Managing Public Expenditure
A Reference Book for Transition Countries

Edited by Richard Allen and Daniel Tommasi
THE SIGMA PROGRAMME

SIGMA — Support for Improvement in Governance and Management in Central and Eastern European Countries — is a joint initiative of the OECD and the European Union, principally financed by the EU’s Phare Programme. The Organisation for Economic Co-operation and Development is an intergovernmental organisation of 30 democracies with advanced market economies. Its Centre for Co-operation with Non-Members channels the Organisation’s advice and assistance over a wide range of economic issues to reforming countries in Central and Eastern Europe and the former Soviet Union. Phare provides grant financing to support its partner countries in Central and Eastern Europe to the stage where they are ready to assume the obligations of membership of the European Union.

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For more information, contact: SIGMA Programme, 2, rue André-Pascal, 75775 Paris Cedex 16, France. Fax: (33.1) 45.24.13.00. E-mail: sigma.contact@oecd.org. Web site: http://www.oecd.org/puma/sigmaweb.

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FOREWORD

This book fills an important gap in the literature on public expenditure management both in terms of its depth and breadth of coverage and its specific orientation towards the needs of countries in transition, especially in Central and Eastern Europe. Even after ten years of transition, many fundamental reforms remain to be completed in these countries, and past reforms are being rethought. The hurdles facing countries in transition that strive to achieve an acceptable standard of performance in budgeting, accounting and auditing become ever higher, as OECD countries modernise their own systems, building on one another’s experience and good practices, and as new international standards are developed. We hope that this book will be useful as a basic reference text for policy-makers and budget practitioners, or as part of training programmes or distance learning courses.

The book covers all aspects of public expenditure management from the preparation of the budget to the execution, control and audit stages. It is intended to be a practical, operational guide to help countries that are designing and implementing new laws and procedures relating to public expenditure management, and to improve the transparency of budgetary procedures and information. Beyond its immediate target audience in Central and Eastern Europe, we believe that the book will be of interest to developing countries and countries in transition - and developed countries also - in all parts of the world. Good budgeting systems rest on certain classic principles and practices of administration, wherever these systems are to be found.

Background

In April 1998, SIGMA and the Asian Development Bank (ADB) agreed to co-operate in the preparation and publication of a reference book on public expenditure management that was to address particular problems of developing countries and countries in transition. Two versions of the book were to be prepared: one for countries in South East Asia and another for countries in Central and Eastern Europe, particularly those participating in the SIGMA Programme.

The two books include a significant amount of common material because they deal with the basics of a budget system. However, there are also substantial differences between Asia and Central and Eastern Europe. The background of central and eastern European countries is that of the distinctive Soviet institutions and culture overlaid, in many cases, with elements of the systems of public administration and budgeting drawn from Western Europe, especially France, Germany, Austria and, in the case of the Baltic States, the Scandinavian countries.

Moreover, most countries in Central and Eastern Europe are candidates for membership of the European Union and are likely to become Member States from 2002 or 2003 and onwards. Ministries of finance, government control offices, supreme audit institutions, national statistics offices and other budgetary/financial institutions in these countries are already heavily engaged in adapting their systems and procedures to the requirements of EU membership; adopting the body of European legislation, the
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acquis communautaire, where this is necessary; and bringing procedures of budgeting, financial control and audit into line with western standards. Practices and procedures used in Members States are particularly important “models” in this respect.

ADB and the OECD, as copyright holder of SIGMA publications, signed an agreement enabling the two organisations to use and adapt each other’s material freely in preparing the two versions of the book. Work on preparing the Asian version, Managing Government Expenditure, started in summer 1998 and the book was published in April 1999 (Schiavo-Campo and Tommasi, 1999). SIGMA and the OECD’s Public Management Service (PUMA) contributed material to that book and participated in a technical workshop in November 1998 organised to review a preliminary draft of the book.

Work by SIGMA on adapting ADB’s Managing Government Expenditure to the European context started in summer 1999. Daniel Tommasi, co-author of the ADB book, was hired as a principal editor/author in order to provide the required continuity. This involved both commissioning entirely new materials (e.g. on the EU budget and procedures for managing and controlling EU pre-accession funds), expanding existing material in certain areas (e.g. financial control and audit) and rewriting case studies and examples to give them a European flavour. The structure of the book has also been redesigned, some annexes added and others removed, the glossary completed and an index inserted.

How to use this book

Many advisers can be found in consulting firms or donor organisations (multilateral or bilateral) around the world who advocate an approach based on the importation of “best practice” techniques into the repertoire of countries engaged in designing new approaches to budgeting or public administration more widely. However, such an approach rarely works in practice. There are a number of reasons for this: the presence of both “formal” and “informal” rules that affect the behaviour of public servants; and the wider economic and cultural factors that determine these informal rules of behaviour.

In many developing and transition countries (and in developed countries also), these informal rules are dominant. As a result, public administration systems are slow to change. There is little advantage, for example, in introducing swathes of new rules and regulations if compliance is poor. Similarly, it is difficult to change a system from an internally controlled culture to an externally controlled culture, or vice versa. Nevertheless, change can occur in the right circumstances and environment, with the right champions, and with the right internal and external incentives. Change needs to “fit” with the environment of economic and cultural behaviour, and the informal rules. This, in broad terms, is the approach to public administration reform that SIGMA has been pursuing since the programme began.

This book as a whole is designed primarily for technicians and practitioners working, for example, in the budget department of the ministry of finance or a line ministry, or the budget committee of parliament, or in a supreme audit institution or government control office, or the technical services of the European Commission. It is not necessarily intended to be read as a whole but used whenever there is a specific need to review the operation of a particular part of the budgetary “machine”, e.g. the medium-term budget framework, the treasury system, the accounting conventions, internal (management) control systems, etc.

Readers who wish to obtain a rapid overview of the main issues involved are encouraged to read the Executive Summary, the introductory chapter, the four summary end-parts, the questionnaire in Annex I and the glossary. Then, if desired, they can delve into the detailed treatment, chapter by chapter. Such readers
could include senior officials in the prime minister’s office or university professors or journalists with an interest, general or specific, in fiscal policy, budgetary issues or European integration.

This book is published on the responsibility of the Secretary-General of the OECD.

Acknowledgements

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So far as this book is concerned, I would like to express special thanks in particular to Bob Bonwitt, Head of the SIGMA Programme, for supporting this idea and work, and inspiring and helping in numerous ways; and to my co-editor, and the author of several chapters, Daniel Tommasi. Special thanks are also due to the authors of new or extensively revised chapters of the book, in particular Chapters 3, 10, and 14, and Annexes I, II and III: Benoit Chevauchez, Alan Pratley, Harry Havens, Bettina Rafaelsen and Larry O’Toole; and my SIGMA colleagues, especially Brian Finn, Kjell Larsson, Stephen MacLeod, Johannes Stenbaek-Madsen and Nick Treen.

Other experts and colleagues who made substantial contributions to the book include Jean-Pierre Baché, David Darby, Rolf Eidem, Jan Kinst, Alain Morisset, Michael Spackman, Harry Wilkinson, and Eduardo Zapico-Goñi. The book has also benefited from interactions, too numerous to mention, between SIGMA and our colleagues and partners in the budget offices, control offices and supreme audit institutions of the countries with whom we are privileged to work; and with officials in the European Commission, IMF, OECD, US Treasury Department, World Bank and other organisations working in similar enterprises and activities.

Last, but not least, I am indebted to Belinda Hopkinson for piloting the book through all its final editorial stages; to Halima Benlatrèche for her bibliographic work; to Gilles Plante for advice on the index; to Catherine Candea and Véronique Chamarit of the OECD Public Affairs and Communications Directorate for their support; to Vif-Arget for preparing the book in camera ready form; and to my assistant, Michelle Gillespie, who bore the brunt of the administration and typing of the project.

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Richard Allen
SIGMA, Paris
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LIST OF ABBREVIATIONS

ABC  activity-based costing
ADB  Asian Development Bank
BOT  build, operate and transfer
CBA  cost-benefit analysis
CEEC central and eastern European country
CIS  Commonwealth of Independent States
COFOG Classification of Functions of the Government
COREPER Committee of Permanent Representatives
DG  Directorate-General (European Commission)
EAGGF European Agricultural Guidance and Guarantee Fund
EBF  extrabudgetary fund
EBRD European Bank for Reconstruction and Development
EC  European Commission or European Community or European Council (depending on context)
ECA  European Court of Auditors
ECOFIN Economic and Financial Council
ECSC European Coal and Steel Community
EEC European Economic Community
EIB European Investment Bank
EMU Economic and Monetary Union
ERDF European Regional Development Fund
ESA European System of Accounts
ESF European Social Fund
ETF European Training Foundation
EU European Union
EUROSAI European Organisation of Supreme Audit Institutions
EUROSTAT European Community Statistical Office
FMIS Financial Management Information Systems
FSU Former Soviet Union
GAAP generally accepted accounting principles
GDP  gross domestic product
GFS Government Finance Statistics
GNP  gross national product
GPA Government Procurement Agreement
IASC International Accounting Standards Committee
IBRD International Bank for Reconstruction and Development
IFAC International Federation of Accountants
IFC International Finance Corporation
IIA Institute of Internal Auditors
IFI international financial institution
ILO  International Labour Organization
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IMF  International Monetary Fund
INTOSAI  International Organisation of Supreme Audit Institutions
IRR  internal rate of return
ISPA  Instrument for Structural Policies for Pre-Accession
MTBF  medium-term budget framework
MTEF  medium-term expenditure framework
MTFF  medium-term fiscal/financial framework
NPV  net present value
OBL  organic budget law
OECD  Organisation for Economic Co-operation and Development
OLAF  European Anti-Fraud Office
PEM  public expenditure management
Phare  Poland and Hungary Assistance to the Reconstruction of the Economy
(European Commission)
PIFCS  Public Internal Financial Control Systems
PIP  Public Investment Programme
PPBS  planning, programming, budgeting system
PPO  public procurement office/organisation
PUMA  OECD Public Management Service
R&D  research and development
SAI  supreme audit institution
SAPARD  Special Accession Programme for Agriculture and Rural Development
SIGMA  Support for Improvement in Governance and Management
in Central and Eastern European Countries (European Union and OECD)
SNA  Systems of National Accounts
TACIS  Technical Assistance to the Commonwealth of Independent States
(European Commission)
TSA  treasury single account
UCLAF  European Commission’s Co-ordination of Fraud Prevention Task Force
UN  United Nations
UNCITRAL  United Nations Commission on International Trade Law
UNDP  United Nations Development Programme
USAID  United States Agency for International Development
VAT  value added tax
WTO  World Trade Organization
ZBB  zero-based budgeting
EXECUTIVE SUMMARY

The national budget is the single most important policy vehicle for giving effect to a country’s economic and social priorities within the scarce resources that are available to government for public expenditure. It is through the budget process that competing policy objectives are reconciled and implemented in concrete terms.

This book provides a comprehensive and in-depth analysis of all aspects of public expenditure management from the preparation of the budget to the execution, control and audit stages. It is intended to be a practical, operational guide that will assist countries in designing and implementing new laws and procedures in this field, and in improving the transparency of budgetary procedures and information. The book will be of general interest but is focused particularly on the requirements of countries in transition, especially those in Central and Eastern Europe that have the objective of being members of the European Union. These countries, like many others around the world, are modernising their budget systems and procedures in line with international standards.

This book is organised into four parts; at the end of each part is a summary containing key points and directions for reform.

The opening chapter is an Introduction. It summarises the three core objectives of PEM systems: fiscal sustainability, efficient resource allocation and operational efficiency. Transparency is another key objective, pushed into recent prominence by the IMF’s Code of Good Practices on Fiscal Transparency. The chapter emphasises the importance of the historic legacy of the former communist regimes in central and eastern European countries which still acts as a constraint on reforming PEM procedures and strengthening the institutional role of the ministry of finance. This chapter then sets out a “baseline” of criteria against which countries can assess the extent to which their PEM systems meet international standards, including (where appropriate) the specific requirements of EU membership.

The opening chapter ends with a section that describes the methods that transition countries might consider using in order to manage the change process effectively. Effective communications, co-operation and co-ordination of activities are essential to successful reform of PEM systems, as they are in other areas of public administration. Building commitment to reform within the ministry of finance and other ministries and organisations directly affected by change is of key importance.

Part I covers the budget and the institutional context.

Chapter 1 reviews the basic concepts and definitions of the budget, the need to have the broadest possible coverage in order to achieve the three core objectives, and the use of special arrangements such as extra-budgetary funds and off-budget expenditures. The chapter also analyses other forms of government activity with a fiscal impact such as quasi-fiscal activities, government liabilities and contingent liabilities, loan guarantees and tax expenditures.
Chapter 2 describes the importance of having a sound legislative base for the budget through the constitution and an “organic budget law”. These should provide a balanced division of responsibilities between the main actors in the budget process — the executive and the parliament — and, within the executive, between the council of ministers, the ministry of finance, and the line ministries and other spending units. The chapter lays out the main elements that should be found in an organic budget law. It also reviews the distribution of fiscal responsibilities between central and subnational (state and local) government entities — the “fiscal federalism” issue.

Chapter 3 describes the key features of the EU budget, the main elements of expenditure and revenue, the role of the Commission, Council of Ministers and European Parliament, and the procedures followed in preparing the annual budget and executing the budget. The chapter also reviews the implications of the EU budget for the national budgets and fiscal policies of Member States and candidate countries. The Stability Pact, and the access of candidate countries to pre-accession funds, imposes requirements on these countries to tighten up budgetary discipline, bring their national accounts and public finance statistics into line with European standards, establish multi-annual budgetary frameworks and introduce rigorous monitoring, control and reporting procedures.

Part II deals with issues relating to the allocation of resources, policy formulation and budget programming.

Chapter 4 describes the presentation of expenditure information in the budget and the importance of efficient, modern systems of budget classification by function (COFOG), economic classification (GFS) and administrative units. The chapter also reviews the strengths and limitations of techniques of performance and programme budgeting.

Chapter 5 describes the main steps and procedures used in preparing the budget. This starts with the government setting the macroeconomic and fiscal policy framework, including key fiscal targets and objectives for the medium-term. The chapter reviews different approaches to setting the budget, e.g. top-down and bottom-up; the important role of the ministry of finance in defining the main assumptions and parameters for the budget through guidelines and circulars; the budget timetable; the negotiation process; and the distribution of responsibilities in annual budget preparation.

Chapter 6 explains the medium-term budget framework (MTBF) and the main issues arising in this field — setting the policy basis, planning new policies and programmes and linking annual budgeting and multi-year budgeting. The chapter also reviews the relationship between capital investment programming and the MTBF, the role of the public investment programme (PIP) and the need for an integrated approach between budgeting for operational and capital expenditures.

Part III covers budget execution and its management, including internal (management) control and internal audit.

Chapter 7 describes the broad objectives of budget execution and the main issues arising. These include a clear working definition of the commitment and verification stages, operational rules for the release of funds, compliance controls and special issues relating to multi-year commitments. The chapter also discusses budget appropriation management rules (e.g. transfers between budget items), issues of overspending and underspending, and the monitoring of budget execution.

Chapter 8 reviews three important areas of budget execution: managing payables and arrears, budgeting and control of personnel costs, and managing the procurement process. All these areas are potential
sources of misuse and mismanagement of public funds where stronger management from the centre of
government is required. In the European context, Member States are required to bring their national laws
and procedures into line with the EC Procurement Directives and wider Treaty obligations. This chapter
also includes a discussion of the advantages and disadvantages of contracting out the delivery of public
services to private sector suppliers.

Chapter 9 reviews the cash management and treasury function. The basic objective is to centralise
cash balances within a single treasury account so as to minimise costs and increase the efficiency of payments
and revenue collection. Efficient financial planning and forecasting techniques are required. The chapter
also reviews issues related to the management of public debt and government assets.

Chapter 10 concerns the implementation of effective internal (management) control and internal
audit procedures. These are essential if the risks of mismanagement or misuse of public funds, fraud and
error or unsatisfactory accounting records are to be minimised. There are two main “models” of internal
(management) control: one is characterised by a centralised approach (e.g. controls carried out by officials
designated by the ministry of finance) and the other by a decentralised approach. This chapter also
includes a section on the financial management of EU funds in candidate countries, through the so-
called National Fund system, where specific EC regulations apply.

Part IV deals with issues relating to accounting, financial reporting, information systems, audit,
performance measurement and evaluation.

Chapter 11 describes the accounting frameworks that lie at the heart of a good budgeting system. The
advantages and disadvantages of cash accounting and accrual accounting, and variants of these two
approaches, are presented. In general, the book argues that transition countries should focus on the
requirement of achieving an effective cash accounting system before moving to an accrual basis. This chapter
also discusses special issues relating to accrual budgeting, generational accounting, cost measurement
and capital charging.

Chapter 12 reviews issues related to preparing reports on the execution of the budget and the scope
and coverage of financial reporting within government, including reporting on projects and programmes
financed from external sources such as EU pre-accession aid. Proper external scrutiny of these reports,
through parliament and the external audit process, is essential.

Chapter 13 describes the architecture of integrated information systems for government financial
management. This includes systems related to budget preparation and execution, debt management, cash
planning, payment implementation, revenue collection and accounting and reporting.

Chapter 14 concerns the external audit function. Different types of audit are characterised (ex ante,
ex post, compliance, attestation, performance) and pre-requisites for effective auditing (independence,
audit coverage, professional skills) are defined. The chapter also reviews the reporting of external audit
results and the limitations of the audit process.

Chapter 15 describes the performance measurement and programme evaluation process. Performance
measurement requires careful design and implementation. It is a resource-intensive activity and, if not
used carefully, the costs can outweigh the benefits. Programme evaluation techniques can also be useful
but have similar limitations, especially in transition countries.

The book includes four annexes:
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- **Annex I** is a questionnaire designed for countries engaged in PEM reform in order to assess the strengths and weaknesses of their systems in areas such as budget preparation, cash management or internal audit, and to measure improvements in these systems over time. It also allows countries to compare their performance with those of other countries.

- **Annex II** is a checklist of the main issues relevant to the establishment of an effective system for managing EU funds through the so-called National Fund.

- **Annex III** is a list of the main EC regulations concerning budget, financial control and audit.

- **Annex IV** reproduces the IMF’s *Code of Good Practices on Fiscal Transparency*.

A list of abbreviations, a glossary, a bibliography, a short list of selected Internet sites, and an index complete the book.
INTRODUCTION —
REFORMING PUBLIC EXPENDITURE: AN OVERVIEW

A. Definitions, Goals and Objectives

1. The meaning and role of public expenditure management

In order to perform the roles assigned to it by its people, the government needs, among other things, to: (i) collect resources from the economy, in a sufficient and appropriate manner; and (ii) allocate and use those resources responsively, efficiently and effectively. The national budget is the main instrument through which these transactions are planned and carried out. Public expenditure management (PEM) pertains only to item (ii). It is thus only one instrument, albeit a key instrument, of government policy. Hence, although this book focuses on PEM, readers are advised to always keep in mind the integral relationship between revenue and expenditure — i.e. between the money collected directly or indirectly from the people, and the use of that money in a manner that reflects most closely the people’s preferences. Also, close co-operation between tax and budget officials is essential for areas such as macroeconomic and budgetary analysis and forecasting, and the analysis of policy trade-offs between proposals for increasing public expenditure or reducing taxation.

Public expenditure management is instrumental in nature. There is a necessary distinction between the expenditure policy question of “what” is to be done, and the expenditure management question of “how” it is to be done. It is true that attempts to set over rigid boundaries between policy and implementation tend to lead eventually to unrealistic policies, ad hoc implementation and, over time, both bad policy and bad implementation. However, the distinction between the soundness of PEM procedures and processes and the goals that they are meant to achieve remains very important. Among other things, the mechanisms, techniques, skills, and data required for good PEM are different from those needed to formulate good policy. Accordingly, the analysis and discussion herein is generally applicable regardless of the strategic priorities and policy choices of the government in question.

2. The objectives of public expenditure management

a. Three basic objectives

It is generally accepted that all budget systems need to achieve the following three basic objectives:

• To maintain aggregate fiscal discipline. Fiscal discipline pertains to effective control of the budget totals, by setting ceilings on expenditure that are binding both at the aggregate level and on individual spending entities. An effective budget system is one that has disciplined (in contrast to accommodating) totals. Control of the totals is the first purpose of every budget system. There would be no need for budgeting if the totals were permitted to float upward to satisfy all demands.
These three objectives are complementary and interdependent. Without fiscal discipline, it is impossible to achieve effective prioritisation and implementation of policy priorities and programmes. Improving the internal management systems to achieve efficiency without a hard constraint is not credible. But mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. If a top-down expenditure limit is imposed in isolation and without any attention to the internal workings of the public expenditure system, the outcome may well be to underfund many worthwhile activities and distort policy priorities. Difficult situations that require special measures to ensure fiscal...
discipline call for increased allocative and technical efficiency, not for arbitrary cuts across-the-board. None of these three basic objectives should be pursued in isolation from the others.

When reforming a budget system, the three basic objectives of PEM provide a framework to assess progress in improving performance of the budget system. The optimal mix of measures that is required in order to make progress according to these three basic objectives depends on the country context. Improvements in one or another area can and should go forward as and when circumstances permit. But a coherent vision of the entire reform process is needed to prevent “progress” against any one objective from getting so far out of line as to compromise progress against the other two objectives.

b. Implications for budget processes

Schematically, the main links between the three basic objectives of PEM and budget processes are as follows (see Figure 0.1):

- **Aggregate fiscal discipline** requires overall expenditure control, with expenditure estimates based on realistic revenue forecasts, and the capacity to set up fiscal targets and enforce them. As discussed in Part II of this book, the preparation of a macroeconomic and fiscal framework must be the starting point of budget formulation. To achieve aggregate fiscal discipline, the role of the ministry of finance is crucial.

- **Allocative efficiency** operates at different levels within the government. The allocation of resources among “strategic areas” and/or line ministries entails appropriate arrangements at ministerial level, and between ministries, to formulate policies and decide on sectoral financial envelopes. The allocation of resources among programmes, projects, and activities within these strategic areas requires both appropriate arrangements within line ministries for sector policy formulation and adequate technical capacities within spending agencies to select the most cost-effective programmes, projects and activities.

- **Technical efficiency** mainly concerns the operational level, and is dependent on arrangements to implement programmes within spending units on the basis of efficient and effective management systems.

Operational performance in programme implementation and service delivery calls for both efficiency and effectiveness in use of resources. Effectiveness in service delivery is closely related to resource allocation decisions and allocative efficiency. But achieving improved efficiency and effectiveness at the operational level also depends on many factors not directly related to the budget system (e.g. the application of EC regulations, and, in the education sector, to policies relating to school curricula).

c. Political aspects

Aggregate fiscal discipline and the efficient allocation of resources are often impeded by the so-called “tragedy of the commons”. There are many claimants to the budget, e.g. interest groups, legislators, line ministries. Each has preferences over the manner in which the budget should be allocated. The sum of these individual preferences puts pressure on increased expenditures. The allocation of resources is the more challenging of the three key objectives because it is dominated by political factors. As Petrei (1998) puts it:

“Resource distribution among programs is perhaps the least technical part of the budget process. With the exception of investment projects, spending decisions are rarely based on technical principles or on detailed work to determine the population’s preference. The allocation of funds results from a series of
forces that converge at different points of the decision-making process, with an arbitrator who rules according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want.”

As discussed below, rules and procedures to discipline policy debates are required, but the political dimension of the budget system is inescapable. Strategic policy choices should be in the hands of decision-makers that are accountable to parliament and society.

This book focuses mainly on the technical aspects of PEM, but it must be kept in mind that success in reforming a budget system to improve fiscal discipline and allocative efficiency depends fundamentally on the political commitment to achieve these objectives.

3. Institutional arrangements

Colloquially, the term “institution” is used as a synonym for “organisation”. However, institutions are best understood as rules, and are thus distinct from the organisations that function under them (see, among others, North, 1990). To use a sports analogy, the game of football (soccer) is played better or worse depending on the players, but all players must adapt to the same rules; the “institution” of football does not change unless the basic rules are changed (e.g. by allowing the use of hands). Budgetary outcomes are profoundly influenced by institutions, which comprise both formal and informal rules.

Comprehensiveness of the budget is fundamental for both fiscal discipline and strategic prioritisation. As reviewed in Chapter 2, the legal framework must include the basic principles of integrity and universality of the budget.

Transparency and accountability mechanisms are needed to impose implicit costs and, when relevant, explicit sanctions on politicians and bureaucrats for violating budgetary rules. Accountability means that politicians and public officials (i) have to respond periodically to questions concerning their activities; and (ii) must be held responsible for the exercise of the authority provided to them. Accountability is essential but does not become operational until one defines accountability “of whom”, “for what”, and “to whom”. Accountability requires clarity in the definition of responsibilities. Being held responsible should lead to consequences that can include rewards or sanctions, as in the case of misuses of public funds. But accountability can also be considered part of a learning-by-doing process that does not necessarily call for rewards or sanctions.

Accountability is required for a variety of areas from policy commitments made by politicians to operational activities. There are various forms of accountability: some are “internal” to the executive branch of government, others affect the relationship between the executive and the other branches of government, or the external world. Accountability to parliament is essential, and one of the basic conditions for sound budgeting. It should be supplemented by accountability to citizens, notably through making public policy commitments and publishing reports on government activities and results achieved. With the development of information and communication technology (ICT), external accountability through feedback from service users and citizens will be obtained at low cost and for a great variety of government activities. Internal accountability contributes to increased efficiency in the implementation of government policies and programmes, but managers and staff can be held responsible only for the exercise of the authority provided to them. However, officials are not always responsible for failures of such policies. Without predictability and clear lines of responsibility, results-oriented management systems can result in civil servants being made scapegoats for the failures of their political masters.
Transparency underpins accountability. Fiscal and financial information, made available on a full, regular and timely basis, is an important ingredient of an informed executive, legislature, and public. Competent legislative staff and independent public media are essential to processing and disseminating this information. It is important not only that such information be provided, but that it be in a relevant and understandable form. In 1998, the IMF assembled a Code of Good Practices on Fiscal Transparency (see Box 0.1 and Annex IV) that emphasises the importance of clear fiscal roles and responsibilities; public availability of information; open processes of budget preparation, execution, and reporting; and independent reviews and assurance of the integrity of fiscal forecasts, information and accounts. This Code identifies good practices that constitute a minimum standard that should be implemented by all transition countries.

Predictability is important for operational performance. Lack of predictability of financial resources undermines strategic prioritisation and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for poor performance). Predictability of government expenditure in the aggregate and in the various sectors also provides important signals to the private sector in making its own production, marketing and investment decisions. However, assuring predictability does not mean making unconsidered promises, which would weaken fiscal discipline. Predictability is a relative notion, the challenging task being to deal with uncertainty in the most suitable manner, taking into account a country’s economic and fiscal context.

In general, flexibility in decision-making is important in order to achieve efficient and effective operational performance. At the policy level, ministers should be given authority to make decisions relating to their particular sector, provided that they fit the strategic policy objectives of the government. Similarly, at the operational level, managers should have authority to take decisions with their defined area of competence. However, such flexibilities need to be balanced by appropriate rules and standards of conduct, proper arrangements for accountability, and control mechanisms.

Appropriate participation by concerned public officials and employees and by other stakeholders is required for the sound formulation of expenditure programmes; participation by external entities, for the monitoring of operational efficiency; and feedback by users of public services, for the monitoring of access to and quality of the services provided. However, it is evidently impossible to provide for participation

**Box 0.1. MAIN REQUIREMENTS FOR FISCAL TRANSPARENCY**

**Clarity of Roles and Responsibilities**

- A budget law or administrative framework, covering budgetary as well as extra-budgetary activities and specifying fiscal management responsibilities should be in place.

- Taxation should be under the authority of law and the administrative application of tax laws should be subject to procedural safeguards.

_(cont’d)_
**Box 0.1. MAIN REQUIREMENTS FOR FISCAL TRANSPARENCY (cont'd)**

**Public Availability of Information**

- Extra-budgetary activities should be covered in budget documents and accounting reports.
- Original and revised budget estimates for the two years preceding the budget should be included in budget documents.
- The level and composition of central government debt should be reported annually with a lag of no more than six months.

**Open Budget Preparation, Execution, and Reporting**

- A fiscal and economic outlook paper should be presented with the budget, including among other things, a statement of fiscal policy objectives and priorities, and the macroeconomic forecasts on which the budget is based.
- A statement of “fiscal risks” should be presented with the budget documents.
- All general government activities should be covered by the budget and accounts classification.
- The overall balance should be reported in budget documents, with an analytical table showing its derivation from budget estimates.
- A statement of accounting standards should be presented with the budget.
- Final central government accounts should reflect high standards, and should be audited by an independent external auditor.

**Independent Assurances of Integrity**

- Mechanisms should be in place to ensure that external audit findings are reported to the legislature and that remedial action is taken.
- Standards of external audit practice should be consistent with international standards.
- Working methods and assumptions used in producing macroeconomic forecasts should be made publicly available.

*Source: IMF (1999).*
4. Governance aspects

Beyond the three basic objectives, a sound system of public expenditure management needs to take into account the wider values and requirements of society. Accountability, transparency, predictability and participation are important instruments for sound budget management, but also have an intrinsic value, and are generally seen as the four pillars of good governance.

If budget managers do not comply with parliament’s authorisations, or if public funds are used for private purposes, it is doubtful whether either aggregate fiscal discipline or efficient resource allocation, or both, will be achieved. The requirements of compliance with parliament’s authorisations and accountability to parliament come essentially from the role assigned to the parliament in a democratic society. In modern societies, citizens expect probity from the people in charge of government activities. Due norms and processes are essential for enforcing the citizen’s rights, as well as for developing a client orientation in public service delivery.

Corruption, which is the misuse of public or private office for direct or indirect personal gain, poses moral and legal problems and is a major source of inefficiency in PEM. Certainly, one effective route to strengthening PEM is to reduce the opportunities for corruption and punish corruption when it occurs. The reverse is also true: a major way to curb corruption is to strengthen public expenditure management systems. Corruption in government is often identified with large procurement transactions and major public works projects (see, for example, Tanzi, 1993). Effective systems of procurement, internal (management) control and audit are required to limit opportunities for corruption. Often in transition countries, the traditional inspectorates focus on relatively minor irregularities, while the more serious cases of corruption are not investigated and remain unpunished. Such cases are often found in the “hidden” part of the annual budget (such as contingent liabilities, off-budget expenditures, and multi-year expenditure commitments). Moreover, the expenditure budget is not the only source of potential corruption. Weak systems of tax administration, debt management, customs administration, privatisation, etc., are equally prone to corrupt and fraudulent activities. Fiscal transparency and accountability, and appropriate audit systems, are essential to fighting corruption in all these areas.

5. Administrative and cultural context

There is no automatic relationship between a particular instrument or institutional arrangement and the budget outcomes. The relevance and effectiveness of institutional arrangements and budget management systems depend on the country context. Hence, any instrument for public expenditure management originating from another country must be carefully analysed in the light of the local context and rejected, adopted, or adapted as needed. There are, however, some basic principles that every budget system should enforce (such as comprehensiveness), and as argued by Schick (1999), when reforming a budget system, the priority actions should be aimed at getting the basics right first (see Box 0.2).

Particularly important for improving PEM is an evaluation of the country’s institutional framework. The rules of procedure are always more complex than what appears at first sight. Informal rules are equally as important as formal rules such as regulations, decrees and operating manuals issued by the government or by government agencies. If budget reforms are designed without taking key informal rules into account, they are likely to fail. Budget organisations can be restructured, recombined and created, and sophisticated instruments implemented, but no change in behaviour (and hence in budgetary outcomes) will result unless the basic rules, procedures, and incentives change as well. One way to improve the overall institutional...
B. Public Finance in the Command Society

As noted, public expenditure management is country specific and rooted within a country’s administration culture. To modernise the budget system in transition countries, it is important to understand the legacy of the command societies from which they originated.

1. The function of the budget

In command societies, the chief functions of the government were to organise overall planning and production of goods and services. In many of these countries, the most important document in terms of the creation of incomes and welfare was “the plan”. Although there were many functions to be carried out by means of state budget resources that derived directly from this plan — such as “social-cultural”,

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**Box 0.2. TEN BASIC PRINCIPLES OF BUDGETARY REFORM**

1. Foster an environment that supports and demands performance before introduction of performance or outcome budgeting.
2. Control inputs before seeking to control outputs.
3. Account for cash before accounting for accruals.
4. Establish external control before introducing internal controls.
5. Establish internal controls before introducing managerial accountability.
6. Operate a reliable accounting system before installing an integrated financial management system.
7. Budget for work to be done before budgeting for results to be achieved.
8. Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
9. Have effective financial auditing before moving to performance auditing.
10. Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

*Source: Schick (1999).*
“defence” and “administration” expenditures — the role of the budget was less important than that in market economies. For example, income distribution was essentially determined as part of the overall plan and little was left for the state budget to adjust.

It is not quite clear on what basis resource allocation decisions between categories such as production, investment, social payments and defence were taken in command societies. Such decisions seem to have been largely the result of the “directive power” of the party. The resource allocation system was founded neither on competitive voting nor on decentralised competition among state firms. Instead, it usually involved negotiations among political leaders to determine a state budget that would safeguard the perceived interests of the state and the political positions of the negotiators. Therefore, to a large extent, the real objectives of the state budget were to secure the political survival of the top leadership, provide political information of sorts, and give the surrounding world an impression that the national ideology worked.

2. The budget in the context of the plan

The organisational structure supporting the planning and budgeting activities in most command societies was a typically hierarchical structure, where all formal information travelled vertically. An enormous amount of information was handled through this structure, first as part of the planning process and second as part of the actual production process. There was a myriad of technical input-output interdependencies in the plan, which was vulnerable to unexpected real-life events. In order to ensure that budget executors complied fully with the requirements of the political leaders, the plan document was normally promulgated into law.

The role of the ministry of finance in the former command societies was chiefly to provide a source of finance both for physical production and social transfer flows, whose directions and volumes were decided elsewhere. The state budget proper was, of course, the responsibility of the ministry of finance, but this was not enough to raise that ministry’s hierarchical role above that of most of the line ministries. Compiling the state budget itself was a relatively minor job, compared with “monetising” the whole of the overall production plan. This “honourless” and enfeebled position of the ministry of finance meant that there was little if no incentive for innovative thinking among the leading staff.

The budget law was accompanied by a huge quantity of detailed administrative instructions that left little room for individual initiatives to change working methods or influence policy priorities. The interpretation of laws was a matter for the dominating party and its members, rather than for the courts. This is one of the features of the former command economies that is the most difficult to grasp. Everywhere in society there was a sort of secondary (if not primary) “judicial” system, whose chief impact (probably negative rather than positive for the development of national welfare) lay in blocking new initiatives that were perceived to be damaging to the party.

3. The budget process

The budget process was basically a negotiated procedure, in which the underlying “directive power” of the monopoly party determined the outcome of the negotiations at all levels.

In the Former Soviet Union, for example, starting at the level of the municipalities, requests in terms of physical resources and/or money were put forward by administrative bodies and production organisations to the regional capitals. Representatives of these municipality level interests went in large numbers to the regional capitals in order to defend their plan proposals against all competing proposals. A similar procedure then took place at the national level, when regional representatives presented their plans to the co-ordinators of the overall national plan, i.e. the Gosplan and the ministry of finance. The prospects for
any production unit in the coming year in large measure depended on the plan document handed down from above and the instructions contained therein about what should be produced and the resources required to put the plan into effect.

The objective of this process was to produce two plan documents: one containing the production plan of the whole country, the other, containing the state budget. After lengthy negotiations to achieve broad consistency across these plans, they were finalised in more detail before being presented towards the end of the year to the Supreme Soviet for formal recognition. Behind this process was a parallel political process through which the communist party made sure that the plan was in line with its political and social objectives by exerting its so-called “directive power”.

Audit, in the sense of an external, independent checking of the financial records of government organisations or production units in order to make statements on their veracity, was never practised systematically in the former command societies. Controls consisted largely of internal checking of whether all instructions had been followed in administrative decision-making and bookkeeping. Such checks were made under the auspices of a control and revision unit in the ministry of finance, and similar procedures were followed in the line ministries. This was more an inspection system than an internal audit system (in the western sense), since it had nothing to do with organisational development. In addition, in the Soviet Union, there were the so-called “people's control commissions”, whose members were called upon by the party to make investigations into alleged misuse of powers by persons, unsatisfactory bookkeeping, etc. However, these commissions were not skilled in audit work and seem to have had little impact on improving the functioning of the system.

C. Improving Public Expenditure Management in Transition Countries

1. The current context

Transition countries recognise the importance of effectively managing government expenditure and are undertaking many important reforms in this area. Nevertheless, they are still burdened, to an extent that varies from country to country, by their inheritance from the previous regimes.

In many transition countries, the tendency to impose decisions from the top, without adequate consultation and co-ordination, still creates inefficiencies in policy development and implementation. Moreover, the distribution of budgetary responsibilities between the ministry of finance and line ministries is often not clearly defined, and the ministry of finance remains insufficiently empowered to ensure adequate scrutiny of budget proposals. Budget fragmentation — e.g. through use of numerous extra-budgetary funds and separate capital and expenditure budgeting and programming procedures — reduces allocative efficiency. Little progress has been made to strengthen the policy-making function and create the necessary links with budgeting. Parliaments are inexperienced and are generally unable to perform their control tasks effectively. Accounting and reporting standards, and systems for financial control and audit, need to be developed further and brought into line with European Union requirements. The development of procurement law and systems is uneven.

Meeting the standards reached by EU Member States in PEM thus remains a challenging task for countries in the region that aspire to be members. In fact, the European Commission does not prescribe any particular model of public expenditure management on Member States. Indeed, there are few explicit requirements in this area except in the fields of aggregate fiscal discipline, the management of EU own resources and financial control. However, in countries of central and eastern Europe, the allocation and
efficient use of EU funds and the necessity for maintaining fiscal discipline call for undertaking PEM reforms in several major areas. These reforms should be aimed initially at implementing essential elements of good practice in budgeting systems and also meeting specific EU requirements for Member States.

With this objective in mind, we present below a set of “baseline” criteria that set out the essential requirements of a well-functioning public management system covering both EU funds and national resources provided through the budget. A strategy for implementing these baseline measures and bringing public expenditure management systems into line with western European standards, is discussed in Sections D and E below.

2. The baseline measures

a. Institutional framework

Clearly defined principles should be set out in a country’s constitution, the organic budget law and related laws. The regulatory framework should provide a sound balance between the legislative and the executive powers. Parliament must be enabled to properly scrutinise the budget, and debate and review fiscal policies. For good macroeconomic management and efficient allocation of resources, the budget should cover all revenues and expenditures. Extra-budgetary funds and sources of external finance (e.g. EU funds) should be integrated into the national budget.

b. Medium-term fiscal framework

Future EU Member States should be able to provide budgetary information within a medium-term framework, and set medium-term fiscal objectives. Once they become EU members, either within or outside the European Monetary Union, they will have to submit either stability or convergence programmes. Both programmes will have to specify the main elements of a medium-term fiscal framework that complies with certain methodological principles and standards (e.g. national accounts statistics should conform with SNA93 and ESA95).

c. Budget preparation process

There should be a well-defined and widely understood sequence of steps in the budget preparation process, allowing sufficient time for each step to be implemented efficiently. Procedures used for preparing the budget for operational and capital investment expenditures should be integrated. Hard budget constraints should be included. The draft budget should be presented to parliament in an appropriate format to allow parliament to scrutinise it properly. It should specify the government’s fiscal policy objectives, the macroeconomic framework, the budget policies and identifiable major fiscal risks. Budget information should be presented to the public in a clear and accessible form.

d. Budget execution and monitoring

The line ministries should enforce spending limits stipulated by parliament, and the ministry of finance should be able to supervise these limits. The ministry of finance should monitor and control the flow of expenditures during the year on the basis of a unified system of financial accounts. Systems for monitoring and controlling personnel expenditures should be as robust as for other areas of the budget. Line ministries should make regular reports to the ministry of finance that compare actual spending with monthly forecasts based on the budget appropriations. Parliament and the council of ministers should have appropriate responsibilities for reviewing periodic reports on financial performance relative to the budget.
and for revising targets and/or policies as required by changed economic or financial circumstances. The cash management (or treasury) function should be strictly managed through a treasury single account under the control of the ministry of finance.

e. Accounting and reporting

Budget and accounting categories at the national level should have a common system of classification that facilitates policy analysis and promotes accountability. Accounting concepts need to be made compatible with concepts related to the disbursements of EU funds (commitments, payments, eligible expenditures, etc.) and the definition of “deficit” and “government” aligned with the ESA95 standards. Fiscal reporting should be timely, comprehensive, reliable and identify deviations from the budget. Procedures for evaluating the efficiency and the effectiveness of expenditure policies and programmes, including those funded from EU sources, should be established.

f. Financial control

A coherent and comprehensive statutory base defining the systems, principles and functioning of management control, or internal control, is required. The following systems and procedures are essential for sound internal (management) control: (i) standards and regulations for financial reporting; (ii) a modern accounting system conforming with international standards; (iii) a defined audit trail, which for the management of EU funds should clearly define the roles and the responsibilities of the different national entities involved, including the National Fund, Paying Agencies and Implementing Agencies (as defined in EC regulations); (iv) ex ante controls of commitments and payments; (v) public procurement procedures that comply with EC regulations and are effectively implemented; and (vi) control of state revenues.

An efficient internal audit/inspectorate mechanism should be put in place. It should meet the following criteria: (i) be functionally independent; (ii) have an adequate audit mandate; and (iii) use internationally recognised auditing standards. Systems should be in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence.

g. Procurement systems

Achieving a properly functioning market is one of the priority tasks of the European Union. One of the key ways of achieving this goal, and other related and essential elements of good governance, is to have an efficient procurement system in which competition is encouraged for contracts awarded by public sector bodies. Sound procurement policies and practice can reduce costs of public expenditure; produce timely results; stimulate the development of the private sector; and reduce waste, delays, corruption and government inefficiency.

Measures to improve procurement procedures include: sound public procurement legislation; the establishment of a central public procurement organisation with overall responsibility for the design and implementation of public procurement policy and national training programmes; the development of the capacity of spending units in efficient procurement procedures; and the establishment of effective control and complaints review procedures.

h. Budget management of EU Funds

The European Commission expects that candidate countries for EU membership will prepare themselves for managing the pre-accession funds (Phare/ISPA/SAPARD) so that, when they join the EU, they have
the required budget and control instruments in place. In order to comply with this, governments should have the capacity to present multi-annual programmes involving careful co-ordination between partners at different levels of government, well-designed co-financing procedures and sound technical and economic appraisal of such programmes.

**D. Approaches to Managing Change**

Streamlining a public expenditure management system requires setting up a strategy for reform and managing the change properly. This section draws together the main messages and lessons of this book and presents some general and practical considerations for developing a strategy and managing the change process. The starting point of the preparation of a strategy for reform should be a comprehensive assessment of the strengths and weaknesses of the budget system currently in place. For this purpose a questionnaire to assess the strengths and weaknesses of a budget system is presented in Annex I.

**1. The approach to reforming budget systems**

a. *The need for a comprehensiveness*

A public expenditure management system includes a wide range of basic supporting services and subsystems, from macroeconomic forecasting to auditing and performance/policy evaluation. There are strong linkages between these subsystems. Failure of any one of them can have negative effects on the other subsystems and may undermine the effectiveness of the whole budget system. In order to target properly the reform measures and plan the phasing of their implementation, it is crucial to identify the causes of the main problems met in budget management. However, such an exercise is not straightforward. For example, what explains unrealistic revenue forecasts? Weak technical capacity in forecasting? External developments beyond the scope of the forecasters to predict? Or deliberate manipulation of revenue forecasts in order to delay hard choices on the expenditure side?

To undertake successful reform, it is necessary, first, to define what the objectives of the reform are; and, second, to undertake a comprehensive review of the budget system in order to determine the main weaknesses and the changes necessary to deal with these problems. Such a review should consist of diagnosing the problems, reviewing the different supporting systems and identifying all the interconnections and institutional weaknesses. A budget reform should generally include a set of complementary actions in several areas. Narrowly focused reforms are often disappointing. For example, it will be illusory to expect significant benefits from introducing programme budgeting or multi-year budgeting procedures if hard constraints are not built into the budget process. Furthermore, it is important to avoid a succession of “paper reforms” that consist of implementing one measure, then moving to the next item on the agenda, without assessing the results achieved and paying attention to the other elements of the budget system.

It is also necessary to achieve a proper mix of reform measures in order to meet the three basic objectives of budgeting — fiscal discipline, effective resource allocation and operational efficiency — in a balanced manner, taking into account the country’s context. For example, implementing a treasury system contributes to increase fiscal discipline and should be favourably considered in transition countries. However, the implementation of a treasury system should not exempt spending agencies from their accounting obligations and should not impede the efficient management of government expenditure programmes. Incentives to strengthen accounting and management systems within line ministries should therefore generally accompany the implementation of a new treasury system. Moreover, improvements in the procedures for budget preparation should go hand in hand with measures to manage cash transactions more effectively.
Linkages between the public expenditure management system and other systems, such as political and managerial systems, must be taken into account. For example, to reinforce expenditure control at the spending agency level, improvements in public procurement and human resources management systems are as important as reforms of the budgetary procedures themselves. Improving budget preparation processes and the information systems that are necessary for informal decision-making is generally required. Nevertheless, it must be kept in mind that policy choice is essentially political, and strengthening decision-making requires recognition of the multitude of factors that bear on these decisions. It is, therefore, also important to address issues such as those related to governmental co-ordination mechanisms, the relationships between the executive and the legislature, and the capacity of the legislature to scrutinise the budget.

b. Institutions and organisations

Improving public expenditure management requires both institutional (regulatory and procedural) reform and organisational development. Improvements in the budget system are largely a function of institutional change, in the contemporary sense of the basic rules that govern the behaviour of organisations and individuals. The distinction between “institution” and “organisation”—and the interplay between the two—is key to understanding the challenge of improving the management of public expenditure in transition countries. Budgeting organisations can be improved but economic, social and political behaviour will not change unless the rules and procedures change as well. However, the reverse is also: rule modification by itself is unlikely to produce beneficial results unless organisational improvements proceed in parallel. Improving public expenditure management requires both institutional reform and organisational development.

In many transition countries, the legal framework needs to be streamlined and rules to enforce it need to be established. Processes for budget preparation and execution need to be regulated. However, understanding of a country’s culture of “informal rules” – namely those unstated rules that define how people, including politicians and government officials, actually behave — is essential in order to design reform measures, enhance formal rules and make them effective. Thus, a country may have an exemplary set of formal rules, but these are meaningless if they cannot be enforced because of the more powerful informal rules. Comparing systematically what actually happens with what should happen according to the formal rules helps to reveal the informal rules. Many informal rules have perverse effects on the budget system, such as those that lead to corruption and patronage. This requires carefully balancing flexibility and restraint, increasing transparency to make these rules more visible, and exercising extreme caution before considering results-oriented management techniques, since a system of performance-based incentives can easily be misused. On the other hand, some informal rules and processes can benefit the budget system (e.g. in a number of countries, the informal working of the network of civil servants can anticipate potential conflicts in budget preparation). Governments should make sure that such benefits are retained when designing a budget reform.

Fragmented organisational arrangements and weak interdepartmental co-ordination impede effective co-ordination of budgeting activities in a number of transition countries. As stressed in this book, the budget processes must be unified and the ministry of finance sufficiently empowered. The ministry of finance should be organised according to functional lines. The budget department should be fully responsible for the preparation of the budget, including: (i) the capital investment budget; and (ii) the review of sectoral budget submissions, which is in some transition countries is made by “branch departments” that are separate from the budget department itself. A department (or unit) for macroeconomic and fiscal forecasting should be established within the ministry of finance. In some countries, the distribution of responsibilities between the treasury department and the budget department needs to be clarified and co-ordination
between these two departments should be reinforced, notably for preparing the budget implementation plan and the cash plans. The debt management department, which is sometimes split into two distinct units, should be unified. A close co-ordination between the department responsible for debt management and the department responsible for preparing the budget implementation and cash plans is required. In most transition countries, co-ordination between the tax administration and the other departments responsible for preparing the annual tax forecasts, and updating them during budget execution, is weak and should be reinforced. Interministerial co-operation also needs strengthening, at the political and operational level, in many transition countries, e.g. between the ministry of finance, the ministry of economy, and the national statistics office.

c. Managing reforms within the government

Specific actions at the sectoral level are required to make effective the reforms established at the central level. For example, improving investment budgeting depends in a large part on the effectiveness of procedures to screen and select projects within the ministries and agencies concerned. Similarly, dealing with the problem of arrears generation requires an efficient internal (management) control within line ministries.

In many areas, the ministry of finance should prepare the general framework for reform and provide appropriate incentives and guidelines. However, the reform measures themselves must be defined and implemented by the line ministries. In reality, a two-pronged approach to reform may be necessary. This might involve parallel reforms at the central level, focusing on measures to improve fiscal discipline and the strategic allocation of resources, and reforms at the sector level, focusing on the allocation of resources within the sector and measures to improve internal (management) control and technical efficiency. The desirable degree of integration of these two parallel sets of actions depends on the nature of the actions, but conflicts between them must be avoided. For example, special programming instruments, such as the establishment of programme budgets, can be developed in some sectors, without requiring a government-wide exercise. Nevertheless, such sectoral exercises must comply with the overall budget ceilings that need to be established at the central level.

In many transition economies, the absence of systematic lines of interagency communication and the lack of incentives to share information result in fragmented policy formulation and atomised decision-making. This presents a major problem for the implementation of reforms. The challenge is how to improve communications and reduce the cost of information within the public sector. The guiding operational criterion for sustainable improvement in public expenditure management systems should therefore be to strengthen the linkages between the components of the overall budget formulation and execution systems, between ministries and agencies, and between central government and subnational entities. Even when supporting the reinforcement of a specific budgetary procedure, it is essential to encourage positive interaction with other government agencies. Such encouragement must not be limited to rhetoric, but should entail specific incentives for greater information exchange, training and co-operation. Special attention should be given to the linkages between the central government and the subnational governments. An increased degree of devolution requires improved circulation of information and increased awareness of fiscal problems at the level of subnational governmental authorities.

d. The pace of reform

Developing a comprehensive approach to budget reform does not necessarily mean adopting a “big bang” theory of reform or importing the model of more “advanced” countries in all its aspects. “Best practice” models are useful to draw up lessons from experience. But the concept of “best practice” is dangerous,
when it is misinterpreted as importing budgetary models without hard-nosed consideration of local realities—particularly the “informal rules” that determine much of the behaviour of officials and their private sector counterparts. Formal rules can be imported fairly easily, informal ones much less so. Replicating foreign institutional practices should be considered only when these practices have a high component of formal rules. This is the case, for example, in the more “technical” areas of public expenditure management, such as accounting procedures or financial control (though even in such areas caution is recommended). By contrast, when the nature of the reform entails a high component of informal rules, such as in “governance” areas or where institutional incentives are affected, the reforms will normally need to be homegrown or, if imported, will require substantial adaptation. There are, for example, many potential pitfalls in attempting to replicate in transition countries aspects of the so-called “New Public Management” approach recently adopted by some OECD countries (see, for example, Verheijen, 1996, and Allen, 1999).

Specific tools and budgetary techniques that can be effectively used in the context of one country can be mere fossils in another country. Substance is more important than form. Thus, many concepts of the “programmatic” approaches to budgeting, such as clarifying organisational or managerial objectives or obtaining better feedback from budget execution to budget preparation through evaluation, or performance monitoring, can be implemented gradually into a “traditional” budget system. It is more important to develop such concepts than to change the format of the budget.

It is sometimes debated, often by reference to some budgeting paradigm, whether a big-bang approach or a gradualist, but often piecemeal, approach should be adopted to reforming a budget system. There is an aura of unreality in this debate when it is posed in general terms. The pace of reform should be defined according to each country’s context and priorities, and depends on the objectives established for a given set of measures. In transition countries, and more particularly in countries that are candidates for EU membership, the pace of the budget reforms should be determined primarily by the following two concerns:

• Reforms must be aimed at getting the basics right and implementing the measures required to meet the minimum standards of developed countries. Strategic attention should therefore focus on implementing the baseline measures summarised earlier on in the chapter. In some areas, especially financial control and public procurement, these measures include specific requirements that are part of the acquis communautaire, i.e. the formal framework of EC rules and regulations. For this purpose, the questionnaire included in this book (Annex I) provides a valuable tool to assess the strengths and weaknesses of the public expenditure management system and determine in which areas priority actions should be undertaken.

• The reform process is continuous. Experience shows that budget reform is in a large part a process of learning by doing. Budget systems are adversely affected by factors such as political instability, entrenched private interests, structural imbalances between existing commitments and resources and severe inflation. The phasing of reforms and the definition of the priority areas for reform must take account of these realities. Moreover, the numerous interconnections between the budget system and other systems can result in unexpected outcomes when implementing reforms. A changing economic and political environment can require additional reform measures. During the reform process a systematic and regular assessment of the outcomes of the reform is needed in order to ensure that the reform programme is kept on track, making any adjustments that are necessary. When reforming a budget system, unexpected developments and potential roadblocks can arise, and how well the reform responds to change must be continuously tested.
2. Preparing and monitoring an action plan

Once the key reform measures have been identified, on the basis of the assessment of the budget system, a phased action plan can be prepared. This plan should include the following elements:

- The **overall goal** of the reform and the **specific objectives** of each of its component parts.

- A list of the **components** (e.g. streamlining the budget preparation process, preparing a new organic budget law, etc.).

- A list of **activities** for preparing and implementing the reforms (e.g. pilot studies, user surveys, training courses); the deadlines for completing these activities; and milestones for accomplishing key tasks.

- **Indicators** to monitor progress achieved.

- The **organisational arrangements** to prepare the reform and supervise its implementation.

- The **resources** that will be devoted to the reform in order to purchase the required inputs of technical assistance, equipment and computer software, training of staff, etc.

It is important to phase and articulate properly the different components of the reform. For example, before undertaking the detailed design of an information system for budget preparation and execution, it is generally necessary to review the budgetary procedures, the budget classification system and the chart of accounts.

The action plan should include appropriate indicators to assess progress against the reform objectives and provide feedback to correct or complete the reform process. These indicators should measure:

- **Progress achieved in the preparation and the implementation of the reform.** To manage the reform programme, it is necessary to monitor: (i) the inputs devoted to reform (e.g. staff hours, equipment acquired, training activities, consulting services, etc.); and (ii) the outputs of the reform process (e.g. laws drafted, laws adopted, circulars issued and effectively implemented, operational manuals drafted, training courses implemented).

- **Effectiveness of the reform.** This requires an evaluation of whether the reform has contributed to improved performance of the budget system on the basis of the three essential criteria (fiscal discipline, allocative efficiency, technical efficiency). To make such an evaluation, quantitative or qualitative measures of (i) the processes and the outputs of the budget system (e.g. production of the annual budget law in a timely manner), and (ii) its outcomes (e.g. a decreased budget deficit) need to be established.

Setting up outcome indicators for measuring the performance of a budget system is a difficult issue since the interconnections between the budget system, other systems and changes in the economic environment pose an attribution problem. Nevertheless, it is important to make progress in this area for several reasons. First, to gain acceptance of the reforms from decision-makers, it is necessary to indicate what are the expected results. Second, as discussed earlier, the reform process is continuous. Perhaps poor outcomes will not necessarily mean that the reforms were badly designed, but they will provide nevertheless a powerful message: “reforms are not completed and additional measures must be taken to strengthen the budget system or in related areas”.

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The following are examples of indicators that can be used to assess the overall effectiveness of a budget system:

- **Fiscal discipline**: Are the deficit targets met? Are revenue forecasts realistic (what is the ratio revenue collected/revenue forecast)? Is there a reduction in overcommitments? Is there a reduction in the stock of arrears?

- **Allocative efficiency**: Does the actual composition of the budget match policy objectives? What is the degree of correspondence between planned and actual composition of expenditures by sector? Does the investment programme focus on the most cost-effective projects or are funds still inefficiently distributed among a variety of uncompleted projects? What is the average time to complete projects included in the budget? What are the total costs of the annual tranche of these projects compared to the balance of expenditure necessary to complete work on the projects?

- **Technical efficiency**: Has the efficiency of the tax administration improved (e.g. a diminished volume of tax arrears, an increased ratio of tax receipts to GDP, after netting out the impact of any new tax measures)? Did measures to strengthen cash management contribute to diminished borrowing costs? Are procurement tendering procedures sufficiently competitive?

Such indicators provide useful feedback, where necessary, to amend and adapt the reform process to unexpected developments. However, it is important not to put too much weight on favourable developments in few indicators. Such developments may, in reality, be attributable to factors external to the reform itself, and the improvements may not be sustained.

**E. Managing the Reform Process**

1. **Building a commitment to reform**

   The reform will succeed only if it has a champion or champions within the government. Financial reforms need unflagging commitment and strong leadership from the minister of finance. The top management of the ministry of finance should actively participate in the reform process. Reforms prepared outside this ministry, or by a reform committee or by consultants working in isolation, often attempt to copy so-called best practice solutions from another country or to focus on technical issues without considering the specific institutional character and culture of the country concerned.

   It is crucial to build up a consensus for reform among the different participants involved in public expenditure management. To design and implement the reforms, the ministry of finance should work in close co-operation with line ministries, subnational government authorities and other key players.

   Consultations with the legislature are very important, particularly when the reform will affect its activities or the legal framework. For example, the legislature must be involved at an early stage in the preparation of new budgeting laws. Parliament’s committees should be consulted about any substantial changes that are proposed in the format of the budgetary documents or of the financial reports communicated to parliament. Improving the presentation and content of budgetary documents should go in hand with measures to improve the capacity of parliament to analyse such material. For example, presenting accrual accounting information in the budgetary documents will be useful only if the parliament is fully aware of the meaning of the data provided and can find in the budgetary documents the information that it needs.
To reach a consensus for reform within the government, it is essential to clarify precisely the objectives assigned to the reform and the expected benefits. For this purpose, it may be useful to carry out some awareness-raising seminars with top managers of the government, members of parliament and subnational authorities on the problems that the reform intends to address and the expected benefits.

Disseminating the information on the proposed reform among the members of parliament and the public, and reaching a wide agreement on the reform, is also important to ensure its sustainability. The reform must be sustained after the main change agents give way to a second generation. This generally requires a period of at least five to ten years.

Rationalising organisational structures, modernising procedures and processes and/or implementing a new computerisation programme can easily be derailed if operational staff do not understand and support the change. Particular attention should be given to how to manage the process with a view to ensuring the necessary level of co-operation and participation. This requires the design of actions aimed at promoting change and communicating the changes to and through middle management, in order to gain acceptance and active co-operation from the civil service managers and operational staff.

Such actions, which might include workshops and wide dissemination of documents, should be aimed at:

• Making sure that senior officials within the government are fully informed about and supportive of aims and objectives of the proposed reform and the measures required to implement it; and are aware of the need for appropriate internal communications and the potential social impact of the changes.

• Creating a culture of “ownership” in the reform by ensuring that middle management levels participate in an appropriate way in the reform activities and that these managers explain the purpose of the reforms to their colleagues.

Reform should not be viewed as either a “one-off” event or an additional burden on managers and staff that must be imposed by necessity, but instead as a way to strengthen the civil service profession, both individually and collectively. It is important at each stage of the reform process to highlight information on progress made in an appropriate, widely circulated newsletter, to encourage feedback from all staff, and to make necessary adjustments to the reform activities.

When some departments are subject to organisational changes, as part of the proposed reform, it is desirable to:

• Designate the manager who will be in charge of proposing, promoting, co-ordinating and supporting colleagues in explaining the reforms, and providing information on developments and results.

• Organise a series of interactive seminars for middle managers on the objectives, content, phasing and consequences of the reform project.

• Organise a similar series of seminars for staff at the operational level who will be directly affected by the reforms.

• Announce at the same time measures that will be taken to cushion the impact of phasing out certain activities. Accompanying measures to promote the redeployment of staff to other activities, and staff retraining, should be devised in advance to minimise uncertainty.
Conduct a regular evaluation of staff attitudes to the reform.

2. Organisational arrangements

Organisational and human capacity is essential to administer the reform and enforce the new framework. Proper organisational arrangements should be made to manage the reform process. These arrangements need to be tailored to the country context and the scope of the intended reform. If a wide reform is intended, they should generally include the setting up of a steering group, a core unit and working groups, organised as follows:

- **Steering Group.** The steering group will provide general direction to the reform and overall supervision. It will consist of the top civil servants involved in the process and will normally be chaired by the minister of finance or a deputy minister. It will be important for effectiveness to include in this steering group the heads of the key departments of the ministry of finance and representatives of line ministries and other organisations participating in the reform (e.g. representatives of subnational governments). One of the aims of setting up a steering group is to ensure that the objectives of reform will be shared by high-ranking officials with a stake in the process.

- **"Core unit".** A core unit or a separately identifiable department should be made responsible for the overall management of the reform. This unit should be appropriately located, in principle within the ministry of finance. The core team needs to have a very clear vision regarding the goals and objectives that should be reached. It needs to be appropriately staffed with persons who are competent, motivated and efficient. It should be given the authority to spread new institutional and organisational practices thorough the government by organising training activities, seminars or workshops. This unit, assisted by the working groups, will be responsible for identifying external consultancy needs and preparing the terms of reference for these consulting assignments, which should include: (i) the objectives of the assignment; (ii) the activities of the consultant; (iii) the time frame for this work; (iv) the expected outputs; and (v) the arrangements under which the consultant makes regular reports to the project manager.

- **Working groups.** The working groups will be responsible for implementing specific reforms in particular area (e.g. a financial management information system). In many cases, formal arrangements will need to be put in place to manage these working groups, including: (i) project planning; (ii) accounting; and (iii) a system for progress monitoring and reporting.

3. Training

A training programme for each component of the reform is essential for successful implementation. Training activities should cover different fields, such as basic training in specialised areas (e.g. training accountants to use new accounting procedures); high-level training in specialised areas (e.g. training of information technology specialists or macroeconomists); or general training (e.g. teaching foreign languages to the staff of the debt management office, or improving skills in the use of spreadsheets and word processors).

To increase awareness of major issues in public expenditure management and facilitate the dialogue between the core ministries and line ministries, an economic and budgeting “culture” needs to be disseminated within the government. Thus, training of budget managers should not be limited to the dissemination of specific techniques and methods (e.g. how to complete the forms for budget preparation), but also be aimed at providing them with information on the context of modern budgeting systems and increasing their awareness of macroeconomic and EU financing issues.
To improve budget preparation it is necessary to increase capacity within the ministry of finance and spending agencies to define clearly the objectives of public expenditure and make informal choices among competitive programmes. Developing such capacity involves both improving analytical methods and discussing sectoral policy issues. This generally requires incorporating into training activities some “learning by doing” activities, such as undertaking a sectoral review with an external team of specialist consultants.

The training programmes must be prepared in advance and require a detailed review of existing skills and training needs. Training needs in the field of public expenditure management are diverse, and the major line ministries should have their own capacity for undertaking or commissioning training. The ministry of finance should ensure that these activities fit the common framework dictated by budgetary laws and procedures. For this purpose, the trainers should be well informed of the existing system, and the intended reforms, and should co-ordinate their activities with the unit responsible for overall management of the reforms.
NOTES

1. Throughout the book we generally use the term “national budget” or simply “budget” to refer to the budget of the central government and the term “subnational budget” to refer to the budget of subnational authorities such as regions, counties or municipalities. The term “state budget” is used occasionally and refers to the budget systems and processes of the centrally planned societies – see for example Section B in this chapter.

2. In this book, the term “public expenditure management”, which is commonly used, covers the management of government expenditure, but not the activities of public enterprises, which are essentially commercial enterprises, nor the activities of financial institutions owned by the state. The book generally focuses on central government, but much of the analysis and recommendations apply also to other levels of government.

3. Adapted from the basic objectives proposed by Campos and Pradham (1996) and the presentation of the basic tasks given by Allen Schick in OECD (1997c). In relation to these basic objectives, the Public Expenditure Management Handbook of the World Bank (1998) develops the concept of three levels of budgetary outcomes: (1) aggregate fiscal discipline; (2) strategic prioritisation; and (3) efficiency and effectiveness of programme and service delivery.

4. “Spending unit” is used throughout this book and covers all entities that have the authority to spend money through the budget, e.g. line ministers, subordinated agencies, and other government organisations.


6. Subdivided, of course, into production plans at national (federal), regional (state) and local levels.


8. EU Member States use a common framework and methodology of national accounts (ESA95), which is a specification of the SNA93 standards in the European context.