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Budget System Reform in Emerging Economies

The Challenges and the Reform Agenda

Jack Diamond

INTERNATIONAL MONETARY FUND
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Abbreviations and Acronyms

ABC	Activity-based costing
BO	Budget office
BOP	Balance of payments
B-O-T	Build-Operate-Transfer
CBO	Congressional Budget Office (U.S.)
CE	Chief executive
CoA	Chart of accounts
COFOG	Classification of the functions of government
CRM	Constituent/customer relationship management
ECOFIN	Council of Economics and Finance Ministers of the European Union
EU	European Union
FAD	Fiscal Affairs Department (of the International Monetary Fund)
FRL	Fiscal responsibility law
GAO	Government Accountability Office (U.S.), formerly General Accounting Office
GFMIS	Government financial management information system
GFS	Government finance statistics
GFSM	Government Finance Statistics Manual
GPRA	Government Performance and Results Act (U.S.)
IMF	International Monetary Fund
IRA	Independent revenue authority
IT	Information technology
LM	Line ministry
MoF	Ministry of finance
MBS	Modified Budgeting System
MTBF	Medium-term budget framework
MTEF	Medium-term expenditure framework
OECD	Organization for Economic Cooperation and Development
OMB	Office of Management and Budget (U.S.)
PART	Program assessment rating tool
PBC	People's Bank of China
PEFA	Public Expenditure and Financial Accountability Program (World Bank, European Commission, IMF, and others)
PEM	Public expenditure management
PFM	Public financial management
PPBS	Planning, programming, and budgeting system
PPP	Private-public partnership
PSA	Public service agreement
SDA	Service delivery agreement
SGP	Stability and Growth Pact (EU)
SMART	Specific, measurable, achievable, relevant, and timed
SNA	System of national accounts
SPO	State planning office
SUNAT	State revenue authority of Peru
TA	Technical assistance
TSA	Treasury single account
UN	United Nations

Preface

Over the past two decades, many countries in the Organization for Economic Cooperation and Development (OECD) have introduced fundamental changes in budget management involving increased emphasis on performance and results achieved from the use of public resources. With increasing frequency over the past decade, the Fiscal Affairs Department (FAD) of the IMF has been called upon to assist middle-income countries, especially emerging economies, in adopting these types of budget reforms. Repeatedly, technical assistance (TA) missions have been required to offer advice on how to introduce or sustain such reforms. In doing so, missions typically have addressed a number of recurring questions. What has been the experience of OECD countries? Are there any general lessons to be learned? Can, or should, the same general reform strategy be applied to non-OECD countries? Just how universal is this reform paradigm? How should countries first begin these reforms, and how should they be subsequently sequenced? Do all countries have the management capabilities within their governments to implement such reforms?

Given that the same questions are raised in many countries, it was considered useful to attempt to provide the answers, perhaps more comprehensively, based on a review of our experience providing TA to middle-income countries. Not surprisingly, this comprehensive view revealed the basic underlying strategy that was being recommended for budget system reform, and this is reported in this study. Not only is this an important input to FAD's ongoing efforts to review and improve its TA advice, but it is hoped that it also will be useful to policymakers and administrators in emerging economies who are contemplating such reforms.

Given the nature of the study, based on a review of TA advice, this is very much a product of the numerous FAD TA teams that have worked on a wide range of related issues. The fundamental contribution from all these colleagues, especially in the two public finance management divisions of FAD, is gratefully acknowledged here. The author is particularly appreciative of the opportunity to work with and to learn from Piyush Desai, Geoff Dixon, Ole Hovland, Tony Olliffe, and Vijay Ramachandran, whose contributions to this study are significant. Special thanks are due to Jim Brumby, Marc Robinson, and Holger van Eden who commented on—and considerably improved—previous drafts. As always, the author bears responsibility for any remaining errors. Special mention should be made to Miriam Villarroel, Raquel Malamud, and Victoria Macchi, who labored with such good humor on a number of previous drafts of this study. Linda Griffin Kean edited the manuscript and coordinated production of the publication.

I Overview

Among the major challenges faced by transitional and emerging market economies is the need to adjust institutions to function in an increasingly market-oriented and global environment. Among the reforms that middle-income countries have looked to emulate are the budget reforms that have been introduced in OECD member countries since the 1980s. These reforms have reoriented budgeting from the traditional focus on inputs to a new focus on the results derived from these inputs. This latter focus has often been termed *performance* or *results-based budgeting*. However, the resulting budget systems embody more than a change in the process of budgeting. They reflect a fundamental change in budget management, away from traditional, centralized control systems to more decentralized management models.

It is argued in Section II that this reform process can be characterized as following three fundamental tracks: first, to allow managers greater flexibility in managing resources; second, to give them greater certainty in resourcing; and third, to introduce a system of rewards and penalties to pressure them to perform, in the sense of achieving the stated objectives of government policy. The pursuit of this three-track reform process in turn has fundamentally altered the accountability relationships within government by replacing detailed central controls with greater flexibility for budget managers operating at "arm's length." These new accountability relationships are designed to impose discipline on this new performance management framework, are oriented toward results rather than toward inputs, and can be viewed as the cornerstone of the new performance management model. Not surprisingly, their introduction has generally required considerable effort to restructure the budget system.

Usually, the first step is to improve the definition of government programs and clarify their objectives, to ensure that programs are prioritized according to a strategic policy framework. While the need for a meaningful link between policy and budgeting has long been recognized, it has also consistently proved elusive, as indicated by a brief review of the history of the performance budgeting approach. Officials in most emerging economies accept that the central role of the program structure is to translate broad policies into activities and projects that can be costed, with the identified resource requirements approved as budget appropriations. At the same time, many also appreciate that this cannot be viewed as a one-time annual exercise. Increasing numbers of countries are adopting medium-term budget frameworks (MTBFs) to assist in capturing the full costs of activities and projects over time, and hence to better plan programs, to improve prioritization among them, and to provide some overall discipline over their resource use. However, as discussed in Section III, developing and maintaining an MTBF is not always easy.

The next step in creating the new accountability framework is to link inputs with program outcomes, and then to make performance information relevant to managers by tying this information to resource allocation decisions. As discussed in Section IV, the definition and measurement of program outputs (and, even more so, of program outcomes) is often problematic. Also, there are added requirements, namely to produce such performance information on a consistent basis, to provide incentives for managers to use this information, and to monitor the managers' performance against these standards. Not surprisingly, it is likely to prove difficult and costly for many emerging economies to implement a full-blown performance management system such as that found, for example, in New Zealand or Australia.

The remainder of this study discusses the type of changes required to facilitate adoption of the new budget management model. Based on OECD country experiences, it argues that, first, certain basic safeguards should be put in place to ensure that public expenditure management (PEM) systems are able to accommodate the new demands. Second, the new accountability framework generally requires complementary changes in the way government operations are institutionally organized. This in turn often requires parallel changes in the legal framework. Third, a considerable investment must be made, both politically and financially, to manage the reform process.

Three aspects of the PEM system that often are weak in emerging countries and require upgrading are discussed in Section V. First, there is the need to strengthen internal controls. Before attempting to give agencies wider responsibilities in resource allocation, it is essential to ensure that they are operating within an effective financial management framework. Good internal control is an important feature of this framework. Without satisfactory controls, management may not detect serious errors and irregularities, and the work of the central oversight agencies, as well as external audit, becomes more difficult. Second, internal audit is a central component of internal financial controls aimed at protecting the government's financial interests. Third, there is typically a greater need to apply information technology. Against the background of the ever-growing volume and complexity of government financial operations, timely management information reports in a usable form are clearly of critical importance to fiscal managers. Tailoring such reports to management needs through a computerized financial information system has been a general PEM reform undertaken in various parts of the world. This has not been easy, and the new performance information requirements are likely to make this more difficult. Fourth, preparing this new performance information requires that institutions have the capacity to capture the full cost of programs and activities so that these can be related to performance measures to judge program performance. Unfortunately, such cost accounting expertise is often scarce in government.

Section VI reviews in greater depth one of the most discussed tools for strengthening government performance—upgrading the government accounting system from a cash to an accrual basis. The typical government accounting system, even if conceptually well defined and internally consistent, is a cash-based system or, at most, a modified cash system. The emphasis is on matching approved items of spending with actual cash outlays, the last stage of spending. This may be adequate for the compliance and stabilization objectives of the ministry of finance (MoF) but it is less relevant for budget managers in government departments. It has been argued, therefore, that the move to the next stage of budget system development requires a switch in government accounting toward an accrual-based system. Those countries that have attempted to shift to accrual accounting have found it difficult and costly. An argument can be made that many of the benefits of improved costing derived from accrual accounting can be obtained by other means, and accordingly, that perhaps an intermediary move to accruals is all that should be attempted by emerging economies.

The performance budget management approach requires introducing enhanced accountability with improved transparency, further emphasizing the evaluation of outputs in relation to inputs, and streamlining control mechanisms to balance control needs and new efficiency requirements arising from more decentralized budget management. Moving to this management model has created parallel pressures to reorganize the way that governments do business. This aspect of budget reforms is taken up in Section VII. To provide a framework for discussing the wide range of institutional innovations, these are ordered into five main groups, each characterized as a progressive shift away from the traditional, centralized budget management model. These groups are characterized as the *five Ds*—deconcentration, decentralization, delegation, devolution, and divestment. The latter three are most closely associated with the new performance management approach.

Two aspects of these new arrangements that have received the most attention internationally are highlighted—the role of contracting in government and the role of more autonomous devolved management units, the so-called agency model. The study warns that these approaches can be problematic, especially initially if administrative and accountability systems are not sufficiently robust. Full output and performance contracting is very resource-demanding and has been fully realized in only a few fairly advanced countries. Not surprisingly, even more limited movement in this direction is likely to strain the administrative systems in emerging economies. Similarly, the demands on PEM systems are quite heavy, especially with regard to reporting requirements and the skills required of managers. Similar concerns are expressed with regard to various strategies for divesting or sharing government responsibility for providing public services, through such mechanisms as contracting and private-public partnerships (PPPs).

The fact that it is difficult to find emerging economies that have made rapid progress on all three tracks of the reform process indicates that there are important implementation problems. Section VIII suggests that many of these difficulties have arisen from the lack of basic management infrastructure within the budget system. The capacity to successfully link policies with programs through strategic planning mechanisms requires the skills to construct MTBFs with well-defined programs. It requires analytical skills and adequate reporting systems to make clear the relationship between the resources used by a program and its outputs and/or policy results (outcomes). As indicated, the basic work of program design and program costing is unlikely to be straightforward and is likely to demand skills, such as cost accounting, which are often in short supply. At the same time, this new approach to budget management also requires parallel administrative procedures to activate the strategic plans and the program structure for decision making. This move inevitably must reflect the reform capacity of the country and, to be successful, should not be implemented too rapidly and should be carefully sequenced. As argued in Section VIII, the transformation from traditional budgeting procedures is likely to require a substantial effort to manage the change process, a dimension which has often been overlooked. Thus, for many countries, human resource constraints may impede, or at least slow, the move to performance budgeting.