections of future inflows.

In recognition of the importance of providing recipient governments with this information, performance indicators have been included in the PEFA PFM Performance Assessment Framework as explained in Chapter 1.

Some of the issues that recipient governments face in using this information include:

- How to include information on donor funds which are off budget, i.e. do not pass through the Consolidated Fund. One approach is to include annexes in the main budget document which present data on aid funds outside of the budget. This is covered in Chapter 6 on Budget Preparation, Principles and Processes
- Including aid funds which are off budget in the government accounts. Work is currently underway in developing public sector accounting standards (IPSAS) which will set out disclosure requirements for recipients of aid, and aim at improving reciprocal provision of information by donor organisations and recipient governments
- Ensuring that there are systems in place for capturing, analysing and reporting on the funds which are not in the main government accounts. There are a number of options:
- the systems that are used for debt recording can also be used for capturing data on all grants, loans, assistance in kind
- accounting systems may be modified to capture these funds
- bespoke systems can be developed to fit the particular needs of a government

Strengthening Government Aid Management Capacity

How aid is delivered and managed and which instruments are used will have a critical impact on the overall transparency, predictability and efficiency of the budget.

With donor organisations acknowledging the importance of enabling recipient governments to take ownership of setting national priorities and the aid agenda, there is an opportunity for governments to take the lead in the aid management process.

Some MEFMI countries are now making very firm statements about preferred instruments and are taking more control of aid management, through new aid management units.

Box 41. Maximising Aid Effectiveness (AE) in Rwanda

This website is designed to assist the Government of Rwanda and its development partners implement the Aid Coordination, Harmonization, and Alignment (ACHA) framework through informational exchange and dissemination. It provides a centralized depository of resources which serve to improve the planning and execution of development activities. The overall objective is for stakeholders to provide each other with mutual support in the achievement of the targets set out in: the Economic Development and Poverty Reduction Strategy, Vision 2020, and the Millennium Development Goals.

http://www.devpartners.gov.rw/

The sections above have identified ways in which governments can take the lead in managing aid, all of which require an effective aid management capacity within governments.

The elements required for developing an effective aid management capacity within governments include:

- Develop institutional capacity for aid management, i.e. broadening the scope of aid management from simply recording donor flows and individual negotiations with donor organisations to include an ability to set the aid agenda with development partners
- Develop a clear aid policy that sets out the preferred aid instruments and mechanisms for dealing with development partners, coordination procedures and reporting mechanisms
- Ensure that there is clarity in responsibilities for aid management, as aid management is a multi organisational task within government and will require effective coordination and strong leadership
- Ensure that the Ministry of Finance has strong oversight of agreements between line ministries and development partners outside government budget and that information is kept in the Ministry of Finance
- Ensure that even new types of donor flows are managed within government systems, e.g. Global Funds and the Millennium Challenge Account
- Learning and networking with other countries.

Capacity for Aid Management

For developing country governments to take the lead in aid coordination and management significant capacity building will be required. This means changing the current focus of aid management divisions from negotiation and management of individual donor agreements, to one of developing and implementing an aid policy, as described below.

This may require an expansion in the size of the division or units currently responsible for aid management and the recruitment of staff with new skills, such as negotiation skills. These divisions will need the capacity to assess different aid options, to critically evaluate the quality of aid, and develop government policies on aid management. Building this capacity will involve a combination of training, improvement in aid management tools such as aid databases, and compiling compendia of donor procedures and policies, as the basis for evaluations.

Some countries will need assistance with institutional reforms to improve coordination of aid management across government agencies and make changes to regulations and procedures for the planning and approval of donor agreements within governments. As noted above some governments are enforcing rules to prevent line ministries signing agreements directly with donor organisations.

Developing recipient government capacity is also important at the regional level, through organisations such as MEFMI and others such as the New Partnership for Africa's Development (NEPAD). These organisations also need to have the capacity to assess the quality and impact of aid. It will also be vital that regional development banks and sub regional funding institutions focus more closely on enhancing aid quality.

Use of Technical Assistance

Technical assistance is one component of donor support and as noted in the review of the Paris Declaration most recipient governments are not fully in control of the recruitment and management of consultants. Box 42 below presents the DAC best practice on capacity building and the use of technical assistance.

Box 42. DAC Best Practice in Capacity Development and Use of Technical Assistance

- Make capacity development an explicit cross cutting focus and ensure all donor support is driven by national strategy and priorities
- Avoid overloading government capacity with too many simultaneous change initiatives, prioritise and sequence
- Strike a careful balance between (i) efforts to fill gaps and to accelerate progress in achieving results, and (ii) the need for longer term efforts to strengthen government institutional capacity
- Distinguish between the different roles for technical assistance and avoid overloading it with conflicting objective (e.g. external expertise may be needed to fill short term gaps but expecting the same experts to train their successors rarely works

- Use national and regionally available expertise where appropriate
- Use and strengthen local procedures for prioritising and managing technical assistance and increase the government' s discretion over the use of technical assistance resources
- Increase collaboration among development partners in supporting capacity development (e.g. coordinate and pool resources)
- Recognise that effective capacity development and use of technical assistance is often problematic and ensure that sector reviews and sector dialogue pay special attention to learning about and (increasing) effectiveness

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Aid Policies

Most developing countries lack a formal external financing policy on aid, except on concessionality and priority sectors. This allows development partners to maintain the leading role in driving the quality of aid flows. It also makes it very difficult for developing country governments to reject poor quality aid, or to rationalise the number of development partners (more than 40 in several countries) providing resources.

Nevertheless, a few countries have taken important steps to lead in designing their own aid strategies. Notable examples are the Tanzania Assistance Strategy (TAS) and the Uganda Poverty Eradication Action Plan (PEAP) Partnership Principles. This section draws lessons for changing donor behaviour.

One of the key requirements of an aid policy is the assessment and choices of aid funds. Under the Highly Indebted Poor Country initiative, HIPC governments have designed an objective framework to analyse donor and creditor (and their own) policies and procedures, to help them identify which are the 'best' external financing sources to fund their national development programmes, and how they can improve the quality of all their external finance. Box 43 below sets out the issues covered in the HIPC Methodology for Analysing Donor Aid Quality.

The 'traditional' factors used by developing country governments to assess resources available from development partners and creditors are the amount and concessionality (grant element) of funds.

Box 43. HIPCs' Methodology For Analysing Donor Aid Quality

For policies:

- Types of assistance: budget/balance of payments support, project, TA or food/commodity
- Channel of assistance: via the budget or off-budget
- Sectors and projects: support is for PRSP or donor-led priorities
- Flexibility of assistance: can aid be channelled to new areas and/or used to meet unexpected financing gaps arising from economic shocks
- Predictability of assistance: multi or one year commitments and whether they are fulfilled
- Policy conditionality: the number and degree of enforcement of policy conditions
- Policy dialogue: the degree of donor engagement in the economic policy dialogue
- Independent support for government policies or alignment with Bretton Woods Institutions.

For procedures:

- Conditions precedent: the types and degree of enforcement and the disbursement delays arising by meeting these conditions
- Disbursement methods: via cash direct to the budget or reimbursement claims
- Disbursement procedures: the number and complexity and disbursement delays arising
- Procurement procedures: the number and complexity and disbursement delays arising
- Co-ordination: the degree of harmonisation between government and development partners/creditors.

Each donor is assigned a score for each of 23 evaluation criteria (with 1 scoring lowest and 5 highest) on the basis of objectively verifiable thresholds, and the scores are aggregated to identify which qualitative aspects are the worst problems, and which development partners have the best/worst quality aid.

HIPC governments also identify whether they themselves have clear aid policies, and preferences for disbursement and procurement procedures. They also analyse the impact of government procedures to fulfil conditions precedent, disbursement and procurement on the delivery of external assistance.

By combining the assessments of development partners and government, HIPCs can:

- Prioritise the most desirable donor and creditor sources of future new financing
- Highlight development partners/creditors which government should look to for better quality aid in future
- Identify priority areas for overall improvement of donor and government policies and procedures
- Design a matrix of measures for governments and development partners to strengthen aid quality and delivery
- Exchange information among HIPCs to monitor donor behaviour against international policy declarations and best practices, and identify priorities for global initiatives on aid quality.

HIPC Methodology for Analysing Donor Aid Quality.

Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) currently runs Public Expenditure and Financial Management (PEFM) courses for its member countries which provide an overview of the issues and techniques in effective PEFM systems, whilst also providing an opportunity for member governments to share their experiences in this area.

Most MEFMI member countries are implementing a number of Public Expenditure and Financial Management reforms and this Handbook seeks to provide useful information on the experiences and approaches to the implementation of PEFM reforms.

The MEFMI PEFM Handbook is a reference document for officials responsible for all aspects of PEFM including practical suggestions for strengthening PEFM systems and implementing reforms within MEFMI member countries.

ISBN: 978-0-797-4-3774-6

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