Chapter 17. HOW TO GET THERE FROM HERE:
THE STRATEGY AND SEQUENCING OF BUDGETARY REFORM

As discussed in chapter 1, improvements in the budgetary system are largely a function of institutional change, in the contemporary sense of the basic rules that govern the behavior of organizations and individuals.[1] The distinction between "institution" and "organization"—and the interplay between the two—is key to understanding the challenge of improving the management of public expenditure in developing countries. Budgeting organizations can be improved—sometimes even created *ab nihilo*—but economic, social and political behavior will not change unless the rules and procedures change as well. For example, simply merging a Ministry of Finance with a Ministry of Planning will not, by itself, do much to integrate current and capital budgeting more thoroughly. However, the reverse is also true: rule modification is unlikely to produce results *in an operationally meaningful time frame* unless organizational improvements proceed apace. Thus, to follow the same example, an improvement of the budgetary rules for coordination and integration of current and capital budgets can be frustrated if the organization of the Ministry of Planning is not improved as well. Clearly, then, improving public expenditure management requires *both* institutional (regulatory and procedural) reform and organizational development.

In the light of the above considerations, this chapter first presents some general strategic considerations; then outlines the key priorities and sequencing of reform in each of the various aspects of public expenditure management discussed in this volume. In addition, Annex XI contains a questionnaire useful for the assessment of the effectiveness of budget systems. Our standard warnings should be repeated once more: (i) budgetary improvements should be assessed not only in terms of the benefits expected, but also of the probable cost and of likely sustainability; (ii) "best practice" is a dangerous term, when it is misinterpreted as importing budgetary models developed elsewhere and without hard-nosed consideration of local realities—particularly administrative capacity, data availability, and the informal rules that determine much of the behavior of local officials and their private sector counterparts in the specific country.

A. STRATEGIC CONSIDERATIONS

1. General reform choices

Aside from the extremes of a "quick and clean" reform strategy (optimal but entirely unrealistic) is optimal and a "slow and dirty" strategy (the worst possible approach), the practical strategic choice revolves around the intermediate options of a "slow and clean" reform strategy or a "quick and dirty" strategy.[2] As a general presumption, the former is preferable because *it is more likely to be sustainable.* Short-term efficiency of public financial resources must be balanced against the need to improve financial accountability in the long-term. This balancing act between flexibility and excessive discretion is probably the most difficult dimension of improving public expenditure management. The extremes are easy to define and to reject. Thus, reform that eliminates ex-ante financial controls altogether in the name of managerial flexibility, without paying any attention to accountability regimes, is a recipe for widespread corruption. At the other end, protecting the integrity of public resources by introducing a list of micromanagement controls is bound to reduce efficiency sharply. The right middle ground between these two extremes is difficult to find and must be country-, sector-, and time-specific.

2. The "torto-hare" approach to institutional change

Strategic attention should focus on identifying areas where it is feasible to move very fast (with only a slight cost in terms of "cleanliness" or deviations from the optimal long-term path), and areas where it is essential to build slowly and carefully the solid institutional foundation required for sustainable reform.

Thus, to the question of what the "optimal" pace of reform is, the reform-maximizing answer is "it depends"—unsatisfying and demanding as such an answer may be. This answer is especially valid in the fluid and opaque circumstances of the current transition. To use the metaphor of road traffic, optimal driving speed depends on traffic conditions—*subject to an overall speed limit and to the need to keep moving.* "Torto-hare" was the slogan (*tarta-lepre* in Italian, combining tortoise *[tartaruga]* and hare *[lepre])* coined by the Italian highway authority in the 1960s to describe the optimal driver behavior: drive fast or slow depending on the circumstances. To complete the metaphor, the worst approach to driving in heavy and erratic traffic and poor visibility is to go on cruise control, whether at high or at low speed.

In this perspective, there is an aura of unreality to the debate between “big bang” and “gradualism”. The underlying premise of the big-bang approach is that, in the absence of simultaneous rapid policy reforms in complementary areas, partial reform measures will have no effect.[3] The underlying premise of the gradualist approach is that there is only so much change and upheaval a society can stand at any one time, and the attempt to do too much may end up in a failure to accomplish anything. The difficulty is that stretching these valid premises to their logical extremes leads to caricature and untenable prescriptions. Thus, the “fundamentalist” interpretation of the big bang is tantamount to advocating reform of everything at once. Aside from being utterly unrealistic, especially for developing countries, such a prescription could also cause extreme damage in a plural society riven by ethnic conflict. At the other extreme, the “fundamentalist” interpretation of gradualism becomes a prescription for total immobility. Hence, the actual operational choice is never between these two extremes, but between the *specific* policy areas where a “big bang” is possible, and those where gradualism is more effective. The obvious alternative to ideological approaches is *analysis*, on a case-to-case basis, of the benefits, costs, opportunities, and risk of specific budgetary reforms in a specific country. A budgetary reform should be pushed very fast wherever and whenever the circumstances warrant, but may need to be postponed in other areas or occasionally slowed down to allow accountability to catch up, absorptive capacity to grow, or public tolerance to be rebuilt. Such an obvious point would not deserve to mention if it were not so often disregarded in practice.

3. Some corollaries

a. The futility of “paper reforms”

A first corollary of the above considerations is that public budgeting improvements are hollow in the absence of effective monitoring and enforcement mechanisms. Organizational and human capacity is essential to administer and enforce the new framework. Administering, monitoring, and enforcing mechanisms take time, resources and genuine commitment at several levels to become operational. Yet, two very different tendencies often converge in practice to sidestep these requirements. The first tendency is the temptation of politicians and foreign donors alike to declare a problem solved and move on to the next item on the agenda. Thus, the introduction of a new budgetary nomenclature can be considered as an isolated output without any attention to the other elements needed to improve the budget process. The other tendency is the ingrained habit of control-minded elites in the Ministry of Finance to try to effect behavioral change by decree. There is overwhelming evidence that such change, if any, is purely transitory.

b. Adopt, adapt, or create?

A second corollary concerns the question of whether it is possible to “import” foreign budgetary and/or accounting practices. The answer to the question is often phrased in dichotomous yes or no terms. The term “best practice” is itself an example, in its implication that a given practice is “best” in all circumstances. However, as is generally true in other instances of transfer of technology, once again the better answer is: “it depends”. Formal rules can be imported fairly easily, informal ones much less so. It follows that importing foreign institutional practices is a practical proposition only when these practices have a high component of formal rules. This is the case, for example, the more “technical” areas of public expenditure management. However, even the most “technical” procedures require an open-minded assessment that country conditions are amenable to the efficient introduction of the new procedures.

By contrast, when the nature of the institution entails a high component of informal rules, as in “social” and “governance” areas or personnel incentives, the institution will normally need to be homegrown or, if imported, will require substantial adaptation and changes over time. In such cases, process and form (“ownership”, “dissemination”, “consensus-building”, etc.) are as important as the eventual results. Indeed, it is sometimes true that (*pace* Frederic Molnar) “the play’s the thing”: the process *is* the reform.

c. Design of assistance for PEM improvement

The risks of giving the “wrong” advice (which, as noted, includes “good” advice that is not suited to local realities) are heightened by the reality of “path dependence”, i.e., that institutional reforms enacted today have inescapable but unpredictable long-term implications—particularly in the more fluid context of developing countries and transition economies. The penalty for mistakes, of course, falls almost exclusively on the people of the developing countries themselves. Thus, the moral hazard inherent in all forms of intervention from the outside—however benevolent the intention—is especially severe in the area of institutional change. Those who urge to “just do it” take on a particularly heavy moral burden.

These considerations should not be taken as counseling inaction or benign neglect—inaction, too, carries its own brand of moral hazard—but to stress the importance of identifying the risks and minimizing them to the extent possible. The risks can be generally minimized by flexible mechanisms of assistance adjusted periodically, with attention to financial accountability and governance implications, and by a focus on local capacity building. More concretely, the risks of intervention can be reduced by interaction with a variety of local interlocutors and optimum use of local expertise. (An example of successful intervention is the ADB loan of US$250 million to the Indian state of Gujarat for public sector reform—see Box 46).

Box 46
ADB Loan of $250 million for the Gujarat Public Sector Resource Management Program

Project Objectives

- *The program supports the Government of Gujarat in improving public finances and augmenting domestic resource mobilization, improving the allocation and efficiency of the public sector, and reducing the role of the Government of Gujarat in commercial activities while promoting market-oriented policies to enhance private sector participation in the infrastructure sectors.*

Project Scope

- *The program focuses on (i) strengthening state public finances and their prudent management; (ii) divesting and restructuring state-owned enterprises (SOEs) to allow the private sector to take the lead in commercial activities while reducing the burden that SOEs put on the budget and the economy at large; and (iii) strengthening the policy, regulatory, legal and institutional frameworks for private sector participation in critical infrastructure sectors (power, ports, and roads) and evolving an enabling environment.*

Highlights of the Program

- *Reduction of overall fiscal deficit to sustainable levels.*
- *Sales tax reforms, including the introduction of value-added tax (VAT), the rationalization of key state taxes, and municipal tax reforms.*
- *Raising of user charges to improve cost recovery.*
- *Expenditure rationalization and improved fiscal policy management.*
- *SOE reform planning and associated institutional mechanisms.*
- *Privatization, partial divestment and restructuring, merger, leasing, or closure of SOEs.*
- *Social safety mechanism for the restructuring of SOEs.*
- *Initial steps to start power sector reforms.*
- *Revision of power tariffs to maintain a 3 percent rate of return on the assets of the Gujarat Electricity Board.*
- *Improved investment planning in power and creation of a framework for promoting private sector investment in roads and ports and initiating private sector investment in roads and bridges by 1997.*
- *Restructuring of the Gujarat Maritime Board.*
- *Strengthening of the capabilities of the Roads and Bridges Department to process private sector road projects.*

Source: *India's Economic Survey*, 1996-97.

4. Operational approaches

The search for operational approaches to improving public expenditure management in developing countries rests on the above strategic considerations, as well as on four premises. *First,* the information problem is massive. *Second,* specific entry points must be identified. On the one hand, it is evident that simultaneous budget system reform across the board is not realistic; on the other hand, total inaction on the institutional front is a recipe for progressive deterioration of functions. Somewhere between those two extremes, intermediate possibilities for constructive action must be found. *Third,* path dependence is a reality. Institutional mistakes tend to become evident only years down the line, when they have become irreversible and the advisers or consultants are long gone, with potentially severe consequences for accountable governance and effective public resource allocation and use. *Fourth,* countries must, after all, work with what they have. The human resource endowment, the inertia of bureaucratic habits, the predictable resistance and backlash of the losers from change, etc.—all these factors can be altered, combated, utilized, perhaps even deliberately neglected, but cannot be *ignored* by those who would assist the institutional transformation. These four premises underpin two interrelated approaches to constructive intervention: (i) strengthening intrasystem linkages; and (ii) fostering the creation of "efficient nuclei".

a. Strengthening internal linkages: The essence of "capacity building"

In many developing countries, and in most transition economies, the absence of systematic lines of interagency communication and the lack of incentives to share information (which is often viewed as a personal asset) result in fragmented policy formulation and atomized decision making. This presents a major problem for the implementation of reforms. The challenge is how to improve communications and reduce the cost of information within the public sector.

It is difficult to decide whether to strengthen one particular agency of government or another; the outcome of bureaucratic "turf" disputes is utterly uncertain, and the risks of losing an organizational bet are potentially severe. The guiding operational criterion of technical assistance for sustainable PEM improvement should therefore be to strengthen the linkages between the components of the overall budget formulation and execution system, not only among central ministries, but between them and subnational entities. Not enough is known to pick winners and losers—and today's winners may well be tomorrow's losers anyway. Strengthening the institutional and communication linkages within the system: (i) does not prejudice or preempt the appropriate transition path for the system as a whole; (ii) entails a direct reduction in transaction costs; and (iii) is most likely to have positive implications for transparency and accountable financial management (except in countries with extreme and systemic governance problems). Even when supporting the reinforcement of one or another specific budgetary procedure, it is essential to encourage *positive* interaction with other government agencies. Such encouragement must not be limited to rhetoric, but should entail incorporating in the assistance specific incentives for greater information exchange, training and cooperation.[4] This point leads to the second approach suggested here.

b. Efficient nuclei

Action to strengthen linkages and communication channels facilitates but does not in itself generate the spread of new rules and efficient organizational practices. There must also exist dynamic agents of change that can generate the positive "messages" to be transmitted throughout the system by the improved communication channels. These agents, these "efficient nuclei", must be deliberately created to perform a few key selected public functions.

A guiding criterion for selecting these key functions (and this is where the interrelation with the previous approach emerges) is their contribution to maximizing the linkages within the public sector. By analogy with Albert Hirschman's "unbalanced growth" approach of 30 years ago, *efficient nuclei should be created largely on the basis of their potential for spreading new institutions and organizational practices throughout the public financial management system.*

Beyond the general criterion of linkage maximization, an efficient nucleus should meet the following practical standards:

- Be small;
- Be fiercely meritocratic, in the initial selection and in the evaluation of staff performance;
- Have flexible and simple procedures;
- Provide adequate compensation for staff (this may require fixed-term contracts without fringe benefits, to permit adequate salaries without compromising

eventual decisions on a fiscally sustainable civil service structure and compensation);

- Have adequate material and financial resources;
- Use local talent, with external advisers only when demonstrably necessary;
- Be a transitional arrangement, with a clear sunset clause and advance specification of the procedures for reassignment of its staff throughout the relevant government agencies;
- Operate not only to perform specific tasks but also a teaching-by-doing function, in cooperation with other agencies.

An illustration can be given in the area of public investment. As discussed in chapter 12, realistic and affordable public investment programming based on economic project evaluation and real-cost financing, is key to efficient and effective allocation of bid resources. However, improving “core ministry” capacity (e.g., in a Ministry of Planning, or of Finance) accomplishes little without sufficient capacity at the sector level to screen out unsound ideas and formulate good projects. It will take a long transition for the sector ministries to build up their own capacity in this respect. In the interim, a mechanism is needed to assure results and speed up the transition as well. By the efficient-nucleus approach, such a mechanism could consist of creating a “visiting team” unit in the core ministry that is charged with public investment responsibility. The unit would comprise a small number of highly qualified, newly trained local analysts and an experienced external adviser, all with excellent communication skills in addition to economic competence. The unit would provide ad hoc assistance to sector ministries, at the right points in the budget cycle, by sending a visiting team “in residence” for a brief period of time. This would combine their technical knowledge with the sectoral familiarity of the ministries’ staff. The team would visit each sector ministry in turn, and interact with its staff to produce better-quality decisions as well as some “teaching by doing”. The relationship would be one of cooperation and mutual assistance—because decisions on actual approval of projects for funding would be entrusted to an entirely different core entity. Such a relationship would therefore encourage informal exchanges of information and advice as and when needed. When, helped by this mechanism (and, of course, their own specific training programs), sector ministries have acquired sufficient project preparation capacity, the visiting team unit would disband, and its personnel would be reassigned to take care of PIP matters within the core ministry or to lead the work in sector ministries.

B. REFORM PRIORITIES AND SEQUENCING OF REFORMS

This section assembles the "directions of reform" recommendations from each of the previous chapters.The convenience to the reader of having a self-contained PEM reform and sequencing agenda justifies this duplication. (This section should be read in conjunction with the last section of chapter 1 which summarizes the key points in the expenditure management cycle.)

1. The budget and its preparation

a. Budget coverage

Priority actions should consist of laying the foundations required for any sound budgeting and policy formulation system, which include:

- A reasonably comprehensive coverage of the budget;

- Assessment, disclosure, and review of all policy decisions that have an immediate or future fiscal impact, such as contingent liabilities, lending, tax expenditures, and quasi-fiscal expenditures;

- An expenditure classification system that fits the needs of both policy analysis and management, and covers all government expenditures.

These actions should be carried out jointly with the priority actions listed below to improve budget preparation, execution, and accounting procedures. They are a prerequisite for further improvements in the budget system.

Among these further improvements, the following can be considered:

- Developing instruments for better assessment of liabilities, contingent liabilities, and policy commitments. These instruments can include a modified accrual accounting system or multi-year expenditure programming.

- Developing special management arrangements for some expenditure programs (e.g., user charges, service delivery agencies) that can improve their operational efficiency without reducing the comprehensiveness of the budget or weakening expenditure control and accountability to the legislature.

- Setting up a classification of expenditure by activity and program, to allow defining the right performance indicators at an appropriate level.

b. Budget systems and expenditure

The main considerations here relate to the absolute need to take into account the lessons of experience and the specific country circumstances. Introducing sophisticated and demanding performance budgeting systems (and particularly their culmination in detailed output budgeting) has been shown by the experience of the last 50 years to be badly counterproductive when local capacity and "ownership" are not conducive to their introduction. In developing countries, this oversight has led to wasted resources and, in some cases, loss of fiscal discipline. The reform lessons are that: (i) line-item budgeting and expenditure control must be firmly established before moving beyond; and (ii) complex reforms in a limited-capacity environment succeed only in disempowering the limited local capacity itself and reinforcing dependence on external advisory. It should be recalled, however, that there are various ways to strengthen the performance orientation of the budget system short of introducing formal variants of performance budgeting.

c. Budget preparation

As noted, weaknesses in budgeting depend in large part on political factors and on the organization of the government. Lack of coordination within the Cabinet, unclear lines of accountability, or overlaps in the distribution of responsibility favor questionable approaches to budgeting. Improving budget preparation is not sufficient to address all problems, of course, but it is necessary. Processes and mechanisms for budgeting and policy formulation should be explicitly designed to reinforce coordination and cohesion in decision making. Generally, strengthening the budget preparation process requires (in addition to the scrutiny of all decisions with a fiscal impact) improvements in the following:

- Financial constraints must be built into the start of the budget formulation process, deriving from the preparation of a macroeconomic framework and adequate expenditure programming (see below). Spending agencies need predictability and should have clear indications of the resources available as early as possible in the budget formulation process.

- Policy coordination mechanisms that fit the country context are needed, with particular attention to the policy-budget link.

- It is necessary to develop appropriate policy coordination mechanisms that fit the institutional, constitutional, and political context. Participation of civil society through consultation mechanisms should be sought.

- Operational efficiency requires making line ministries accountable for the implementation of their programs. However, they can be held accountable only if they have sufficient authority to design these programs. This requires, in a number of countries, reviewing the distribution of responsibilities in budget preparation.

- Aid-dependent countries need to pay more attention to the programming of expenditures financed with external aid and should scrutinize their budget as a whole (despite the fact that the project approach adopted by donors may favor fragmentation in budgeting).

d. Moving to a multi-year perspective

Every country should prepare its budget within a medium-term macroeconomic framework, covering three to five years, to be able to assess fiscal sustainability. The degree of sophistication of projections depends on technical capacities within the country, and could be progressively improved by the development of econometric models. However, the development of these tools should not be a prerequisite for preparing a macroeconomic framework. The macroeconomic framework should be supplemented by projections of aggregate expenditures by function and broad economic category, to assess its realism and to identify policy requirements and constraints in achieving the fiscal objectives.

To improve budget preparation, the first priority is to set sectoral spending limits and announce them early in the budget preparation calendar. Also, close coordination in the preparation of the different components of the budget (revenue, current and capital expenditures, expenditures from funds, etc;) is required, whatever the government organizational arrangements. In countries where responsibilities for the capital budget are separated from responsibilities for the current budget, the priority measure is to require joint reviews of the two components of the budget at *each stage* of budget preparation and at each administrative level.

Budget preparation should systematically adopt into *a multi-year perspective*. This requires:

- *At least,* preparing aggregate expenditures estimates by function and broad economic category, and estimating and reviewing the forward costs of programs when preparing the budget;

- *At a further stage,* preparing multi-year expenditure programs, within a macroeconomic framework, linked with the budget preparation, and including only programs/projects for which financing is certain (multi-year programs should focus only on ongoing policies, and new policies should be decided only during the preparation of the annual budget);

- *As a final stage,* preparing a formal medium-term expenditure framework with the same coverage and in the same degree of detail as the budget. To achieve this objective effectively a progressive approach can be considered. As a first step, aid-dependent countries should prepare a strong PIP and detail the forward costs of investment projects financed by external sources. Other countries could focus on the more costly items, e.g. entitlements, large investment projects/programs, or major specific sectors). It is also possible to gain experience by preparing a full sector expenditure program for one of two key sectors. These partial programs, as noted, must be supported by projections of aggregate expenditures, by function and broad economic category.

e. Organizational issues and the budget approval process

The legislature is the appropriate locus of overall financial accountability:

- The obvious first step is to give adequate means to the legislature to review policies and the budget;

- The budget should be presented to the legislature on time, to allow its proper scrutiny and budgetary debates to be completed before the start of the fiscal year;

- Aggregate revenue, expenditures, and fiscal targets should be reviewed together.

To contain pressures to increase expenditures, limits may have to be set on the powers of the legislature to amend the budget (e.g., any amendment that increases expenditures or decreases revenues should be accompanied by a counterbalancing measure to maintain the initial deficit target). The legal framework should stipulate that laws that have a fiscal impact take effect only if the fiscal measures are authorized in the budget or its supplementary acts.

2. Budget execution

Budget execution generally needs to be improved along two lines: enhancing expenditure control, and creating the conditions for increased efficiency in public spending. An adequate balance between these two different requirements should be found. In addition, certain priorities for improving cash management can be suggested.

a. First stage: Ensuring basic expenditure control

In a number of countries, the first stage should be both to reinforce expenditure control and to ensure better conformity in budget execution with budget policies. In this respect, special attention needs to be paid to the following:

- Timely release of funds;.
- Cash planning in conformity with budget authorization and taking into account ongoing commitments (of course, a sound budget is a prerequisite to begin with).
- Effective controls at each stage of expenditure (whatever the organization of controls, internal to the spending ministry or ex ante/external);
- Adequate monitoring at each stage of the expenditure cycle (commitment, verification, and payment);
- Clearly defined procedures for registering transactions (notably for commitments).
- Adequate cash management;
- Transparent procedures for procurement.

b. Second stage: Improving the efficiency of the system

For more efficient public spending, the following actions are generally needed:

- Flexible rules for virement and regulated carry-over provision, especially for capital expenditure;

- Progressive decentralization of controls (*in parallel* with a reinforcement of procedures for auditing and reporting); and eventually;

- Development of market testing and consideration of possibilities for contracting out.

c. Cash management and the Treasury function

In most countries priority actions should concern the following areas:

- The centralization of cash balances should be ensured (together with a centralization of the monitoring of transactions). In countries where the payments system has broken down, this may call for implementing a centralized Treasury system from scratch. In other countries, banking arrangements and procedures for transferring funds should be reviewed to better control cash and avoid idle balances. Factors to be taken into account include: (i) constraints due to the localization of local agencies and the infrastructure of the country; and (ii) the possibilities offered by modern information technologies.

- Sound cash planning should be established, together with other measures such as improving revenue forecasts and commitment accounting.

- Debt management, especially the timely tracking of borrowings and repayments, should be strengthened.

Once the centralization of cash flows is ensured, incentives for managing and forecasting cash flows more efficiently could be considered, but in practice this concerns only a limited number of developing countries.

d. Management control, audit and evaluation

The several elements that can contribute to the integrity, efficiency and effectiveness of government organizations and programs, must be instituted by government. They do not come into existence because one wishes them to. Some of the key considerations involved in developing effective management controls, auditing and program evaluation are as follows.

A government that is convinced of the need to build or strengthen its control and analysis capabilities needs to define a strategy for accomplishing these goals and establish responsibility for doing so. In most countries, there are two institutions that should play critical roles in this process, the Ministry of Finance and the Supreme Audit Institution. Ideally, the strategy should be the outgrowth of consultation and cooperation between these two institutions. Implementation of the strategy, involving the actions that must be taken by the line ministries, should be the responsibility of the ministers and senior civil servants in the line ministries, under the leadership of the MOF and external oversight by the SAI.

It is not possible to develop all the needed institutions and procedures at one time. In almost all countries, and especially in developing and transition states, the highest priority should be placed on assuring the reliability of the financial systems and the integrity and security of the controls over transactions. This translates into placing first emphasis on building reliable management control structures and effective internal audit units in the ministries and on assuring the effectiveness of the SAI as the external auditor. Only when these are in reasonably satisfactory condition is it worthwhile to focus on the efficiency and effectiveness of operations.

Countries need not depend exclusively on their own knowledge and experience in developing effective management controls, auditing and program evaluation. Technical assistance is available in all these areas from multilateral institutions, donor nations and professional organizations. SAIs and MOFs in developed countries are often willing to provide technical advice and assistance to their counterparts in developing and transition countries because of their professional commitment to sound financial management in all countries.

3. The technical infrastructure

a. Accounting and reporting

In a majority of developing countries, it is necessary first to focus on the following:

- In countries that monitor only payments, a commitment register and an ancillary book for outstanding payments should be implemented. More generally, a comprehensive budgetary accounting system and register expenditure should be implemented at each stage of the expenditure cycle. Budget execution reports must show expenditures at each stage of the expenditure cycle.

- Develop a debt accrual accounting system should be developed if none exists, and comprehensive reports on debt should be prepared.

- Operations of extrabudgetary funds (if any), should be consolidated, and all government entities should be made to follow the same classification in their reporting.

- Contingent liabilities should be recorded and statements of these liabilities must be prepared and published.

- Publication of financial statements.

Further steps should include:

- Implementing modified accrual accounting to provide a comprehensive framework for reporting on liabilities, and systematic registration of contingent liabilities;

- Implementing asset registers, at least for the categories of assets that need to be carefully monitored.

When (and only when) the previous actions have been implemented, and are on a solid basis, can a move toward full accrual accounting and the accompanying financial reporting be considered.[5] Taking into account the heavy implementation requirements, accrual accounting could be implemented gradually, beginning with agencies with a more urgent need to assess full costs.

b. Public investment programming and aid management

The broad goals of public investment programming are to: (i) raise investment efficiency by improving project quality; (ii) bring investment allocation in line with country policies and priorities; (iii) assure consistency between investment programs and available financing at favorable terms; and (iv) lead in time to a more comprehensive multi-year expenditure framework.

All these goals require sufficient control by the recipient government over project selection and strategic allocation of aid moneys—assuming a reasonable degree of integrity and efficiency in the country's governance and public management.[6] Conversely, a good public investment programming process is most often the best practical way in which the recipient country's government can get into the driver's seat and stay there.

The directions and sequencing of reforms in public investment programming and aid management stem directly from those four goals. For better project quality and investment efficiency:

- The first priority is to design ironclad procedures against the birth of "white elephant" projects. Once a project of large size is on the drawing board, the bureaucratic dynamics from both donor and recipient sides make it very difficult to stop it. Among these procedures, involvement of high-level policy makers (and, for very large projects, the Cabinet) must be built in at a very early stage.

- Also essential is the capability for economic appraisal of projects. Because of the need to economize on scarce capacity (and to minimize reliance on expatriate expertise), in developing countries simple appraisal methods are preferable, and selectivity is needed. Only projects of significant size should be analyzed in detail, with smaller projects “bundled” and the bundle evaluated only for its general correspondence with sectoral policies and common sense.

- Third, an agile procurement process that minimizes the opportunities for corruption, and effective physical monitoring of project implementation and completion are a must. Strengthening the audit function and obtaining systematic feedback from local entities can be extremely useful.

For the other three objectives of public investment programming:

- It is important to have a procedure for early decision of whether the investment allocation corresponds to aggregate and sectoral policies, and the ensuing preliminary definition of the sectoral expenditure envelopes.

- Also, through good aid management and coordination among donors, regulations are needed for assessment of the probability of financing for various projects, and strong regulation should be in place to assure that only projects with certain financing are included in the investment program.

- Finally, a realistic procedure and minimum capacity for estimating the total cost of investment projects and their recurrent costs is a must. This is always preached but rarely done. The absence of these estimates, however, is sufficient in itself to cast a cloud on the usefulness and integrity of the public investment programming process. Conversely, the experience gained through these forward estimates can be invaluable for the eventual move to a comprehensive multi-year expenditure approach.

c. Performance orientation and contracting out

Injecting new formal performance-related elements into the budget process requires extreme care, both because better performance orientation is critical for improving public expenditure management and because there are many wrong ways of pushing it and only a few ways of doing it right. The lessons of international experience for the reform process in this area are thus essentially the following:

- Never confuse the objective of better performance orientation with any one of the specific instruments for achieving it. There are many ways to foster performance, short of making formal changes in the budgeting system;

- If the public expenditure management system is performing reasonably well, be particularly mindful of the risk that changes may actually make the situation worse. (Symmetrically, if the budget process is extremely weak and corrupt, radical changes may be the only way to improve it.)

- Consider carefully the probable impact on individuals' behavior, especially in multi-ethnic societies or very small economies.

- Understand clearly the different uses and limitations of input, output, outcome and process indicators, and tailor the use of each to the specific sector and issue in question. Whenever possible, avoid using any single indicator to assess performance.

- Assure robust monitoring of performance, with swift and predictable consequences.

- Build-in provisions for the systematic assessment of *performance of the performance system itself*. It is inherent in the logic of the system that it, too, must be subject to a reality test, and to periodic proof that its concrete benefits have outweighed the cost.

- Beyond these caveats, it is important to continuously look for any possibility to expand the "service awareness" of government administration; raise the rewards for good performance (not necessarily monetary) and the sanctions for unsatisfactory performance; and keep under constant review the possibility of introducing the various tools for measuring and monitoring performance. In all these tasks, systematic feedback from the service users and the public at large is invaluable, and so is an informed and aggressive free media.

- The process of introducing performance indicators can consist of first picking one or two government departments that provide services directly to the public; introduce simple performance measures at an acceptable cost (including transactions cost); monitor closely the functioning and impact of the measures; debug the measures and adjust as needed; gradually expand the application of performance measures to other governmental areas as and when appropriate; and stop when reaching the point of diminishing returns. The performance indicators can be used right away in the dialogue during the budget preparation, but direct and mechanical links to budgetary appropriations should be postponed to a later stage.

C. A Concluding Word

The approach of this book has been resolutely pragmatic, providing a menu of options rather than single "best-practice" models, and highlighting the need to consider carefully the specific country context. However, pragmatism degenerates into ad-hockery and shortsightedness if it isn't guided by coherent and universal principles. Among these, the following are fundamental and applicable everywhere:

- Strengthening the "four pillars" of governance (accountability, transparency, predictability, and participation).

- Reinforcing their foundation in civil society, through such means as efficient and responsible fiscal decentralization, and encouragement of citizens' "voice".

- Using improvements in public expenditure management partly to reduce opportunities for corruption, both home-grown and imported.

- Following the beacon provided by the PEM objectives—fiscal discipline, strategic resource allocation, good operational management and due process.

- Stretching the horizon of budgeting beyond the immediate future—through a concrete multi-year approach, when feasible, but at a minimum at the level of systematic reflection and dialogue.

In addition to these universal principles, we suggest from experience four practical rules for assessing the merits of recommendations to improve expenditure management in the specific country context:

- *Put first things first*. "Getting the basics right" is a must for the process of spending the people's money, especially in poor countries where the people can least afford costly experiments. Other areas of economics and technology may offer realistic opportunities for "leapfrogging" over the immediate problems into a more advanced state of affairs. In public expenditure management, such opportunities are very limited, the costs of mistakes are very high, and these are rarely borne by the advocates of the experiment. In the words of the Press Communique of the Conference on Fiscal Policy and Reform (February 2-4, 1999, Apia, Samoa): "…fundamental elements of budgeting preparation; implementation; and monitoring that permit effective control, promote transparency, foster accountability, and ensure legitimacy need to be firmly in place before highly sophisticated concepts of budget management…[are] introduced."

- *Don't make the same mistakes*. Mistakes are inevitable; but repeating the mistakes of others can be avoided, by a realistic assessment of the concrete experience of a variety of other countries with the same mechanism or process.

- *Put the right driver in the driver's seat*. Any measure to improve public expenditure management in developing countries must raise the country's own capacity to manage its public expenditure. An "improvement" in public expenditure management designed and implemented primarily by expatriate specialists is no improvement at all, quite the contrary. Nor can improvements last if they are imposed top-down by the central agency with little involvement or implementation capacity of the sector ministries.

- *Finally, be open-minded but questioning.* The history of development assistance is littered with the bones of imported institutional failures. If the recommendation is sound, it will withstand critical challenges; if it is not, only critical challenge will reveal that fact.

[1] See Schiavo-Campo, 1994, for a summary of the main issues. Section A of this chapter is based on parts of that publication.

[2] This may be considered by some as an obvious choice, given that there is no credible alternative to some sort of step-by-step process. In actual practice, however, the attempts at "shock therapy" are all too frequent and have caused considerable problems.

[3] A macroeconomic example of such a mistake would be an attempt to reduce the fiscal deficit by improving the tax effort without concomitantly strengthening expenditure control mechanisms. A microeconomic example would be the liberalization of public enterprise pricing without the complementary measures to place the enterprise on a commercial footing.

[4]Furthermore, interdonor cooperation is important to prevent tunnel-vision actions by individual donors.

[5] Because almost all developing countries still need to complete the improvements listed above, full accrual accounting is a realistic option only for developed countries, although many of these have not even begun to introduce it.

[6] Because aid is fungible, if the government would implement a particular project in any case, aid earmarked for it releases governmental resources to finance a "marginal" project of which the donor knows nothing. The aid in effect finances the latter project, and the earmarking is an illusion. Hence, if the quality of governance or of public management is seriously deficient, donor control over the investment program as a whole may be the only way for aid moneys to have a positive development impact. (A far stronger impact, however, would result from assistance or insistence to improve governance in the first place.) In most developing countries, instead, donor financing for a project which the government does not consider a priority can distort resource allocation and create other adverse incentive problems and moral hazards which more than offset the direct positive impact of the assistance itself. Hence, strong coordination and direction by the recipient country's government are essential to the development impact of the assistance. The implications of aid fungibility for the investment program under different assumptions have been examined long ago (see Schiavo-Campo and Singer, 1970) and have been recently rediscovered.