

# **Integrating Financial Management and Performance Management**

By  
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## **1. Introduction – Setting Out the Key Issues**

### **1.1. Purpose and Plan of the Paper**

The objective of this paper is to assess mechanisms to improve resource planning and allocation by integrating financial and budgetary management with performance management.

The paper is organised in four sections. This first section lays out the basics. The objectives of financial management and performance management as part of an integrated resource management framework are discussed. However, it is noted that in practice such integration has often been hard to achieve. A list of reasons why integration can be difficult – or can fail – is set out.

The second section sets out a framework within which a systematic analysis can be launched. This framework consists of: 1) a map of key interfaces at which the degree of integration of performance management and financial management may be assessed (i.e. the scope, depth, consistency of integration); and 2) a set of five

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main contextual variables which, depending on their “setting” in any given context, may increase or reduce the difficulty of integration.

The third section looks in more detail at the varieties of integration; that is, it seeks to identify the dynamics that result from the interaction of key variables at specific interfaces between processes. Potentially, these dynamics provide the basis for the articulation of a set of “indicators” of integration.

In the fourth and final section, the focus moves directly to the possibility of developing indicators of integration. A preliminary and tentative list of such indicators – set out in the form of questions to be asked of the arrangements in any jurisdiction under study – is suggested as a stimulus to further discussion. The paper concludes with some brief observations about possible strategies for integration.

## **1.2. Definitions and Objectives**

Financial and performance management systems are tools to achieve the objectives of the resource management system within which the budgeting and management activities of government take place. Therefore, the discussion of integrating financial and performance management systems must begin around the basic objectives of a resource management system. These are to:

- *instil and maintain aggregate fiscal discipline (i.e. to ensure the government does not, overall, spend more than it intended to);*
- *allocate resources in accordance with government priorities (i.e. to spend on what is deemed politically most important – allocative efficiency);*
- *promote efficiency in the use of budgetary resources to delivery programmes and services (i.e. to encourage technical efficiency).*

(Campos and Pradhan, 1996; Schick, 2001)

Campos and Pradhan (1996) describe three key interrelated problems related to achieving these objectives: 1) the “tragedy of commons” whereby the budget is viewed as a common resource pool which various claimants for resources can “dip in to” with no or little costs; 2) information revelation and “voting cycle” problems that can impede strategic prioritisation of allocations to government priorities; 3) information asymmetry and inappropriate or incompatible incentives within government (principal-agent type problems) that can impede efficient allocation and use of resources. In addition to these three problems, it should be acknowledged that sophisticated resource management systems may encounter significant organisational problems. Designing institu-

tions and operating procedures to meet the three objectives identified in the quotation above is as yet an only partly understood craft.

Ideally, the systems for financial management and performance management (including people management) introduce the tools, incentive systems and institutional arrangements by which governments seek to mitigate or minimise these problems and maximise achievement of objectives. In doing so, both financial and performance management systems share four key objectives (although the processes and skills employed to achieve the objectives are likely to be different):

- setting objectives and allocations for government actions (*e.g.* based on input, outputs, and/or outcomes; historical incrementalism or strategic prioritisation);
- establishing the types of authorities for carrying out those actions (*e.g.* centralised, decentralised, devolved, contractual, legal);
- determining what information is needed to know if actions are executed properly (*e.g.* measurement, information and reporting needs);
- rewards and sanctions for performance (*e.g.* accountability framework, incentive systems).

In a well functioning resource management system, financial management and performance management processes will exist using complementary and mutually supporting processes. However, in reality, financial management and performance management systems tend to develop separately as parallel systems that may or may not (or only to varying degrees) be harmonious or even compatible. Similarly, they may or may not be appropriately aligned (individually or collectively) to achieve the objectives of an effective resource management system as set out above. In some systems, it may not be clear whether processes are attached to performance management or financial management systems (*e.g.* target setting, control systems).

In general, however, there are a number of distinct processes that can be identified for each system. Although in the case of financial management, there is no ready-made and universally agreed view (Miller, 1994; Neuby, 1997; Rubin, 1992), we can start with the following:

*The control and operation of the cycle "budgeting-accounting-audit", embedded in a broader policy and management cycle of policy preparation and planning, decision, implementation, monitoring and controlling, and evaluation and feedback.*

(Reeth, 1998)

However, it is necessary to unpack and modify Reeth's definition before it will suit our purposes. Budgeting, accounting and audit are all certainly important elements within financial management, but to achieve a definition that will include the full range of "financial" activities which interface with performance management then it is necessary to construe "budgeting" in a broad way – so that it is understood to include the various processes of budget *execution/implementation*, as well as the "headline" activity of budget-making. Therefore we will consider "budgeting" to embrace not only monitoring and control activities, but also (for example) cash-flow management, purchasing, debt collection, property management and risk management. It is also worth noting that while there is a *normative aspiration* that financial management is always part of a wider system of planning, evaluation and feedback, this is by no means always the case in practice. Indeed these activities are often identified more clearly with the performance management side of resource allocation.

Taking into account the above points, for purposes of this discussion, a financial management system is defined as "the operation of those systems and processes designed for budget-making and budget implementation; the maintenance of an accounting system which records financial decisions, flows and transactions, and the auditing of all aspects of these accounts".

The definition of *performance management* is equally difficult in that it means very different things in different administrative systems, from the most basic management of employee performance in a highly centralised administration, to the vehicle for establishing and managing the highest strategic priorities of government and transforming them into strategic outputs cascading down through organisations to individuals. The OECD has described performance management in the latter terms (*i.e.* its strategic aspects) in the context of "new public management" type reforms. For purposes of this discussion, a performance management system is defined via a series of processes related to:

- *setting performance objectives and targets for programmes (and in many cases made public);*
- *giving managers responsible for each programme the freedom to implement processes to achieve these objectives and targets;*
- *measuring and reporting the actual level of performance against these objectives and targets;*
- *feeding information about performance level into decisions about future programme funding, changes to programme content or design and the provision or the provision of organisational or individual rewards or penalties;*

- *providing information ex post review bodies such as legislative committees and the external auditor (depending on the latter's performance audit mandate), whose views may also feed into the decisions referred to above.*

(OECD, 1995)

The general approach is, therefore, to shift attention from resource inputs and *ex ante* controls to output and outcome measurement and *ex post* controls. This approach rests upon the decentralisation of managerial authority in exchange for more explicit output- and outcome-oriented forms of accountability (such as meeting unit or individual targets). Control becomes more strategic and less concerned with compliance to prescribed processes (some commentators refer to this as “steering” rather than “control”). The institutional arrangements have, therefore, included a wide range of forms of decentralisation and performance measurement. Underpinning these is the development of more consciously designed system(s) of performance information. Taken together these elements comprise our understanding of performance management.

It is also important to note that a well functioning performance management system includes incentives, rewards and sanctions for translating performance objectives, measurement, and accountability to the staff level. Although the topic of human resource management is not addressed separately in this paper, its critical importance to a well functioning resource management system is noted and key linkages between organisational and individual performance management are revisited in Section 4 on *Indicators of integration*.

In summary, if we compare the above objectives of financial management systems and performance management systems, some overlap and mutual reinforcement is immediately apparent. Financial management systems aim for aggregate fiscal discipline at the macro level and also for more efficient service delivery. Echoing these objectives, performance management aims for increased efficiency at the micro and meso levels. Financial management seeks to allocate resources in such a way as to concentrate on those programmes which are of the highest political priority. In principle, there should be a link between this objective and performance management's aim of improving the quality and effectiveness of programmes, to the extent that political leaders wish to prioritise programmes that work well and achieve their objectives. Furthermore, the enhancement of accountability features as a goal for both financial management and performance management. In all these ways, therefore, financial management and performance management would appear to enjoy a “shared mission”. One could plausibly go further and state that progress with implementing contempo-

rary forms of financial management and progress with performance management are, to a significant degree, mutually interdependent.

### **1.3. So Why Hasn't Integration Taken Place?**

Despite the aforementioned vision of mutual interdependence and harmonious comparability leading to an effective resource allocation system, many commentators have acknowledged that integration of financial and performance management can be very difficult, and often does not take place. For example, one noted budgeting expert opined that:

*Performance budgeting has had many difficulties, and while sometimes implemented has seldom worked as billed, and has often been modified. (Rubin, 1992; see also Bouckaert and Ulens, 1998; Jones and McCaffrey, 1997, Mayne, 1996 and numerous other analysts who have pointed to the difficulties of marrying budgeting decision-making with good performance information).*

More commonly perhaps, the difficulties are never fully confronted, because the two streams of reform – financial and performance management – proceed largely independently of each other. To take one example, the Australian Department of Finance and Administration has recently published a very useful guide to *The Performance Improvement Cycle*, but one in which budgets and budgetary processes are scarcely mentioned, though there are some paragraphs about costing (Department of Finance and Administration, 1998). Another example would be the U.K. Citizen's Charter Programme, a major performance management improvement initiative which developed with very little reference to financial systems, other than the application of a Treasury rule-of-thumb that the exercise as a whole should be budget neutral.

A historical perspective also gives grounds for caution. The present enthusiasm, in a number of countries, for some variant of performance budgeting, is hardly the first time governments have attempted to bring budgeting and performance management processes closer together. In the USA, "... the federal government has attempted to implement performance budgeting in one form or another from the late 1940s through the 1950s" (Jones and McCaffrey, 1997).

In the United Kingdom and France, the history of attempts to implement Programme-Planning-Budgeting (PPB) type systems (called "RCB" in France) from the late 1960s and during the 1970s are well-documented (*e.g.* Monnier, 1992; Wildavsky, 1979). The general message seems to be that these systems were too ambitious, too cumbersome and too distant from the engrained habits of political

decision-making to take firm root, although they did work better in some departments and for some programmes than others, and they did leave a useful residue of data and analytical capacity.

So it is important to examine this “downside” of integration as well as the “upside”. As one expert asks, “if it is such a great idea, why isn’t everybody doing it?” (Gianakis, 1996). Have the frequent instances of failed or disconnected initiatives been mere accidents or oversights, or are there actually some risks or penalties attached to integration which need to be set alongside the benefits identified in the previous section?

Integration of performance management with financial management faces both technical difficulties and potential behavioural/political resistance. These are discussed below.

Budget processes are among the most deeply rooted routines of government, and involve both powerful players and considerable political interests, not least over crucial distributional issues. Therefore, to link change in these processes with the introduction of performance management schemes may sometimes be to complicate the process, multiply the number of hurdles to be overcome, and generally increase the risk that a reform process will fail to achieve its targets. Performance management is difficult enough to implement by itself. Trying simultaneously, and in one process, to achieve performance management and budget reform, may increase the chances that both will fail. As Mayne (1996) puts it: “Though consensus is needed for the implementation of results-based management, tensions are greater when the objective is to link performance to resource allocation”. Therefore, this is not an insuperable barrier, but rather a matter of managing change and ensuring that while systems may develop on different schedules, they are co-ordinated so they do not, at the very least, work against each other. One might term this the “*Trying to do too much at one time*” problem.

Some commentators claim that there will always be situations in which the requirements of the political process which surrounds budgeting and the requirements of the management processes which characterise performance improvement are in tension, one with the other. Here the argument runs that, in order to reach the complex and sensitive distributional deals which budget-making entails, politicians (both in the executive and the legislature) need to appeal to vague and general values, in order to create or maintain sufficiently broad coalitions of support (or at least, acceptance) for continuing this programme or cutting that one (see, *e.g.* Le Loup et al, 1998). The last thing they are interested in, during this

delicate and frequently adversarial process, is careful comparative evaluations of rival programmes or the specification of precise operational priorities and targets (e.g. Jones and McCaffrey, 1997; Monnier, 1992). Such exercises would show only too clearly “who gains and who loses” and what is the relative cost-effectiveness of different programmes, and would thus make coalition-management all the more difficult. The progress of performance management, by contrast, requires the participants to discuss and agree on realistic, measurable, dated goals, targets and standards, with a highly specific identification of client groups and their preferences. Whilst it is not necessary to believe that contradictions of this kind must always exist it would be foolish to pretend that the requirements of budget deal-making never conflict with the principles of good performance management. This could be called the “*comfort of ambiguity*” issue. This raises the interesting question of whether procedures and information flows can be designed in such a way as to encourage political decision makers to begin to give up the comfort of ambiguity in order to embrace a more informed stance. It is a sensitive issue, but some countries have at least begun to try to involve politicians in these issues, and to tailor information for their specific needs.

Nor do the incentives to maintain a certain opaqueness, or at least avoid clear, fully-costed inter-programme comparisons, affect only politicians. Civil servants may also be motivated to protect “their” programmes, and in doing so they may be less than welcoming towards schemes for full financial and performance transparency. This issue of “*Defending Your Patch*”, which can also occur at the agency/departmental level is well-known. In the US, for example, despite major management reform legislation in the early 1990s:

*[t]here remain very real incentives for departments and agencies to hide the full costs of comprehensive social welfare, national defence, public land management, transportation, energy and other programs in the federal budget decision process.*

(Jones and McCaffrey, 1997; see also Gianakis, 1996)

There is also what might be termed a cultural divergence between financial and performance management. Given the constant upward pressures on public spending, financial management is – at least in part – a process of discipline and control. Central budget offices struggle to moderate the demands of spending departments, and to remind other ministers of the need to give priority to macro-economic considerations which lie outside the particular social, strategic and managerial goals which inform and motivate most major government programmes (social security, health care, education, defence, etc.). By contrast, many performance improvement initiatives stress the deep social values of the particular goals

to be achieved by a specific programme, the need for teamwork, partnership and commitment to continuous improvement, and the paramount requirement of responsiveness to clients. There is, thus, what might be described, not so much as a contradiction, as a difference of mood between high-level budgeting and performance improvement schemes. One could call this the “*constraint or empowerment*” problem. It can manifest itself in a number of different ways, including tensions between finance and human resource management sections, and between those with a “hard”, “number-crunching” approach and those who prefer to focus on “softer” issues of quality, cultural change and capacity-building.

One serious technical difficulty occurs where the performance management system includes measures of effectiveness. In a number of countries, governments and experts have recognised the need to move beyond measures of outputs (usually efficiency measures) to measures of outcomes (effectiveness) (*e.g.* East, 1997). A balanced performance measurement system needs both. Indeed, outcome measures can be divided into two categories, as measure of effectiveness, and as improved policy planning through using outcome measures as indicators of direction in achieving public objectives (rather than as measures of impact) – *i.e.* as a tool for formulating policy rather than maintaining accountability (Schick, 1996). The difficulty arises, however, if there is an attempt directly to link budgetary allocations to effectiveness measures. While this may sound just common sense, in fact it is fraught with problems. “The primary obstacle to the integration of performance measurement and budgeting is that the required outcome measures are difficult to construct for public sector programmes” (Gianakis, 1996 – for a more colourful expression of essentially the same point see Wildavsky, 1979). The reasons for this are several. To begin with, for many programmes, outcomes change over a much longer time cycle than the budgetary year. So this year’s change of outcomes probably does not reflect the efforts of the current managers at all. Second, it is also frequently the case that outcomes are only partially determined by government programmes – that there are other determining variables which are beyond the control of the managers – and that linking resources to outcomes is, therefore, to greater or lesser degree unfair (Pollitt, 1997). Thus there is an “*attribution of outcomes*” issue.

Finally, it is necessary to recognise that, politically, for many programmes, failure to achieve outcomes does not mean that resources should be withdrawn and the programmes abandoned. The original political objectives (reducing poverty, reducing crime, creating jobs) will remain as important as ever. There may even be a case for allocating more resources to the task, whilst modifying the

programmes in the hope of achieving increased effectiveness. In short, automatic or formulaic links between measures of effectiveness and budgetary allocations will rarely be either technically or politically acceptable. This is not so much a barrier to integration as a recognition that, even where integration between performance information and financial information is achieved, the consequence of low performance cannot be assumed to be reduced funding. For example, it may be that those who have had authority to make decisions, have that authority revoked.

Acknowledging that there can be barriers to, or difficulties with, integration is one thing: concluding that integration is impossible is something quite different – and on the evidence available would be a sweeping and unwarranted conclusion. To take the discussion further it is necessary to be more specific about the particular types of integration that may be sought, and the particular *contexts* in which these efforts may take place.

## **2. An Analytical Approach**

### **2.1. *The Scope of Integration: Mapping the Interfaces between Financial Management and Performance Management***

There are dangers in speaking of “financial management” and “performance management” as though they were homogenous activities. In reality, they are broad labels, each covering a wide range of decisions and activities made and carried out at different levels and for different purposes. When a cabinet sits down, in the full glare of media attention, to decide whether cuts should fall more on defence, social security, or trade and industry, it is allocating resources. When the university professor ponders the department’s budget and wonders whether to spend the £5 000 which is free at the margin on a new computer, more part-time clerical assistance, or increasing the conference allowances, this is also allocating resources. But there are huge differences between the two processes – differences which go far beyond the larger numbers of zeros on the ends of sums which the Cabinet is debating.

It will be a theme of this paper that such differences are important for the question of integration. The specific problems of integration depend, to a large extent, on which processes are being integrated, in respect of what kind of activity, and at what level. The signs of success (or failure) for one process or at one level or one phase may not be the same as the signs for a different process or at a different level and phase. Thus, it is argued that there is a need to refine the ques-

tion of the integration of financial and performance management so as to allow for at least two sets of factors:

- which processes are being integrated, *i.e.* which specific financial and performance management systems are being integrated?
- which contextual variables (*e.g.* level of decision-making, type of programme or activity) are in play in the particular instance?

One preliminary step is therefore to create a framework within which it is easy to locate which processes are being integrated (or not, as the case may be). The framework provides a map of the terrain, so that the ensuing analysis can pinpoint the different kinds of “games” (*i.e.* different interactions between the key contextual variables) which are played in each part of the field. Table 1 provides a first approximation at such a map.

Table 1. **Key Processes in Financial and Performance Management**

Financial Management	Performance management		
	Target-setting	Performance measurement	Monitoring and reporting
Budget-making	A	B,	C
Budget implementation	D	E	F
Accounting	G	H	I
Audit and control	J	K	L

Thus, there are two axes: financial management and performance management. Financial management consists of the four processes of budget-making, budget implementation, accounting, and audit. Performance management divides into processes for target-setting, processes for measuring performance and arrangements for monitoring and reporting. Of course, this is a fairly crude division, but it already creates a field with a dozen different cells (A to L), and therefore the possibility of at least 12 different types of interface where integration may or may not take place. A more complex and sophisticated sub-division could easily be made – for example budget implementation could be broken down into many sub-categories including cash flow control, stock control, debt collection, risk management controls, etc. – but this level of detail is neither appropriate nor practical for a paper with the purpose and length of this one. We will return to the “map” in Table 1 when we come to Section 3.

We can now turn to the second set of factors, the contextual variables.

## 2.2. Key Contextual Variables

The literature (both practitioner and academic) on financial and performance management are full of allusions to important contextual factors. Five which are frequently mentioned are:

- types of budget;
- types of accounting system;
- types of programme;
- levels of decision-making;
- timescales.

The reasons why these are significant, and the implications they may have for integration, are discussed below.

### 2.2.1. Types of Budget

Many expert commentators have argued that different types of budget encourage (and discourage) different types of behaviour, both among the budget setters and the budget implementers. It is easy to see that some types are more open to the inclusion of performance information than others. Each type of budget has strong and weak points (Gianakis, 1996).

Line item budgets (with separate appropriation lines for salaries, travel, office supplies, etc.) are easy for non-experts (including legislators) to use and they facilitate micro-control. However, line item formats make it hard to integrate any significant type of performance data other than simple compliance with input appropriations. It should be noted that the input/line item form of budgeting may be deeply entrenched – even specified as a legislative requirement. To change it, therefore, may be no simple matter.

The introduction of global budgets (with single consolidated appropriations for all operating costs) and concomitant increase in managerial flexibility has been a major theme of budget reforms in a number of OECD Member countries in recent years. The introduction of global budgets, therefore, removes a major obstacle to the integration of financial and performance management. In fact, the move to global budgets presupposes a move to a performance-based accountability regime. This, however, has been difficult in practice as Allen Schick has noted:

*In every country that has moved in this direction, devolution of managerial control has advanced much further than has the assimilation of new accountability methods. The*

*quid pro quo of giving managers more freedom in exchange for making them accountable for results is asymmetrical: the former is much easier to accomplish than the latter.*

(Schick, 2001)

### 2.2.2. Types of Accounting

At least three aspects of accountancy systems influence the possibility for integration with performance management. First, there is *the* identity of the accounting entities. This may be encapsulated in the question: are the entities which report on performance the same as those which account for finance? In the case of, for example, U.K. Executive Agencies, the answer is generally “yes”. The agency has a framework document specifying its performance targets and it is also an accounting entity with its own accounting officer (usually the chief executive) who presents the accounts and may be called before Parliamentary committees to give evidence about the agency's financial position. In other cases, however, there may be a divergence – for example, where an agency or unit may have been given considerable managerial autonomy but the finance ministry still presents only a unified set of accounts on behalf of the government or the state as a whole.

Second, there is the extent to which a performance management entity operates with incomplete costing data (all the costs are not budgeted for directly). The point here is straightforward. Performance information about an entity may be distorted if the reported performances are, in part, being achieved on some other entity's budget. Thus, if an agency's buildings or vehicles or legal services are supplied by some central agency with a separate budget (a ministry of public works, a government vehicle service, a central legal unit), then it becomes harder to assess certain aspects of its performance – and impossible to conduct accurate price/quality analyses.

Third, there is the related question of whether accounting is conducted in cash or accruals terms. A number of OECD Member countries have moved or are moving from cash accounting to some version or other of accruals accounting (see, *e.g.* Jones, 1998; Likierman, 1998; Straw, 1998). Accruals accounting records costs and revenues as they are incurred/earned whereas cash accounting registers them when payments are made or receipts received. Proponents of accruals accounting argue that it yields improved management information – especially on costs and assets – and that it facilitates a closer integration of financial and performance measures. For example, New Zealand's experience of introducing accruals accounting suggests that it can certainly stimulate a sharper management of capital assets.

### 2.2.3. Types of Programme

Certain types of programmes lend themselves to performance measurement much more readily than others. For example, Bouckaert and Ulens (1998) distinguish between:

- Tangibles: measurable, standardised activities providing recurrent products or services (*e.g.* building roads, issuing licenses).
- Non-tangible individually tailored services: more individually tailored services such as teaching or health care, where there are routine aspects but also a need to adjust the service to individual, personal needs and contexts. Here, it is more difficult to capture the essence of the service in just a few key measures.
- Non-tangible ideal services: less standardised, less routine services (*e.g.* co-ordination of other activities, provision of policy advice).

Both performance measures and the calculation of reliable unit costs are likely to become more difficult as one moves down the scale from Type 1 programmes to Type 3 programmes (see also Bouckaert and Halachmi, 1996). It therefore seems obvious that, *ceteris paribus*, the integration of performance and financial measures is likely to be least difficult with tangible, standardised products and services. One might add that the Bouckaert and Ulens classification does not seem to take full account of a fourth – and growing – category of governmental activity, namely regulation. Measuring the performance of regulatory agencies poses special problems (see *e.g.* Foster, 1992), as does budgeting for regulatory agencies (*e.g.* Thompson, 1997).

Briefly to illustrate the importance of programme type further, consider the application of the new Resource Accounting and Budgeting (accruals) framework to the U.K. Ministry of Defence. Two experts explain that:

*Many central government departments simply process cash, for example grants or social security payments. In such cases, resource accounting and budgeting will produce few changes. The Ministry of Defence is different. It deploys extremely expensive assets, to produce a result which is tangible in concept, but mercurial in practice, "fighting power".*

(Gillibrand and Hilton, 1998)

They go on to point out a number of complexities – and possibilities for perverse incentives – which arise from the peculiarities of the defence programme.

The type of programme also influences the scope for price/quality (or cost/quality) trade-offs. Tangibles such as the construction of stretches of roads or

the issue of licenses or permits have clearly identifiable costs and equally clear outputs (the road gets built to schedule, or not). The product is fairly standardised, so quality measurement systems should not pose too great a challenge. Thus, a price/quality schedule can be calculated and considered and targets based on that may be set at the same time as financial allocations are being made. With non-tangible, personal services it is considerably more difficult, particularly because the lack of standardisation often leaves the quality side of the equation in shadow. Nevertheless, considerable progress has been made over the last two decades. “Ideal” and regulatory services are even more problematic – taking policy advice as an example, while it is perfectly possible to establish performance targets in terms of timeliness and comprehensibility, that is not at all the same thing as the underlying quality of the advice. Attempts have been made – notably in New Zealand – but, however one judges their success, it remains the case that price/quality trades-off are easier to measure and to comprehend with tangible, standardised products (Boston, 1994; Pollitt and Bouckaert).

#### 2.2.4. Levels of Decision-making

There are various ways of classifying the different levels, but for present purposes a five-fold classification is probably sufficient.

- a) Agreeing the global totals for public expenditure. We may term this the level of aggregate expenditure policy-making (remembering the definition of the objectives of budgeting given in Section 1.2 above).
- b) Dividing the total between major sectors (defence, education, law and order, etc.). This is the level of inter-sectoral allocation.
- c) Allocating resources to particular programmes within a sector (*e.g.* to nursery education, secondary education, universities, within the education budget). This might be referred to as intra-sectoral policy-making.
- d) Allocating resources to particular activities or institutions within a particular programme (*e.g.* allocating proportionately more resources to university X than university Y, because X has a better research performance and/or because it has expanded its student numbers faster in subjects which the government regards as being of high priority). We could call this programme priorities management.
- e) Allocating resources within a particular institution or activity (*e.g.* if a university decides to transfer resources from the academic salaries budget to the travel budget, or even whether to purchase services from

outside sources rather than produce them in-house). This is operational management.

It should immediately be noted that real budgetary and financial processes are not necessarily arranged in this neat, clearly layered manner at all. In some jurisdictions, there is currently no process by which overall global totals are agreed upon before sub-allocations take place. In many countries, budgeting at different levels is more a continuing process of interaction and mutual adjustment than a hierarchical, logical sequence. In short, top-down and bottom-up elements have different weightings within different countries, and there is sometimes even considerable variation between different levels of government within single countries. For analytical purposes, however, the present paper will make use of these five levels.

Another point to bear in mind is that the line between budget-making (or budget setting) and budget implementation (or budget execution) may be differently perceived by different “players” at different levels. Normally, for example, decision processes A and B are unmistakably budget-making, and the decisions, when taken, are sanctioned by the legislature and possess legal force. By contrast, from the point of view of a minister or top level civil servant in a ministry, decisions at levels D and E may appear as straightforward budget execution. However, to those directly involved (institutional leaders, divisional or departmental heads within agencies and service-providing institutions) levels D and E may be experienced as budget-making (available resources are allocated between competing demands, etc.).

As noted earlier, a feature of the public management reforms carried through by many OECD Member countries since the late 1970s has been a decentralisation of authority for financial management, and the encouragement of greater cost-consciousness among staff at all levels. One strand in this development has been the tendency to abolish or relax the strict divisions between different budget lines, increasing the powers of transfer exercised by middle and lower level managers – the ultimate stage being a “one-line” or block budget, where local managers can move resources between all budget lines. As the discretion available to middle and lower tier managers increases in this way, their task takes on more of the character of budget-making as well as budget execution. Of course, practice varies considerably between different OECD Member countries and different types of public bodies in these respects. In some cases, traditional line item budgeting is still strongly in force, and transfer is tightly controlled from the centre.

Some general relationships may exist between the five different levels of decision-making and the integration of financial management with performance

information. The two “highest” levels – aggregate expenditure policy-making and inter-sectoral allocation – are probably the most difficult into which to introduce and integrate performance information. A number of studies in a number of countries indicate that these are the levels at which political values and ideologies, plus macro-economic pressures, have their most direct and powerful influences, to some extent “crowding out” consideration of performance data concerning specific programmes or services (see, *e.g.* Bouckaert and Ulens, 1998; Jones and McCaffrey, 1997; Mayne, 1996).

At lower levels (C,D,E), a significant degree of integration between operational management and financial processes may be more obviously attractive to the key “players”, and therefore more readily attained. We will return to these issues in Section 3.

#### 2.2.5. Timescales

Particular difficulties may arise where programmes have long timescales for achieving their effects, *e.g.* some environmental improvement programmes or basic research programmes or advanced military weapons development. To some extent, the same problems arise where programmes are focused on “eternal goals”, such as reducing crime or eliminating poverty – variables which are unlikely to shift dramatically within the space of a few months (or not because of government action, anyway). In such circumstances, to budget annually, or to set and re-set performance targets annually may not make a great deal of sense.

These programmes can be seen as an extreme case of a more general problem – that quite a few of the activities of government cannot be optimally managed if their financing is rigorously divided into chunks of only a single financial year at a time. High spending in the last month of the financial year is merely the best known symptom of the dysfunctional effects of strict annuality. To ameliorate these perversities a number of OECD Member countries have introduced some operational flexibilities at the end of each year (*e.g.* the Swedish provisions for carry forwards and borrowing against future allocations – see Blondal, 2001).

### 3. Varieties of Integration

#### 3.1. Which Are The Key Interfaces?

Section 2 identified at least 12 interfaces at which integration could be high, low or completely absent (A to L in Table 1). Arguably, some of these are more

important than others, and therefore should attract the attention of those studying integration first. For example, it can be suggested that interfaces A, C, E and H are of great significance whereas (say) G and J are somewhat less crucial in the overall scheme of things. The remainder of this section explains why this is (usually) so.

Interface A (budget-making: target-setting) is important because for performance targets to be set without any link to the way in which the budget is made risks an air of unreality infecting the performance management system. Confidence in performance targets will be undermined if they bear no relation to the allocation of budget resources, and the ultimate achievement of the targets in question can easily come to seem arbitrary and/or of only secondary importance.

Interface C counterposes budget-making with the monitoring and reporting of performance. This is a fundamental interface because, if the budget-making process does not routinely include inputs of performance information (how efficient and effective programmes have been; whether they have met their targets) it is impossible for budget decision-makers to shape their allocations on the basis of performance at all. Of course, the mere presence of performance information does not guarantee that it will be used (Gianakis, 1996) but its absence absolutely ensures that it will not be! Moreover, this raises the question of how to increase incentives or pressures at the political level to use information in evaluating resource planning and allocation decisions.

Surely, one might say, budget allocation decisions should be made in the light of reported information about the performance of each programme? In practice, however, the ease or difficulty of achieving this are often strongly related to the variable level of decision-making. For the reasons developed in earlier sections, it is much harder to achieve integration at the highest levels (aggregate expenditure policy-making, inter-sectoral allocations) than at lower levels (programme priorities management, operational management).

The middle level – intra-sectoral policy making – can also be difficult. Here, the problem is often some variant of the “*Attribution of outcomes*” issue. When a Minister of Education is making allocations between, say, primary, secondary and tertiary education programmes, it is hard to argue that the minister should do so principally on the basis of current measures of either efficiency or effectiveness. Efficiency measures may be radically disconnected from educational outcomes (*e.g.* low efficiency may produce good results, so that withdrawing resources could damage some of the most effective institutions). Effectiveness measures (educational outcomes) may be determined as much by the catchment population and by earlier educational experiences as by the efforts of the current teaching force, so to

allocate resources on that basis would be somewhat unfair. And in any case, even if, say primary education seems to be both inefficient and ineffective, it would be a brave, if not foolish, minister who would, therefore, withdraw resources and transfer them to secondary or tertiary programmes. Good primary education would remain a fundamental public objective, however poorly the current set of institutions were performing.

In sum, we arrive at a modified conclusion – interface C (budget-making: monitoring/reporting) is of crucial importance, but one must expect that the influence of performance data on allocative decisions will vary somewhat with the level of decision making, generally being more influential at middle and lower levels. If, however, one were to find that the presence of performance data in budget-making decisions was flimsy even at these lower levels, then that would be a significant indicator of a low degree of integration between financial management and performance management in the system as a whole.

Interface E (budget implementation: performance measurement) is also a vital one. This is where the implementation of the budget – month by month financial management – connects (or fails to connect) with performance measurement. The central question is whether operational managers, when applying their financial resources, are also measuring the performance achieved with each financial input, or whether the two streams of information, financial and operational, are quite divorced from each other? For example, when the manager of a social security office decides to hire 10 extra part-time staff to cope with an anticipated surge of work following a local factory closure, is the manager also able to measure whether the presence of those staff actually does maintain or improve the service which the office provides? Are the requisite measures in place, or are the extra staff merely being thrown at the problem on the basis of faith and hope?

A third crucial interface (H) is the one between the accounting system and the performance measurement system. Integration of this type means that the categories within which performance is measured are aligned with the categories in which accounting information is collected. If, for example, accounting is conducted only in a highly aggregated way, by department – or, alternatively, only by detailed budget “lines” – whereas performance is measured for each autonomously managed local service delivery unit, then managers will not be able to obtain reliable costings of their activities. Since efficiency is usually defined as the ratio between resource inputs and measured outputs, a lack of input cost data grouped by activity means that performance data cannot be turned into efficiency data. To know that the number of claims dealt with or grants issued has increased

is interesting, but unless the accounting system will divulge the changes in costs associated with processing more claims or issuing more grants, then the efficiency dialogue cannot even begin.

Interfaces G and J (accounting: target setting and audit/control: target setting) may be said to have lower importance in the general scheme of things. They are dependent upon integration at the more crucial interfaces, and in that sense are secondary. Thus, the integration of target setting and accounting depends on the prior integration of the performance measurement system and the accounting system (interface H), as discussed in the previous paragraph. Similarly, performance auditing of target setting can certainly serve a useful function within a broader system of integration (see, *e.g.* National Audit Office, 1995) but the very possibility of this occurring rests largely on the more fundamental establishment of integration at other interfaces, especially B and E (budget-making: performance measurement and budget implementation: performance measurement). Likewise, more generally, the establishment of a system of independent performance auditing may act as an important guarantor of the integrity of an integrated system of financial and performance management (Hencke, 1998; Pollitt *et al*, 1999) but this can only follow a shift to performance management and activity-based costings by departments and agencies themselves.

The main “message” of this section is therefore that some interfaces are usually more fundamental than others, and should be attended to first.

Table 2 presents a summary of the contexts in which integration would be more or less difficult to achieve. Most contexts will be neither as favourable as column one, nor as unfavourable as column two. Indeed, in practice, few government programmes possess all the characteristics in column one. While the second column presents us with an extreme example of the “trying to do too much at one time” problem combined with the “attribution of outcomes” problem, plus the possibility of a variety of other difficulties.

The literature reviewed does not permit any firm generalisations to be made about the relative importance of different single variables, but the level of decision-making does seem to be mentioned with particular frequency, and clearly both the type of budget and the prevailing accounting system go a long way towards determining where the “starting line” is for any exercise in integration. Neither budgeting systems nor accounting systems can be changed overnight. If the budget is line item and/or the accounting system cannot be used meaningfully to cost programme activities, then these basic “building blocks” in any integrated

financial and performance management system will need to be addressed before anything more sophisticated is attempted.

**Table 2. Key Variables for Integration**

<b>Integration would be easier in a context where:</b>	<b>Integration would be more difficult in a context where:</b>
<ul style="list-style-type: none"> <li>• Strategic target/objective setting is linked to resource allocation.</li> <li>• Global or output-based budgeting is in place.</li> <li>• Full cost activity accounting is in place.</li> <li>• The programme in question consists of a set of tangible and measurable products or services.</li> <li>• Integration is being attempted at the levels of programme priorities management and operational management.</li> <li>• The impact of a programme can be seen soon after the services or products are delivered.</li> <li>• The results (outcomes) can be attributed to the programme with high confidence (rather than there being reason to suspect that they were caused by other factors).</li> </ul>	<ul style="list-style-type: none"> <li>• Historical incrementalism is the basis of resource planning and allocation.</li> <li>• Line item budgeting is in place.</li> <li>• The accounting entities do not match the units in which programme activities are carried out and performance is measured.</li> <li>• The programme consists of non-standardised, non tangible, “ideal”, services.</li> <li>• The effects of the programme can only be detected in the long-term.</li> <li>• Even when “result” are detected, attribution directly to the programme is uncertain.</li> </ul>

### **3.2. All, or Nothing, or Something In Between?**

In an ideal world, “full” integration would presumably involve entirely compatible finance/performance systems being in place at all 12 interfaces mapped in Table 1, and this completeness being attained for all programmes (of whatever type) and at all levels of decision-making. The literature contains no suggestion that this state of grace has actually been achieved in any jurisdiction, and for the many reasons cited above, that is hardly surprising.

On the other hand, it is equally unlikely that any government would completely forswear all ambitions to link financial management and performance management. That would be quite out-of-tune with the times, and would amount to a declaration that the government concerned did not want to know what relationships might exist between, on the one hand, the resources they allocated to

various activities and, on the other, what those activities achieved or how well they were run.

In practice, therefore, all jurisdictions are somewhere in between the poles of complete integration and no integration. It is quite clear that many governments think it both worthwhile and a matter of urgency to “move up” the integration scale, even if the ideal of full integration remains elusive (Auditor-General of Canada, 1997; East, 1997; Likierman, 1998; Mayne, 1996; OECD, 1997; Radin, 1998). This being the case, the question becomes more one of “where next to seek further integration” than “how to move swiftly to complete integration at all interfaces”.

#### **4. Conclusions: Indicators of Integration**

##### **4.1. Indicators of Integration: Interpretations and Limitations**

The following subsection contains a list of possible indicators of integration. However, before getting into the detail and substance of the matter it is necessary to make some preliminary remarks about the derivation, status and intended modes of use of the indications suggested.

First, it should be apparent that the indicator questions chosen have been derived from the earlier parts of this paper. In particular, they reflect the significance already attributed to differences in the levels and types of decisions with which legislators, executive politicians and public managers may each be involved. Thus, the first key question and subsidiarity question is mainly concerned with quite high-level budget-making – aggregate expenditure policy-making, inter-sectoral allocation and intra-sectoral allocation. The second key question, by contrast, is focused more on the budget implementation phase – programme priorities management and on operational management.

It should also be clear that the questions are selective. Not every interface identified in this paper has a corresponding question or questions – the “map” is not completely covered by the questions presented here. That is partly for practical reasons – it would be easy for the questions to grow to an unmanageably large number. But the selection also reflects the discussion in Section 3, in particular the argument that some interfaces and variables are usually more significant than others, and it is upon these that any assessment of the degree of integration achieved should therefore concentrate.

The status of the set of questions is that they are intended as a basis for further discussion and refinement. It is probable that further consideration will

suggest additional questions, or sharpen existing questions, or indicate that some variation in the schedule of questions is advisable according to the particular circumstances and institutions of each jurisdiction. The author is very conscious that the present paper is something of an expedition into uncharted territory, and it would be fortunate indeed if this first sketch map were to prove either complete or entirely reliable.

Finally, it should be understood that the questions are intended to be used as “tin openers” rather than “dials” (Carter *et al*, 1992). It is considered that the state-of-the-art will not – at least not yet – permit a simple “tick-the-box”, check-list approach. The questions proposed will do their job if they lead to other, deeper questions (if they open the tin). The answers to these further questions would then gradually build up an overview of the state of integration between financial and performance management systems in a given jurisdiction.

#### **4.2. Indicators of Integration: Some Modest Proposals**

Taking into account the qualifications expressed in the preceding subsection, we now propose, and briefly comment upon, some indicators of integration. These will be presented in the form of a series of questions that may be asked of any jurisdiction.

- **Key question A: is performance data routinely included in the main budget documents?**

This is a primary indicator of integration, since budget-making is a basic process of financial management and if no performance data is included in budget documentation then performance cannot be taken into account by the relevant decision-makers. However, the question as formulated above is still very general, and can be refined by breaking it down into a series of subsidiarity questions. These would include:

- A1. Is performance data routinely included in the main documents considered by ministers?
- A2. Is performance data routinely included in the main documents considered by the legislature?
- A3. Is the inclusion of performance data in budget documents for the legislature optional for the government, or is it a legislative requirement?
- A4. How precise is the performance data: in particular, does it include performance targets (for ministers, for the legislature, for both)?

- A5. If the performance data includes targets, are reported performances for period  $t + 1$  (or as anticipated for  $t +$  future years) routinely compared with the targets set at period  $t, t - 1, t - 2$ ?
- A6. Is there evidence that performance data is regularly used in budget discussions, or is its presence mainly decorative?
- A7. Is the performance data which is included in budget documents subjected to any form of external validation (*e.g.* by an independent audit office)?
- A8. What is the balance of performance data as between process data, efficiency measures and measures of effectiveness?
- A9. When proposals are made for significant new expenditures is there a regular practice or requirement that such budget proposals must be accompanied by a formal evaluation (internal or external) of the new programme's likely cost, efficiency and effectiveness?

The above questions are mainly focused on budget-making as a public, accountable process. Clearly, most of these questions can be answered as matters of degree rather than as simple yes/no alternatives. Thus, in respect of question A4, the answer may be "Occasionally targets are given", or "In the majority of cases targets are given", or "targets are mandatory for all programmes". Or, for A7, the answer may be "The national audit office may inspect performance data on a case-by-case basis, as agreed with the legislature", or "The national audit office has the right to validate any performance data", or "The national audit office has the right to validate any performance data, and has a planned programme of sampling that ensures it covers most agencies and sectors over a five-year period."

One brief example may help further to illustrate the point. In 1997, the Canadian Treasury Board published a document entitled *Accounting for Results* (President of the Treasury Board, 1997). In it, it was claimed: "departments and agencies are publishing their commitments for the coming year, but they are also reporting on their success in meeting the objectives they set themselves last year" (*ibid.*, Introduction). One might imagine, therefore, that Questions A1, A2 and A5 would each be answered with a resounding "yes". However, a closer reading indicates the need for a more nuanced comment, and for deeper questioning. The document contained few quantified targets and many broad, qualitative statements of intent. The financial data was not arranged by activities but simply consisted of a listing of the total, aggregated budget for each department and agency. In the majority of cases, the reader could not in any way establish what

value for money was being delivered, or to what degree that value was improving or diminishing, year on year.

To return to the list of questions, it should not be assumed that all of them have “right answers”. A8 is an important question, but does not have a single “best” answer, even if some answers are clearly less satisfactory than others. Thus, the response that most performance data was process data (*e.g.* speed of processing applications; number of appeals against decisions) would be less impressive than the response that there was a mixture of efficiency and effectiveness data (*e.g.* Pollitt, 1986). However, there is no “magic” balance between efficiency and effectiveness – a high-quality performance management system needs good measures of both.

The second key question refers more to the internal processes of programme management and budget execution than to the public process of budget-making. It is:

- **Key question B: do programme and operational managers routinely integrate financial management and performance data in their stewardship of programmes?**

This question refers principally to the levels of programmes priority management and operational management (see Section 2.1.4 above). Again, it breaks down into a series of more precise sub-questions:

- B1. Are the entities or units of account for financial management generally orthogonal with the entities/units for which performance data is collected, or are these two streams of data collected in incompatible categories?
- B2. Is activity costing in place?
- B3. Is activity costing based on full costs?
- B4. How closely is the budgeting process linked to the corporate planning process (or nearest equivalent)?
- B5. Are operational managers routinely involved in the discussions about budget-making?
- B6. Do purchasing plans regularly include both financial targets and performance targets?
- B7. Do debt and credit management systems incorporate some form of performance targets?

- B8. Are there incentives/sanctions which apply to responsible organisational units for achieving/failing to achieve their targets?
- B9. Are there incentives/sanctions which apply to individuals (or teams/sections) for achieving/failing to achieve targets?
- B10. Do external auditors take into account performance aspects as well as the traditional issues of compliance with accounting standards?

It is not possible fully to assess the actual state of integration between financial and performance management by talking to central budget offices and central departments or units for public management alone. Integration at operational levels is a vital part of the overall picture, and to get a clear view of these levels it will be essential to hold discussions with programme and operational managers

The third key question concerns *preparations* for the integrated use of financial data and performance data. A jurisdiction may still “score” highly on this dimension, even if integration is not yet in place. Such preparations are signals of intent to integrate. The basic question is:

- **Key question C: are plans in place to enable the jurisdiction to move firmly towards the progressive integration of financial management systems and performance management systems, and to encourage all the principal stakeholders to make good use of both types of information?**

Sub questions would include:

- C1. Does the normal training in financial management include elements of performance management (*e.g.* does it include a consideration of performance indicator systems)?
- C2. Does the normal training in general management include elements of financial management?
- C3. Are there plans to introduce activity costing/accruals accounting/other systems which will collect and present financial data in the same units as performance data? At what stage are these plans?
- C4. Do the plans first, recognise, and, second, prioritise for action the wide range of interfaces which are potentially involved in an integration of financial management and performance management? [as per Table 1, or some more refined “map”]
- C5. Are members of the legislature encouraged/supported to pay attention to performance data when budgetary and other financial matters are being considered? [In some jurisdictions, for example, special seminars

have been presented to inform elected members about the strengths and weaknesses of new performance data, when it becomes available. In others, financial support may be provided for members individually or collectively to employ expert advisers.]

- C6. Are there mechanisms by which outcome measures as indicators of direction in achieving public objectives (rather than as measures of impact) – *i.e.* as a tool for formulating policy rather than maintaining accountability.

#### **4.3. Strategies for Integration: Avoiding the “Bridge too far”**

Finally, let us assume that a particular jurisdiction has examined the degree of integration between its performance management systems and its financial management systems, and has concluded that there is still a long way to go before full integration at all relevant interfaces is achieved. What, then, is the most appropriate strategy, always assuming that greater integration is deemed desirable by policy-makers?

One approach would be the radical one of launching a comprehensive strategy, designed to encompass all sectors and all levels. This would carry with it some obvious political benefits (it would sound dramatic and progressive) and would impress upon all public servants the priority accorded to integration by “top management”. However, it would also bear risks. The opportunity and, in some cases cash, costs would be high, as would the likelihood of failure in some programmes and at some levels where the variables (Section 2) were unfavourable. The lessons of PPB in the U.S., RCB in France and even – on a less spectacular scale – the Financial Management Initiative in the U.K. (Zifcak, 1994) should not be forgotten.

An alternative strategy – one towards which the present analysis clearly leans – would be more selective. It would begin by mapping the status quo and assessing the degree of readiness at each interface. It would then move on to identify those domains in which the key variables were favourable, or at least not too adverse, and concentrate resources for change in those areas. It would seek to establish the foundations, in terms of “performance-friendly” accounting and budgeting systems, before placing too much weight on attempts at sophisticated integrated decision-making. It would be a mixture of top-down and bottom-up rather than a preponderantly hierarchical exercise. In these ways, a selective strategy would reflect the fundamental point that integration is a means to an end – or rather to a series of ends – not an end in itself.

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