

# Guide to Transparency in Public Finances

*Looking Beyond the Core Budget*

## 1. Extra-budgetary Funds



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# Introduction

For more than a decade, civil society organizations around the world, as well as international financial institutions, have been pushing for governments to provide the public with more comprehensive budget information. The International Budget Partnership’s (IBP) Open Budget Survey examines the accessibility in countries around the world of eight key budget reports that governments should publish in order to enable civil society, oversight institutions, and members of the public to participate effectively in budget processes and hold governments accountable for how they use public money. In two companion guides to the briefs listed below – the *Guide to Transparency in Government Budget Reports: Why Are Budget Reports Important, and What Should They Include?* and the *Guide to Transparency in Government Budget Reports: How Civil Society Can Use Budget Reports for Research and Advocacy* – the IBP describes the importance of each key budget report, the information that it should contain, and how civil society organizations can use them.

This is one of five briefs that goes beyond the eight key budget reports covered in the guides to examine other areas of public finance that are less well understood and especially vulnerable to efforts to shield them from public scrutiny. The other briefs are:

- ➔ Tax Expenditures
- ➔ Quasi-fiscal Activities
- ➔ Contingent Liabilities
- ➔ Future Liabilities

## **All of the briefs examine the following questions:**

- ➔ What are these issues or activities, and why are they of interest?
- ➔ What information should the government include in budget documents and other reports on these issues in order to provide a comprehensive picture of the government’s fiscal position and increase the public’s understanding of how their money is being utilized?
- ➔ How can civil society groups use information contained in these documents to achieve their research and advocacy goals?
- ➔ Where can further information, country examples, and “model reports” be found?

The briefs are based on existing guidance and practices related to these areas of public finance gathered from various sources. In some cases, concrete examples are scarce, as these are new and complex areas of public budgeting.

The IBP will continue to build on this material and identify further public finance issues and activities that are typically shielded from public scrutiny but may have a major bearing on a country's public finances. Any additional briefs will be added to the IBP's website at: [www.internationalbudget.org](http://www.internationalbudget.org).

# Extra-budgetary Funds

Extra-budgetary funds and operations make sense in some cases, for example, when they ensure more effective management of government pension schemes or when they are designed to save and invest revenues from exhaustible natural resources for future generations. However, in other cases they reflect the government's interest in keeping certain budget items away from public scrutiny. While generally speaking, civil society organizations (CSOs) should campaign to minimize the use of these funds, they also should assess: a) the validity of the rationale for off-budget arrangements, and b) the adequacy of the governance arrangements put in place to manage extra-budgetary funds, and the degree to which they guarantee sufficient transparency and accountability.

## A. What are extra-budgetary funds, and why are they of interest?

The term extra-budgetary funds generally refers to public resources and government transactions that are not included in the annual budget or are not subject to the same general level of reporting, regulation, or audit as other public finance items. Extra-budgetary funds include a wide variety of arrangements, but traditionally they have included pension or social security funds, funds held by state-owned enterprises, and other discretionary or secret funds. More recently they have also included arrangements for public resources from natural resource extraction, foreign aid, debt cancellation, proceeds from privatization operations, and Public-Private Partnerships.

These funds, when combined, can amount to a sizable share of government activities. On average, extra-budgetary funds account for nearly 40 percent of central government expenditure in transitional and developing countries. The majority of these funds are social security funds, which constitute an average of 26 percent of government expenditures in these countries (Allen and Radev 2006).

A distinction can be made between those extra-budgetary funds that are established by and operate within budgetary and other laws and regulations of a country, and off-budget transactions that are undertaken outside these laws and regulations and so should be considered irregular transactions. For example, a Pension Fund Act may legally establish a fund with specific guidelines that do not require it to follow the government's general financial regulations but do require it to be publicly reported on in the same way as other government expenditures or to be subject to the same level of audit as the use of other public funds. In contrast, a secret fund that is kept off budget, ignoring the government's financial regulations, reporting, and audit requirements, can give rise to illegal or irregular transactions.

That is not to say that public funds cannot be managed efficiently and effectively through extra-budgetary funds; in some instances, this happens. However, depending on the specific case, extra-budgetary funds may not be subject to some or all of the following arrangements that provide adequate oversight:

- ➔ parliamentary approval of the government's budget;
- ➔ compliance with approved financial regulations;
- ➔ being accounted for through the government's accounting systems;
- ➔ being reported on through in-year or year-end financial reports; and
- ➔ statutory audit by the supreme audit institution.

Transactions outside the budget are unlikely to be subject to the same kind of financial discipline as are budget operations (for example, state-owned enterprises may have their own financial regulations and appoint their own auditors), partly because they are financially independent and partly because they are not explicitly compared with other public expenditures. This may result in an increased level of fraud, irregularity, or the use of such funds for unauthorized purposes. In addition, the use of extra-budgetary funds means the reported level of government expenditure may be understated. It also is more difficult to compare the finances of two governments if they have different levels of extra-budgetary funds.

In some countries the audit of extra-budgetary funds may not be undertaken as promptly as that for other public sector bodies. For example, in Ghana the results of the audit of central government ministries are reported to parliament within six months of the end of the fiscal year. In contrast the Auditor General's report on the public accounts of Ghana's public boards, corporations, and other statutory institutions for the year ending 31 December 2005 was not presented to parliament until September 2008. Even then, the audit report was not complete as some of the entities had not submitted their audited accounts. Similarly in Uganda, in mid-2007 the audited accounts for 19 of 49 autonomous government agencies were two or more years in arrears.

#### **A few examples of extra-budgetary funds include:**

- ➔ **Funds with their own income streams** – Extra-budgetary funds may refer to pension, social security, or other funds that have their own separate sources of income in addition to or in place of those provided through the government budget. In these cases, expenditures from the fund are financed by income from earmarked taxes or contributions, although in some cases a subsidy may also be provided through the budget. An example is a road fund that is funded from vehicle license fees. All vehicles are required to have an annual license and the fees are paid into a separate road fund. This fund is then used to finance the building and maintenance of roads. This arrangement may protect the fund and ensure that it is spent on the designated activities. However, it may also reduce the level of public scrutiny over the use of the fund.

In recent years the number of insurance-type arrangements that provide funding for such expenditures as pensions or health services have increased. For example, in Nigeria the pensions of former civil servants, rather than being funded directly from the current budget each year, are based on contributions made to a pension fund by existing civil servants, which are invested and used to fund future pension payments. Similarly in Ghana, rather than funding health services directly from the budget, citizens or their employers make contributions to the National Health Insurance Scheme. In each case special extra-budgetary funds have been established. Government payments into these funds may be subject to budgetary approval, but the overall level of receipts of and payments by the funds, the management of the funds, the financial regulations they follow, and the reporting and audit arrangements are separate from the normal government arrangements. This does not necessarily mean that such arrangements are more prone to abuse than those of the government budget, but it does mean that they deserve particular attention to ensure that such extra-budgetary activities are managed in a transparent and accountable manner.

➔ **Natural resource funds** – Countries with ample natural resources – oil or diamonds, for example – may establish extra-budgetary funds to try to smooth the volatility of resource revenues (dramatic changes in prices for resources can make this revenue source unpredictable) or to invest the funds for future generations, given their exhaustible nature. The Government Pension Fund of Norway and the Foreign Holdings of the Saudi Arabian Monetary Agency are two examples of such arrangements. They both rely on oil revenues, and they are among the largest in the world, with holdings of around \$500 billion. While the motivation and operation of such funds can be meritorious, depending on their governance arrangements, they can easily turn into slush funds for corrupt governments, particularly if they are subject to less oversight than the rest of the government’s budget. The Sovereign Wealth Fund Institute ([www.swfinstitute.org](http://www.swfinstitute.org)) compiles rankings of these funds based on the amount of information that they publish and on their governance arrangements. Norway’s fund scores a full 10 out of 10, while Saudi Arabia’s a mere 2.

➔ **Funds established to manage donor aid** – In many aid-dependent countries, projects financed by foreign aid are often channelled outside government systems and, therefore, can be considered extra-budgetary funds. According to a recent survey, more than half of official development assistance does not flow through country systems, meaning that detailed information on the use of these resources is not captured in budget documents (OECD 2008), or does not follow normal budgetary procedures. For example, in Ghana funds from debt relief proceeds were kept in a separate account and disbursed by the Ministry of Finance & Economic Planning, without the approval of parliament (IDASA 2005).

## B. What information should the government include in budget documents and other reports on extra-budgetary funds?

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For government budgets and financial reports to be comprehensive and accurate presentations of total public revenues and expenditures, the use of extra-budgetary funds should be minimized. The creation of special or extra-budgetary funds should be restricted to exceptional cases and authorised by specific legislation, with governance arrangements that guarantee adequate levels of transparency and accountability. Wherever such funds exist, as argued in the International Monetary Fund's (IMF) Manual on Fiscal Transparency, their activities should be identified in the annual budget, or an annex to the budget, along with a statement of the purpose or policy rationale (IMF 2007), which should be periodically reviewed.

How much unreported off-budget spending is too much? According to the benchmarks adopted by the Public Expenditure and Financial Accountability (PEFA) initiative, which developed a set of indicators to assess the quality of public financial management systems, unreported extra-budgetary expenditure (other than donor-funded projects) should be kept below 1 percent of total expenditure for a country to attain the best score on the relevant PEFA indicator. The worst score corresponds to a situation where this spending constitutes more than 10 percent of total expenditure. For donor-funded projects, the PEFA benchmarks indicate that complete income and expenditure information should be available in the government's fiscal reports for 90 percent of the value of donor-funded projects, and that proportion should never fall below 50 percent.

Furthermore, the rules and procedures that govern the establishment, operations, and management of extra-budgetary funds should be open to public scrutiny, along with their audited financial statements covering all inflows and outflows and, if relevant, the allocation of and return on assets. The financial reports for such funds should not simply report net income against expenditure but should also report the total income and the total expenditure of each fund at a minimum. Income and expenditure should generally be presented according to the standard classification or code of accounts used in other budget documents produced by the government.

South Africa does a fairly good job of accounting for extra-budgetary funds. The executive's budget and supporting documentation present extensive information on extra-budgetary funds, including both a narrative discussion and quantitative estimates of such funds. The bulk of extra-budgetary funds in South Africa are composed of social security funds, such as the Road Accident Fund, the Unemployment Insurance Fund, and the Compensation Funds. The money for these items is not included in the budget, but information on their payments and receipts is included in the accompanying document, the Budget Review. The Office of the Auditor General of South Africa publicizes its reports of audits of all extra-budgetary funds. The reports include all charges against the Revenue Fund, including extra-budgetary funds.

In contrast, in Ghana the executive's budget and supporting documentation present some information, but they lack important details. Year-end reports do not present the actual outcome for extra-budgetary funds, and the Auditor General does not release to the public reports of the audits of extra-budgetary funds.

India also provides a reasonably good example of openness with regard to extra-budgetary funds. Information highlighting key extra-budgetary funds is presented with the annual budget, though some details are excluded. In addition, the Comptroller and Auditor General release the audit reports of all extra-budgetary funds except those on secret items of expenditure. These are generally not released to the public. However, with the passage of the Right to Information Law, even this information can be requested. Extra-budgetary funds include the National Small Savings Fund; the Steel Development Fund, which is an industry-wide loan scheme that operates on commercial principles; and the Prime Minister's Relief Fund, which finances disaster relief from public donations.

## C. How can civil society use this information for research and advocacy?

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In general terms, the significant size of extra-budgetary funds suggests a role for civil society organizations in monitoring these funds and advocating for greater openness in their management. In some cases, extra-budgetary funds do serve legitimate purposes, so CSOs should also assess: a) the validity of the rationale for an off-budget arrangement on a case-by-case basis, and b) the adequacy of the governance arrangements put in place for the extra-budgetary funds, and the extent to which they guarantee adequate levels of transparency and accountability.

To the extent that information on extra-budgetary funds is not publicly available, civil society organizations should advocate for its publication in line with international best practice. The use of all public money should be subject to the same high level of public scrutiny, comply with uniformly strict rules and procedures, and be audited to the same standards. Audit reports for all public funds, entities, or transactions should be made public promptly. Where necessary, civil society groups should advocate for such standards to be applied uniformly to both budgetary expenditure and what may be considered to be extra-budgetary funds.

In some cases, it might be useful for civil society groups to undertake some comparative research to see how extra-budgetary funds in their country fare when compared to similar funds in other countries or to international standards. For example, the "Santiago Principles" were developed as a voluntary code of conduct for sovereign wealth funds, covering accountability, transparency, and governance. In those 20 or so countries with significant sovereign wealth funds (often funded from natural resource revenues) civil society organizations should ensure that this code of conduct is adopted. The Public Finance Monitoring Center in Azerbaijan, for example, undertook a study of sovereign wealth funds across their region and internationally to develop a series of recommendations to improve the transparency and management of these funds.

More generally, civil society budget groups can use the information provided on extra-budgetary funds in the same way as they use other information on government finances.

One example of a successful campaign against opaque extra-budgetary financing of expenditure comes from Mexico. As part of the process of political liberalization in the mid-1990s, civil society leaders demanded information on what was called the president's "Secret Fund." How much money was there in this fund? How was it used? Did it include the president's salary, and if so, how much was it? While there was initially no clear response to the information request, it served to highlight important issues for which groups could use budget analysis to answer, if they had access to the necessary data. The Mexican civil society budget group, Fundar, was formed in part to seek answers to these questions, and its analysis of the fund contributed to the fund's dissolution.

## D. Relevant materials, websites, and "model reports"

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[http://www.pfmc.az/index.php?option=com\\_content&view=article&id=253:sovereign-wealth-funds&catid=39:swf&Itemid=64](http://www.pfmc.az/index.php?option=com_content&view=article&id=253:sovereign-wealth-funds&catid=39:swf&Itemid=64)

# The Open Budget Initiative

This guide is part of a series that looks at public finance topics in terms of transparency and accountability. The Open Budget Initiative may produce additional guides around other important related topics in the future.

1. Extra-budgetary Funds
2. Tax Expenditures
3. Quasi-fiscal Activities
4. Contingent Liabilities
5. Future Liabilities

This series is a companion to two earlier **Open Budget Initiative** guides on public budget transparency — one for governments and one for civil society organizations.



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